

Digitization: DO or DIE!

Arthur D. Little EU5 Media Flow of Funds 2014



Content

Executive summary	3
Key figures	6
Introduction	7
1. The years of the double squeeze, 2007–2013: Financial crisis and digitization	8
2. Challenges and strategic imperatives for individual value chain steps	19
3. Highlights by Country	32
4. 15.1bn€ of online growth are expected until 2017: grab them!	42
Annex	46

Authors:



Clemens Schwaiger

Principal, Global Head Digital Media
schwaiger.clemens@adlittle.com



Javier Serra

Principal
Arthur D. Little Spain
serra.javier@adlittle.com

Acknowledgement for their support and valuable input: Carlos Abad, Martin Born, Elisabetta Cafforio, Damien De Vroey, Enrique Flores, Vikram Gupta, Eytan Koren, Tanneguy Laudren, Didier Levy, Francesco Sabatini, Richard Swinford, Karim Taga

Executive summary

Plotting the transformation

The media industry is going through a massive digital transformation. New online competitors and business models are challenging traditional media players. At the same time, through the digitization of the industry, consumers are gaining access to sheer endless opportunities to consume media.

This creates a complex and volatile environment for media companies and it is ever more important to understand how this transformation affects value flows. With this report, Arthur D. Little will provide insight into the speed and main beneficiaries of this transformation of the media industry.

The objective of this report is to enable:

- Media corporations to identify opportunities for vertical or horizontal integration, as well as to guide portfolio optimizations and go to market strategy
- Financial investors to identify the most attractive market segments and acquisition targets
- Policy makers to identify areas where excessive value capture is leading to economic imbalances during the transformation
- Academia to build on a strong base of data and a framework, which can be used to deepen research into the transformation of individual segments of the media industry

“Flow of Funds” Methodology

Arthur D. Little employed a unique methodology to study the recent evolution of the Media & Entertainment sector in Germany, France, Italy, Spain and the United Kingdom (“EU5”). The analysis comprises the period between 2007 and 2013, as well as a forecast until 2017, distinguishes the sources of funds and their destinations, as well as online from traditional consumption. In addition, more than 50 interviews were held with senior executives in the European media industry to gather their views on the main winners and losers of the transformation in their industry.

The years of the double squeeze, 2007 – 2013: Financial crisis and digitization

The financial crisis has significantly impacted the EU5 media markets. A key component of the industry’s revenue is advertising spend, a source of funds that is particularly sensitive to macro-economic effects. As a consequence, the financial crisis between 2008 and 2010 made its mark on the industry. In particular in Italy and Spain, a near collapse of traditional advertising markets during this period (-22.3% and -25.5%, from 2007 to 2013, respectively) has put major media players under severe pressure. In these countries, a number of players in the aggregation space have either faced consolidation through M&A or went out of business. In France, Germany, and the

United Kingdom, advertising revenues exhibited small growth (0.7% CAGR, 2007-2013) as growth in online revenues compensated for the decline in traditional media.

Besides the financial crisis, the traditional media players faced significant growth in consumers' digitization. The United Kingdom is clearly leading the EU5 markets in digitization, with the highest broadband penetration and proliferation of connected devices, which also explains the higher online revenue shares across all industry segments. All other EU5 countries have similar broadband penetration rates (high relative to the US), and ownership of connected devices such as smartphones, eReaders, smart TVs and tablets is widespread among EU5 consumers. Mobile is becoming an increasingly important digital channel and the high penetration of flat-rate data plans, which account for between 70-80 percent, means that access costs are no longer a limiting factor.

While digitization of consumers is high, they still only contribute a comparably small share of their overall spending to online media, 11.2 percent in 2013 in the EU5. This suggests significant upside potential for the media industry, once consumer spending catches up to their demand patterns. This should be an urgent call for action to traditional players, in particular those in distribution and retail, that are yet to face the effects of the industry's digital transformation.

On the other hand, advertising revenues have already shifted considerably to online media (39 percent in 2013 in EU5), due to its increased importance. Unsurprisingly, this trend is expected to continue, however going forward the speed of transformation from traditional to online advertising will decrease, which should be good news for some traditional media players, in particular those in aggregation. Furthermore, as the macro-economic outlook improves, overall advertising revenues will increase again, further alleviating pressure on aggregators.

For all companies active in the media industry the need to embrace online media and to transition existing business models is more important than ever.

Besides consumer spending and advertising, public funding has played an important role in the transformation of the industry. This source of funds, which was predominately targeted at traditional media such as TV and radio broadcasting and filmed entertainment, limited the effects of the value shift in the industry. However, to be effective, these public interventions need to be sufficient in size to alleviate the negative effects of the transformation, while not distorting competition. Policy makers, specifically in France, Germany and Italy, should reconsider their current interventions; in France and Germany, they are potentially distorting competition, and in Italy, public spending has not kept pace with the challenges faced by traditional media players.

Challenges and strategic imperatives for individual value chain steps

Common sense suggests that physical media retailing, printed press, and radio and music has suffered the most in recent years. However, the reduction in spending by consumers and advertisers also trickled through the entire value chain, significantly affecting some players' ability to capture part of the value. TV & Video is overall the largest segment of the industry and has created incremental revenue through the industry's digitization. This segment also has among the highest online growth rates, relative to its size, and the lowest declines in the traditional media flow of funds (+0.1% CAGR from consumers to retailers, while all other segments show negative growth). The book industry is another segment that is holding onto its value for now. The growth rates for

online flow of funds are among the highest at CAGR +78% in consumer spending, while decline in traditional flows are among the lowest, behind TV and video.

The major shifts in the flow of funds between 2007 and 2013 were:

- Online players added €12 billion or +116% in value since 2007, now accounting for € 22.1 billion
- Traditional retailers lost €12.2 billion or -11.4% in value since 2007, with physical media retail having experienced a massive volume and value decline, while PayTV is holding up
- Traditional aggregators lost €16.9 billion or -25.3% in value since 2007, as online players successfully employ “dis-aggregate, re-aggregate” strategies
- Content producers and rights holders added €2.0 billion or +3.4% in value since 2007, accounting for more than €63.7 billion

15.1bn€ of online growth are expected until 2017: grab them!

Arthur D. Little has developed a granular forecast of consumer spending and advertising revenues until 2017. Public funding was assumed to be flat over the period, given the budget pressure most of the EU5 countries will face during the forecast period. Current market dynamics suggest that the EU5 media industry is headed back to growth, albeit at ~1.1% CAGR (or €7.4 billion incremental revenue by 2017).

Consumer spending will be the main absolute contributor to this growth, with a net growth of €3.8 billion by 2017. This growth is a result of strong online revenue growth over-compensating the decline in traditional media. Spain and the UK will lead the EU5 group in terms of online spending as a share of total consumer spending.

Advertising is expected to grow by €3.6 billion until 2017 mainly due to the growth expected from Italy and Spain, where a limited ‘recovery’ is expected after the collapse experienced from 2007 to 2013. The already high online share in advertising is expected to further increase, to reach between 37% - 60% of total revenues depending on the respective country.

At the same time, total online spending by consumers and advertisers will increase by €15.1 billion until 2017, with online by then representing 27% of total industry revenues.

Arthur D. Little’s key take-aways for traditional players:

- The window of opportunity is closing for traditional businesses, an urgent need to act now!
- Learn how the digital world works: “Dis-aggregate, re-aggregate”
- If you enter, enter bold!
- A need to accelerate organizational transformation.
- Move into original programming – UGC times are over and the rest of the content is non-exclusive.
- Policy makers should ensure same rules of the game for all.

Key figures

-0.4% per year

average growth of the **media industry** in Europe since 2007

-0.8% per year

average growth rate of media market **excluding public funding**

16% per year

average revenue **growth of online media** since 2007 (vs. -2.6% in the offline segment)

18.6%

share of online in overall media market in 2013 and **+2.2%** pt annual **increase of online share**

€22.1 billion

value **captured by online players** in 2013 (+€12 billion or +116% since 2007)

-€12.2 billion

value **lost by traditional retailers** since 2007 (-11.4%)

-€16.9 billion

value **lost by traditional aggregators** since 2007 (-25.3%)

€63.7 billion

value **captured by rights holders** and content producers in 2013 (+3.4% since 2007)

1.1% per year

annual growth expected until 2017 for the Total Market

€15.1 billion

of incremental value **to be captured in online** segments **until 2017**

Introduction

The media industry is going through a massive digital transformation. New online competitors and business models are challenging traditional media players, while consumers are gaining access to sheer endless opportunities to consume media.

This creates a complex and volatile environment for media companies in which it is ever more important to understand how this transformation affects value flows. With this report, Arthur D. Little will provide insight into the speed and main beneficiaries of this transformation of the media industry.

The objective of this report is to enable:

- Media corporations to identify opportunities for vertical or horizontal integration, as well as to guide portfolio optimizations and go to market strategy
- Financial investors to identify the most attractive market segments and acquisition targets
- Policy makers to identify areas where excessive value capture is leading to economic imbalances during the transformation
- Academia to build on a strong base of data and a framework, which can be used to deepen research in transformation of individual segments of the media industry

Arthur D. Little employed a unique methodology to study the recent evolution of the Media & Entertainment sector in France, Germany, Italy, Spain and the United Kingdom ("EU5"). The analysis covers the period between 2007 and 2013, as well as a forecast until 2017, distinguishes the sources of funds and their destinations, as well as online from traditional consumption. In addition, more than 50 interviews were held with senior executives in the European media industry to gather their views on the main winners and losers of the transformation in their industry.

1. The years of the double squeeze, 2007–2013: Financial crisis and digitization

The economic environment and the move to digitization have had a transformative impact on the media sector in Europe. In this section, we will review the major trends that have impacted the industry in the EU5 since 2007, and assess the ramifications going forward.

1.1. The industry has weathered the financial crisis; a more stable environment lies ahead

Europe faced a severe economic crisis since the year 2008, which has clearly impacted the media industry. The GDP of the EU5 countries has been more or less stagnant over the last 7 years, amounting to €9,600 billion in 2013, an increase from 9,300 billion in 2007 (+0,5% CAGR in 2007-2013). In this context, the overall revenue of the media industry in the EU5 amounted to €163.9 billion in 2013, a decrease of €4.4 billion from 2007 (-0.4% CAGR).

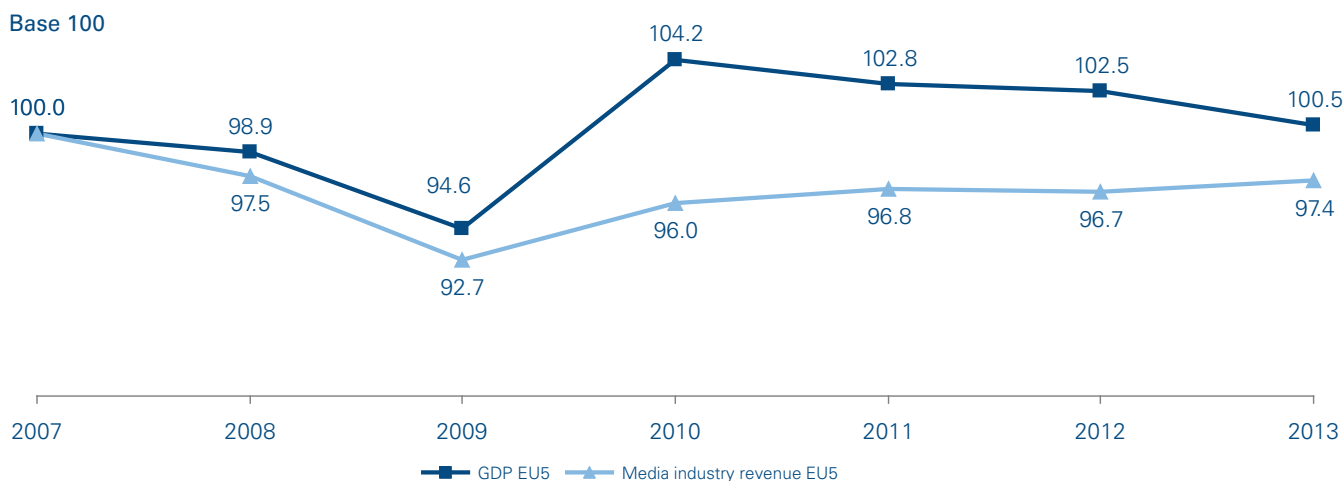
From an industry funding perspective, advertising and consumers have reduced their expenditure on media (- €4.3 and -€2.9 billion, respectively, in the period) while public funding increased by €2.7 billion, partially offsetting the decrease observed in the others.

Digitization already reached 18.6% of total media expenditure in 2013, growing at 16.1% CAGR in the period. Online media expenditure reached €30.5 billion in 2013, which is equivalent to the entire media industry of Italy and Spain, and is gaining over 2 p.p. of market share over traditional media every year. In fact, online media grew by over €4.0 billion both in 2012 and in 2013 in the EU5. Thus, the economic crisis seems to have impacted mainly traditional media.

Although overall media revenue has been resilient to the crisis, traditional players in all EU5 markets suffered the most, in particular those in Italy and Spain. At the country level, the economic crisis did not hit the EU5 countries in the same way, and the same can be said of the impact on their respective media industries.

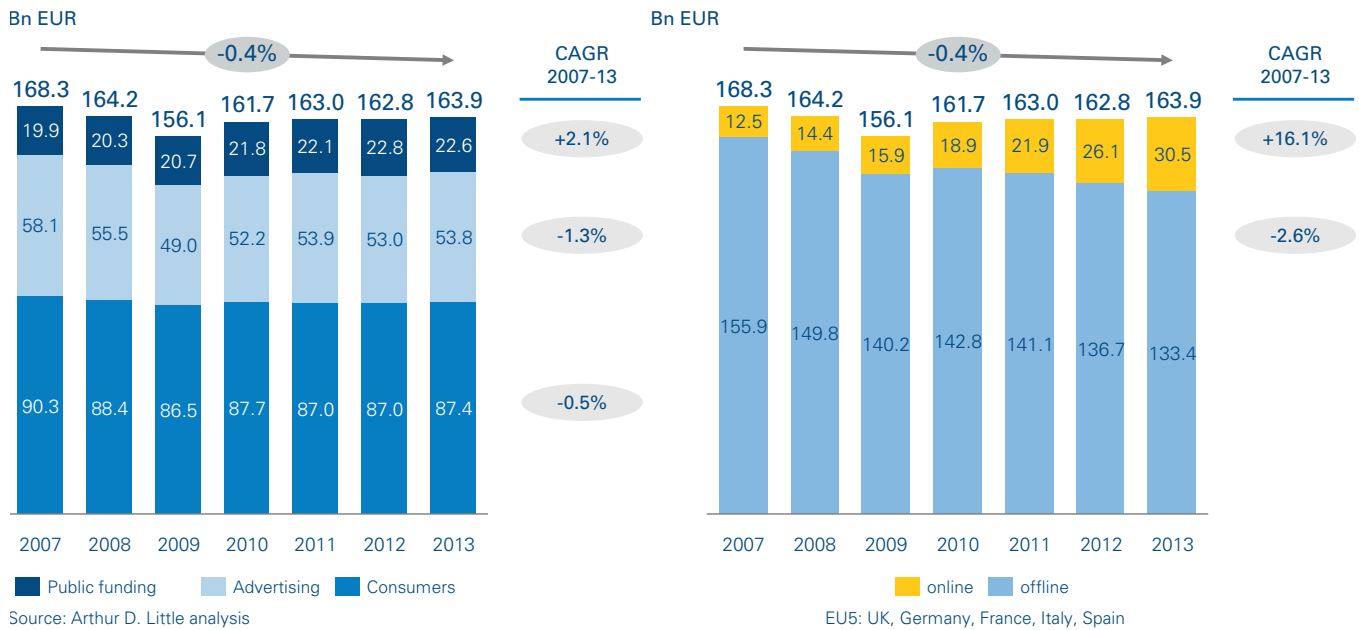
Based on the evolution of the media industry’s revenue, two groups of countries can be distinguished within the EU5, as illustrated in the figure 5. On one hand, media revenue has collapsed in Spain and Italy, where revenue has decreased by €4.5 and 5.5 billion, -4.8% and -4.2% CAGR, respectively. On the other hand, the media sector has grown in France, Germany and the UK by €2.1, €2.0 and €1.5 billion, respectively, with +1.0%, +0.7% and +0.6% CAGR.

Figure 1: EU5 GDP vs media revenue, 2007–2013



Source: Eurostat. GDP at current prices. Arthur D. Little analysis Note: EU5 = UK, Germany, France, Italy, Spain

Figure 2: EU5 media market by type of funds



On the segment level, media is one of the industries that, besides undergoing the economic crisis, have truly started to transform due to digitization. Specifically, as shown in the figure below, while online segments have experienced double-digit growth between 2007-2013, some traditional media, such as Newspapers & Magazines or Radio & Music, have seriously decreased (-5.2% and -2.6% CAGR respectively). Between these winners and losers, other segments are struggling in their transformation process, such as TV & Video, which is stagnating, or videogames, which has successfully achieved growth through digitization (+1.9% CAGR in the period).

On the other hand, the new online world has not been enough to save Italy's and Spain's media collapse. However, in these countries online media managed to partially offset the offline revenue decrease of 19% and 25%, respectively. All good news in this difficult period came from the new world of online media.

Finally, the combined effect of the economic situation and the advance of digitization in each of the countries highlight relevant insights. As the figure below shows, in the countries less impacted by the crisis, the industry has achieved a significant growth through digitization. For instance, online growth compensated for the offline decrease in Germany and France, which resulted in a revenue increase of €1.9 billion and €2.2 billion in media revenue, a 4% and 6% increase in revenue in the period, respectively.

In the UK, online growth has also more than offset the offline drop, with a revenue increase of €1.1 billion. Even when the offline drop amounted to €5.8 billion, online growth brought in €6.9 billion. Of course, there have been winners and losers among the market players, but the industry as a whole has managed to create value out of digitization in a challenging economic environment.

Figure 3: EU5 media market by type of territory, 2007-2013

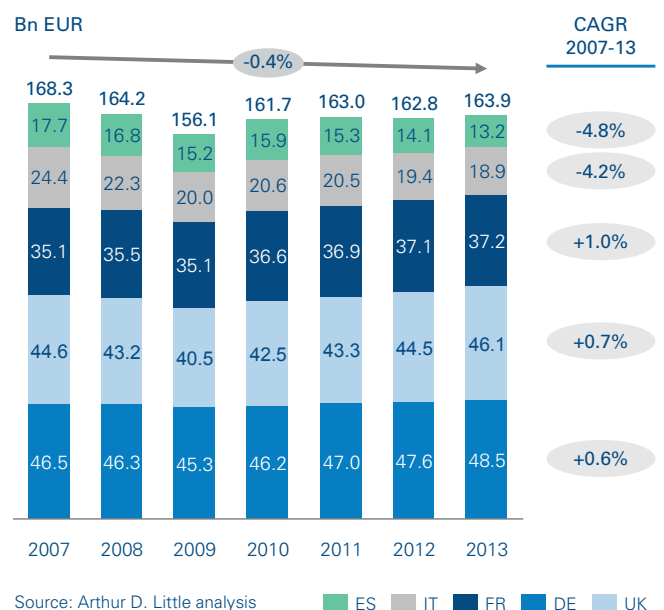
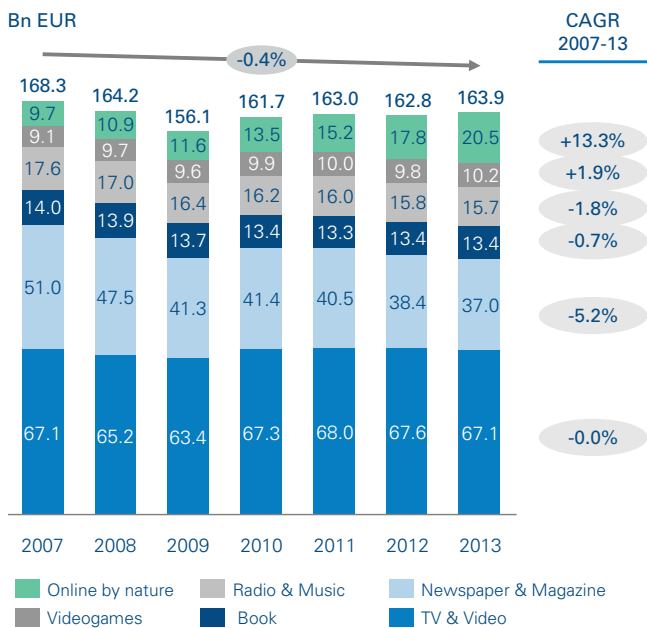


Figure 4: EU5 media market by segment, 2007–2013



Source: Arthur D. Little analysis
EU5: UK, Germany, France, Italy, Spain

The changes in revenue by segment, partly due to changes in customer behavior, have had an impact on the industry's structure. There has been a net increase in the overall number of registered companies in the industry. Considering the market revenue has slightly decreased, this means that the market is fragmenting. Investments and scale required to make business

in the online world is significantly lower than in the offline world. This is especially true, for instance, for audiovisual production, which has seen a net growth of 7,300 companies. In contrast, the number of publishing and programming companies has decreased (-6% and -9%); the former because this industry has been hit the hardest in the period, and the latter because consumers are increasingly moving toward non-linear consumption for which programming is not required.

In conclusion, media has a favorable environment because in the age of the connected consumer (see section 1.2) more content than ever is being consumed and this will continue to increase. In other industries, such as Food or Automotive Manufacturing, such an increase in consumption would directly lead to significant growth in revenue. However, the financial crisis and a deep digital transformation have prevented the creation of value from this explosion in demand. The financial crisis has significantly impacted the media industry due to the close link of advertising revenues to GDP. However, the digital transformation increasingly is a blessing for the industry, as in some markets it has already created more value than has been lost in traditional segments.

This same situation, but for different underlying reasons, can be found in the telecom industry. As Arthur D. Little Exane BNP Paribas report 'CAPEX: the long march' (March 2014) states, even when consumers are increasingly using mobile and fixed telecom networks, the industry is not profiting from it proportionately.

Figure 5: EU5 media market bridge, 2007–2013

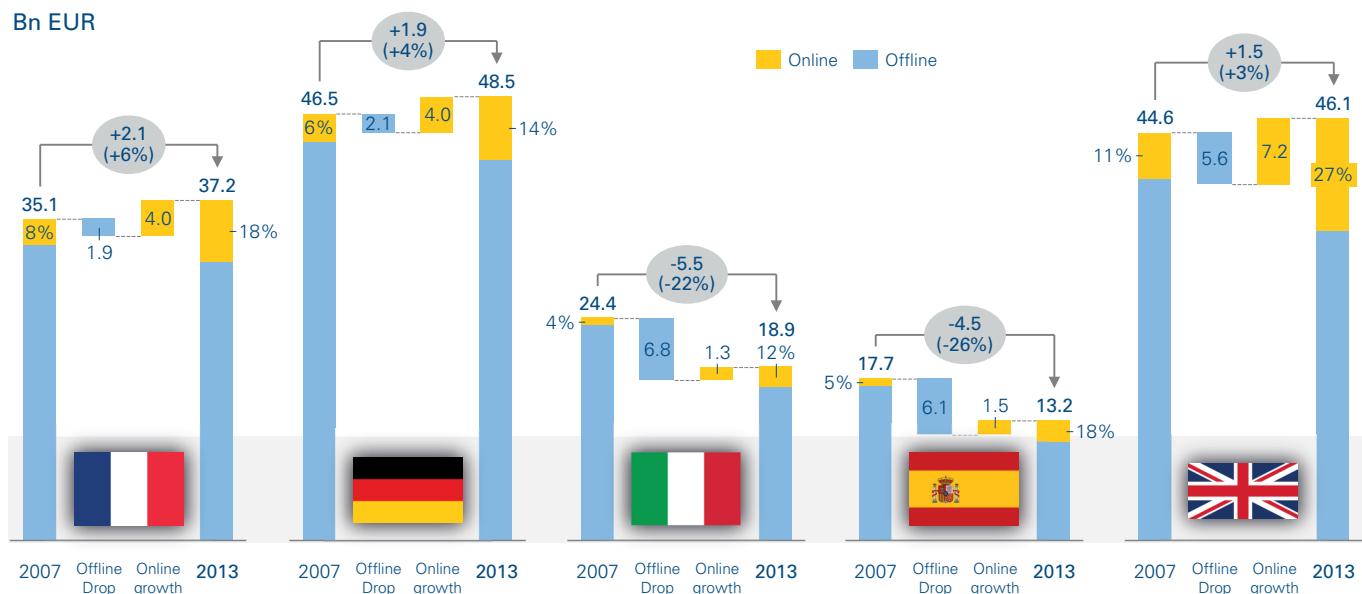
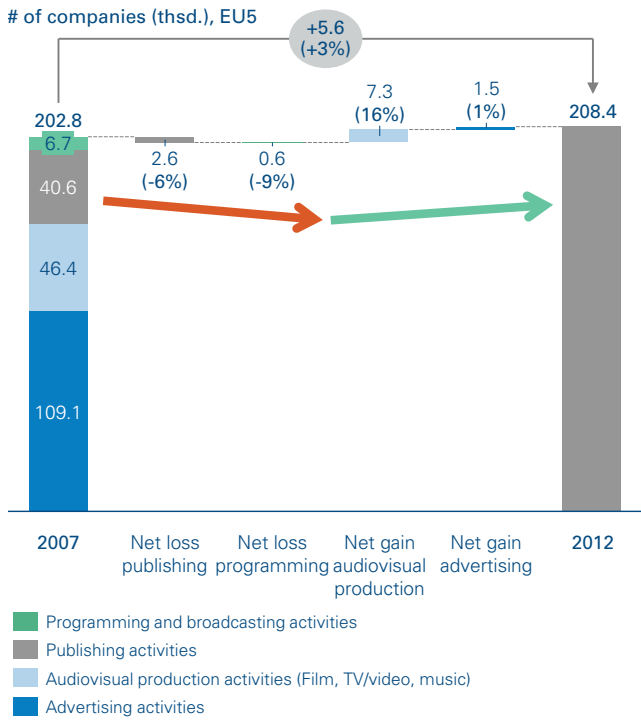


Figure 6: Registered companies EU5 by segment



Media companies thus have a unique opportunity, but at the same time face a series of challenges. As the economic situation seems to improve, the ability of the media industry players to create value out of the fact that people consume more and more media, and their ability to shift revenue from offline to online will surely offer quite a different industry landscape by 2017.

1.2. The EU5 consumers' current low online spending is the industry's best source of future growth

Key to the development of and the speed of transformation in the online media industry is the accessibility of new digital offerings and services. This accessibility has two important components:

- **Broadband penetration:** this is the basis of all online activity, either allowing usage at home, predominantly through fixed broadband technologies, or on the move through mobile broadband dongles or built-in SIM cards and mobile data tariffs for smartphones
- **Connected devices/CPEs:** these are the screens through which consumers experience online media, existing in a wide variety of forms and connected devices, resulting in fundamentally different use cases (e.g. smart TV vs. smartphone) that have to be addressed.

Differences in the speed and state of transformation of major media markets in Europe can partly be explained by the relative development of these two enablers.

The British consumer spends more than twice as much per capita in nearly all online media segments, compared to other EU5 countries. While France is still close in a number of these segments, Germany, Italy and Spain are significantly behind

in most. Differences in broadband penetration explains part of these national differences and the overall gap with the UK. The UK has among the highest mobile broadband penetrations in Europe and on par fixed broadband penetration; it also leads the United States in both these statistics.

Connected personal devices like smartphones, tablets and smart TVs are increasingly democratized across EU5 markets. However, again the UK is well above the average in all three categories and significantly ahead in smartphone penetration, even compared to the US.

Mobile is becoming an increasingly important digital channel and the penetration of flat rate data plans means that access cost are no longer a limiting factor. In France, Germany and Spain, most of the smartphone user base already uses flat-rate tariffs either with speed caps (tariffs are differentiated on their speed of the connection in Mbps) or volume caps (tariffs are differentiated on the amount of inclusive megabytes with speed being reduced significantly for out-of-bundle traffic). In these countries, only a small portion of the market still buys connectivity by volume (megabytes/gigabytes without out-of-bundle usage). Italy and the UK are structured differently, with most tariffs requiring volume packages to be added as they are consumed.

Figure 7: Online share of spend by media segment and market, 2013

Online as % of total spend/capita

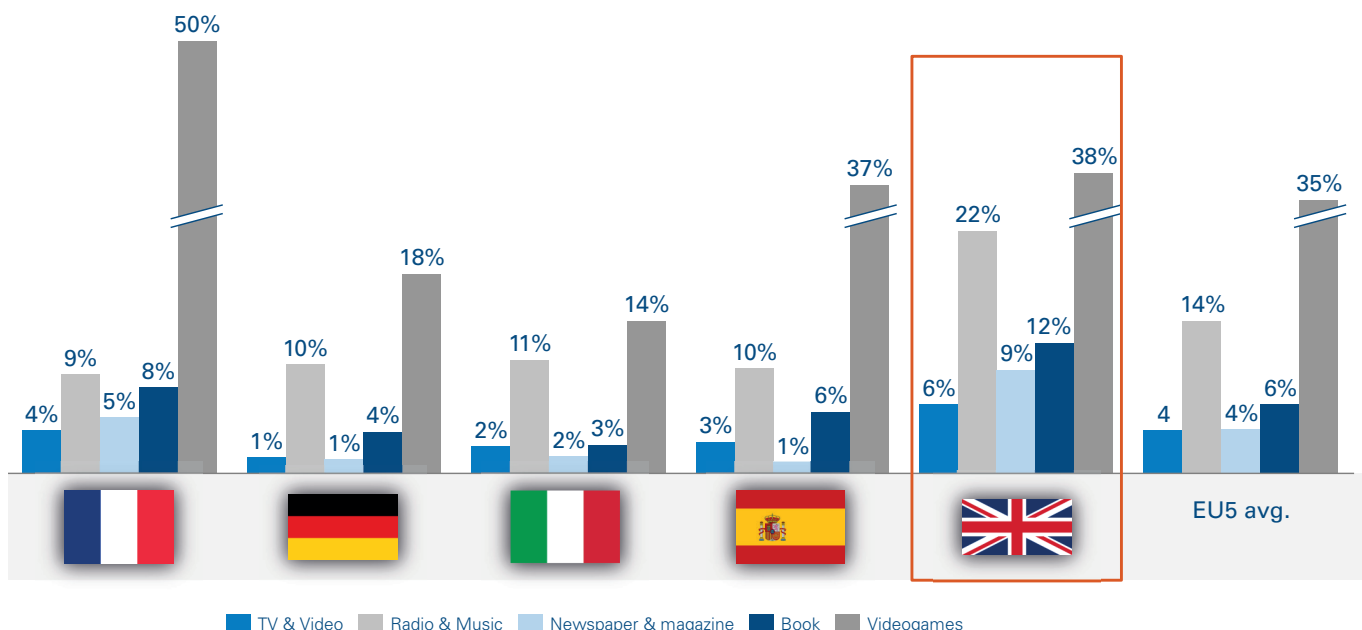


Figure 8: Broadband penetration by market, eop 2013

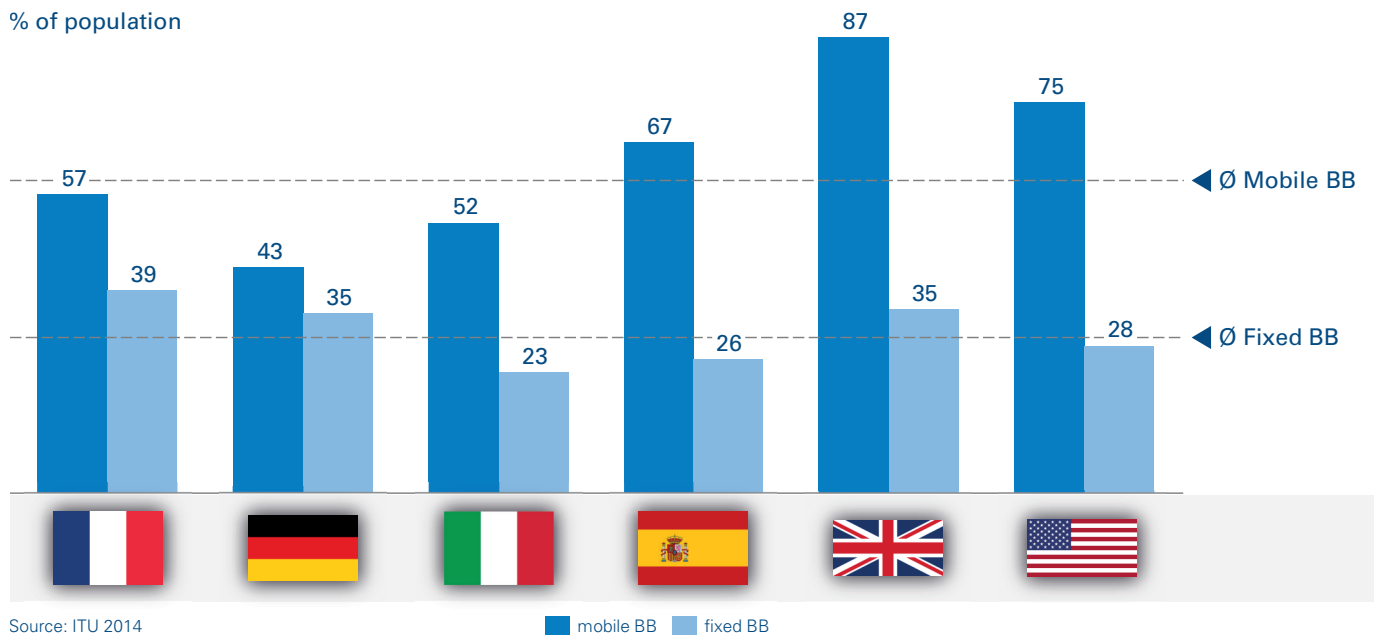


Figure 9: Connected device penetrations by market, eop 2013

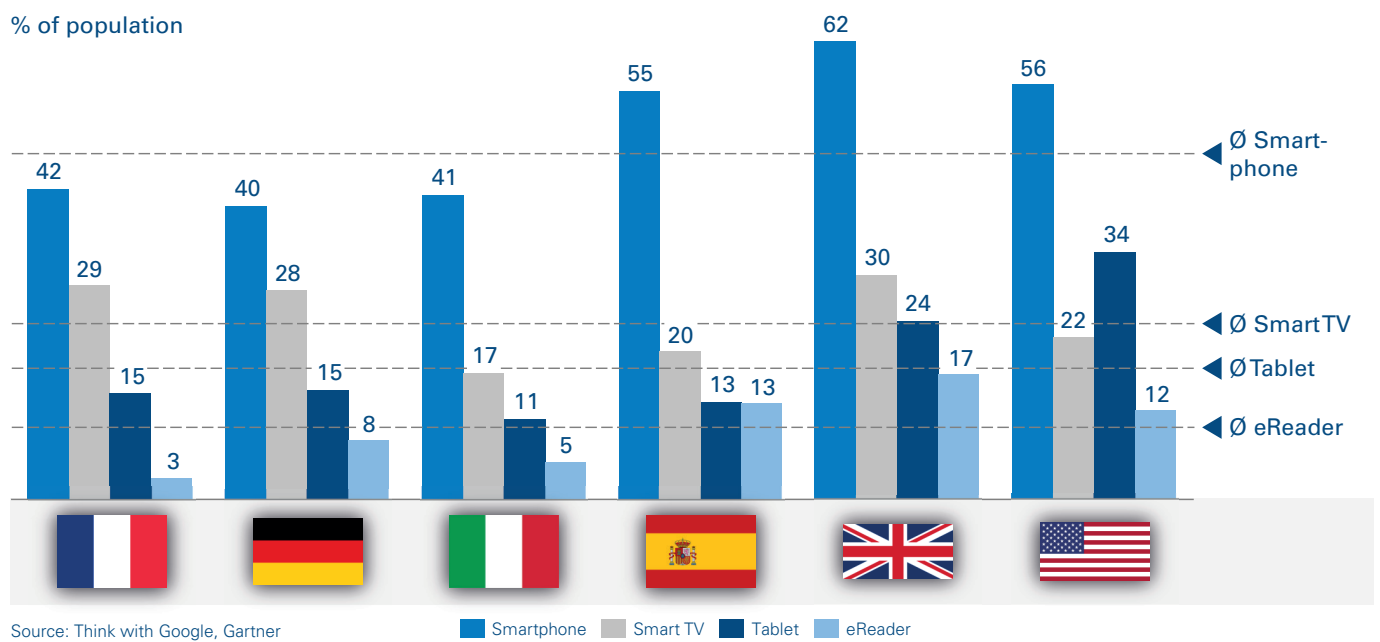
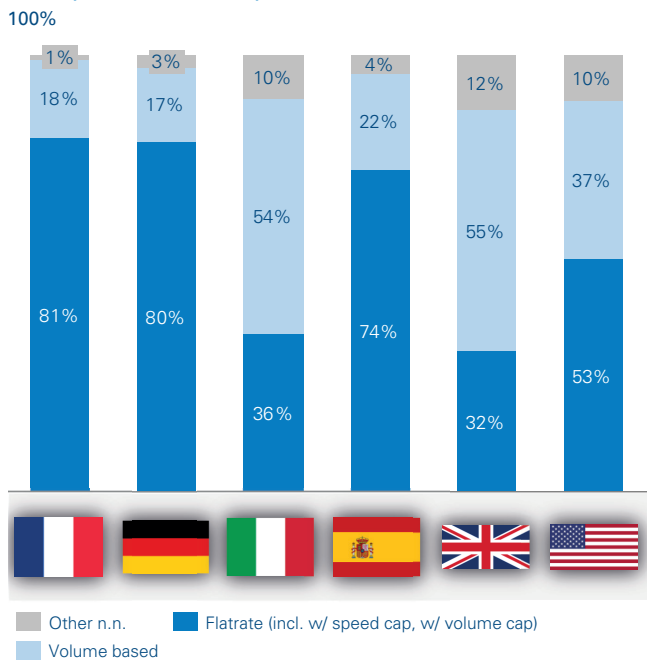


Figure 10: Penetration of different data plans (of smartphone users), eop 2013



Source: Think with Google

The differences in tariff structures, however, appear not to have had a significant effect on usage behavior. Figure 11 clearly illustrates that European smartphone users have very similar usage behavior. This suggests that mobile data tariffs do not have a structural impact on the development of online media markets.

In summary, the UK is clearly leading the EU5 markets in the digitization of the consumer (broadband penetrations and proliferation of connected devices), which also explains the higher online shares across all industry segments. However, all other EU5 countries have comparably high broadband penetration rates (relative to the US), and connected devices are increasingly democratized. Mobile is becoming an increasingly important digital channel and the high penetration of “all-you-can-eat” data plans of between 70-80 percent, means that access is no longer a limiting factor.

However, consumer spending is not keeping pace with the growth in media consumption and the online shift. The industry seems to be failing to monetize this underlying trend in volume growth. Significant differences exist among European countries, which indicates there are considerable opportunities in under-exploited segments.

For example, per capita expenditure in Spain is around a third of that in the UK. Even considering purchasing power parity, this is too high of a difference. In addition, a French citizen spends twice as much on media as a Spaniard. This is due to the special

impact that the crisis has had in Spain, as well the higher piracy levels in Spain compared to France. If the crisis has hindering media expenditure, then a return to growth of the Spanish economy over the next few years should also have a positive impact on consumer spending.

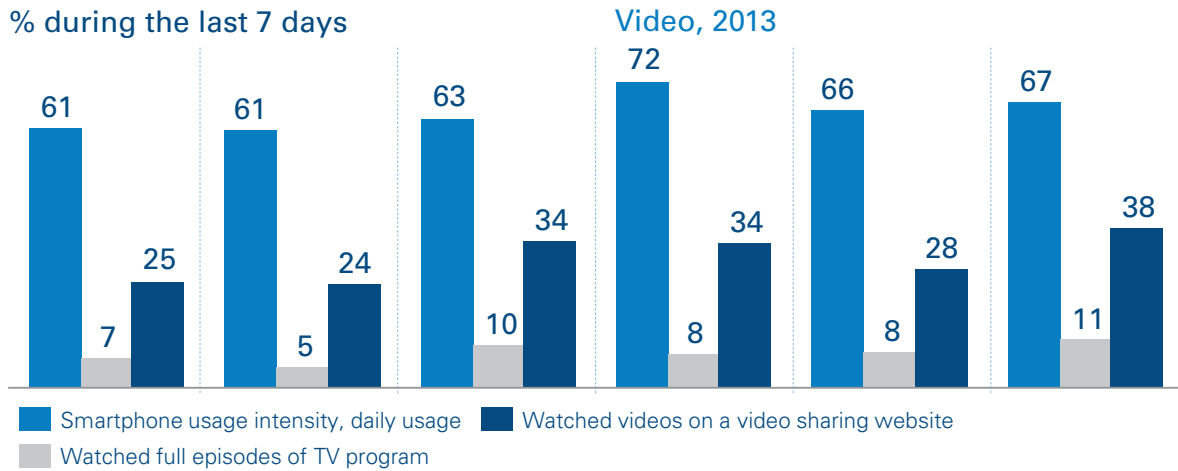
More opportunities can be found in other markets. For instance, the German book industry clearly has achieved remarkable success, with per capita expenditure double that in France and Spain. This is partly due to the popularity of book self-publishing; over half of the top 10 eBooks on Amazon.de are self-published titles. Also, the French newspaper and magazine segment clearly leads over its European peers, especially compared to the UK, Italy and especially Spain.

Probably the most striking example is the UK’s TV & Video per capita expenditure, which is more than three times that of Spain and Italy, and double compared to Germany. The UK online TV segment was driven by a substantial increase in the number of services and devices, which allowed users to conveniently access on-demand content. This segment is leading many other European markets, due to early consumer adoption (lovefilm, blinkbox and the iPlayer were introduced prior to 2007) and the depth and breadth of content libraries.

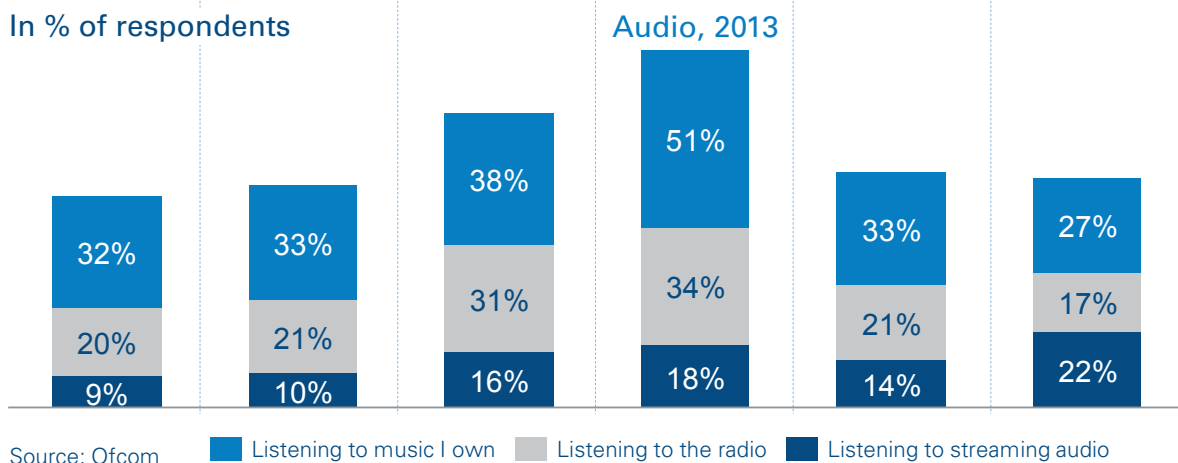
In 2013, both BT and TalkTalk expanded their Video-On-Demand (VOD) and catch-up services by offering YouView STBs as part of their subscription bundles. Additionally, Sky released the NOW TV Box. This pay-as-you-go service allows users to access Sky content for non-subscribers and includes Sports, Movies and Entertainment passes. In fact, Vodafone now offers Red 4G customers free access to the basic package (typically costing £6.99 per month). In September 2013, Virgin Media became the first pay-TV provider to strike a deal with Netflix app to its TiVo box capabilities. In February 2014, Amazon re-named the LoveFilm service Amazon Prime Instant Video, which is offered free to its Prime customers. New players also entered the UK VOD market in 2013, such as the Spanish on-demand provider Wuaki.tv. New devices, such as Google’s Chromecast and Amazon Fire TV, have also been developed and are now available in the UK market at very attractive prices.

The ability to learn from the successful monetization in particular segments in the most successful EU5 media markets will be a key source of the next phase of growth. Based on the maximum spend in each segment, this could lead to consumers spending €411/year on media. In Italy and Spain, this level might not be achievable in the mid-term, but in France and Germany this should clearly serve as an ambition level.

Figure 11: Smartphone usage



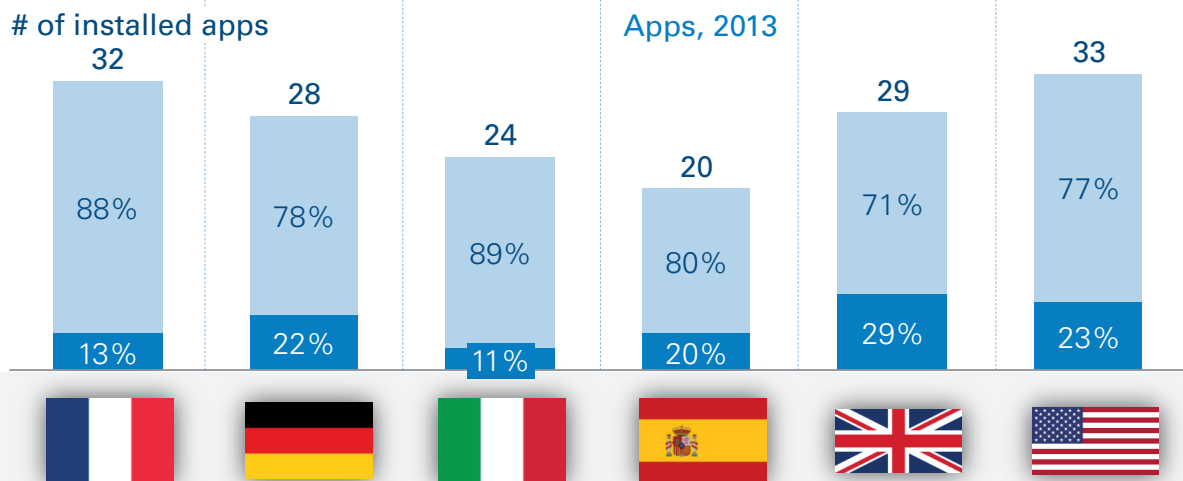
Source: Think with Google



Source: Ofcom

Note: 18+ years; internet users with a smartphone.

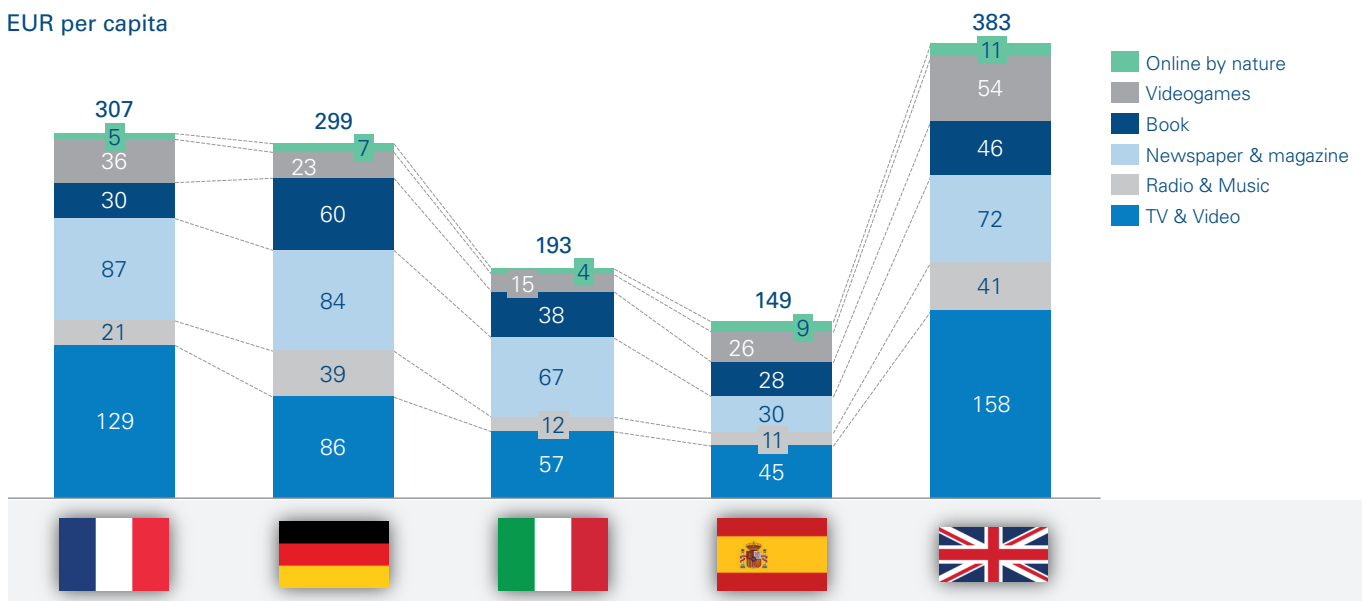
Base sizes: UK=894, FRA=850, GER=890, ITA=904, USA=793, SP=897



Source: Think with Google

Unpaid apps (Light Blue), Paid apps (Dark Blue)

Figure 12: EU5 consumer spending per media segment, 2013



Source: Arthur D. Little analysis

1.3. Public funding is central for the transformation of the industry, but requires tweaking

The media industry is an important pillar of modern democracy and common cultural values. Not all of its activities can or should be purely based on the free interplay of supply and demand. As a consequence, direct public intervention and the funding of a range of media segments has a long history. The ways European governments evolved their funding between 2007 and 2013 are a key to understanding its true impact on today’s market.

In Europe, this intervention takes three primary forms:

- **Public service broadcasting:** with the BBC, ARD/ZDF, France Television, RAI and RTVE as the main beneficiaries of either license fees or direct government assignments
- **Public support of film production (TV, filmed entertainment):** providing direct and indirect funds, in the form of tax benefits, to independent film and TV producers for local and European content
- **Public support of printed news:** providing direct and indirect benefits to newspapers

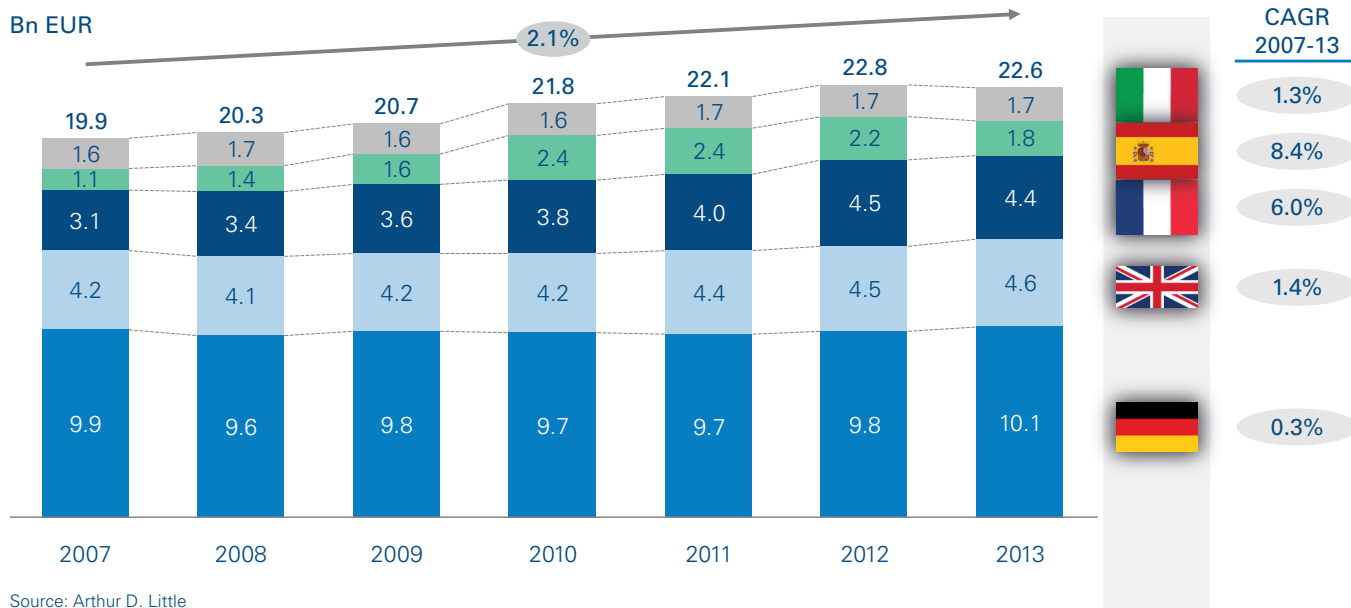
The sum of direct public intervention in the EU5 markets accounted to close to €20 billion in 2007, representing approximately 12% of total inflows into the industry. The size and importance of this source of funds has expanded over the past 5 years, and accounted for €22.6 billion or 14% of total inflows by 2013. Public spending increased in particular in France

and Spain, considerably outpacing organic growth in these markets.

With a ratio in excess of 20% of total inflows, Germany has by far the largest public funding of all EU5 countries, essentially due to a complex public service broadcasting sector with two full channel families, ARD and ZDF, vying for audiences and resources with fully separate organizations and operations. In the other observed countries, public funding accounts for between 9 to 14% of overall industry revenues.

Besides direct funding, specific governmental policies can have a considerable impact on the media industry of an individual country. France and Spain, for instance, have made specific changes to the financing of their public service broadcasters in support of the commercial TV sector. In 2009, the French government banned advertising on France Television after 8 pm, which, in a falling market, shifted a higher share of advertising budgets to commercial channels. In 2010, the Spanish government followed the French example and banned advertising on RTVE entirely, while introducing a series of regulated contributions to recoup the forgone revenue: 3% on free-to-air channels’ revenues, 1.5% of pay-TV channels’ revenues, 0.9% of net Income of telecom operators that have video offerings. At the same time, TV advertising markets experienced a strong decline (i.e. -11% in France, -23% in Spain 2008–2009). By reducing the potential advertising inventory of the market, the commercial channels could achieve higher utilization and prices for their inventory.

Figure 13: EU5 public funding by territory, 2013

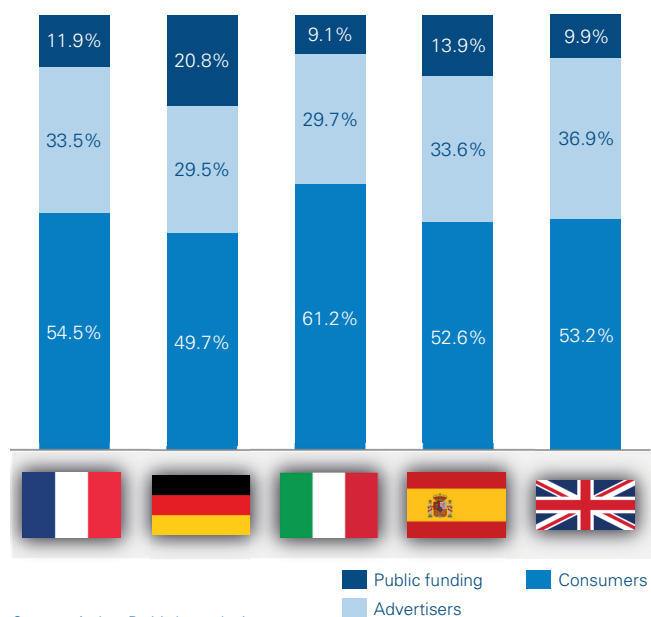


Source: Arthur D. Little

The above-mentioned share of public funding can be seen as a historical difference of European media markets. However, the differences in how European governments evolved their funding between 2007 and 2013 are key to understanding the true impact of public funding.

Comparing incremental spending with the real decline of traditional media segments reveals the true size of public intervention in the transformation of funding of the European media industry. Although growth in public funding in Germany was a mere 0.3% CAGR (or an increase of €182 million from 2007 to 2013), this covered 8% of the real loss in traditional media, which is roughly in line with Spain and the UK. Although Italy increased its public funding by about the same amount as Germany, this resulted in much less fire-power given the large-scale contraction of traditional media there. In France, however, the incremental increase in public funding amounted to €1.3 billion, represented a staggering 40% coverage of the traditional media's losses.

Figure 14: EU5 sources of funds by type of territory, 2013

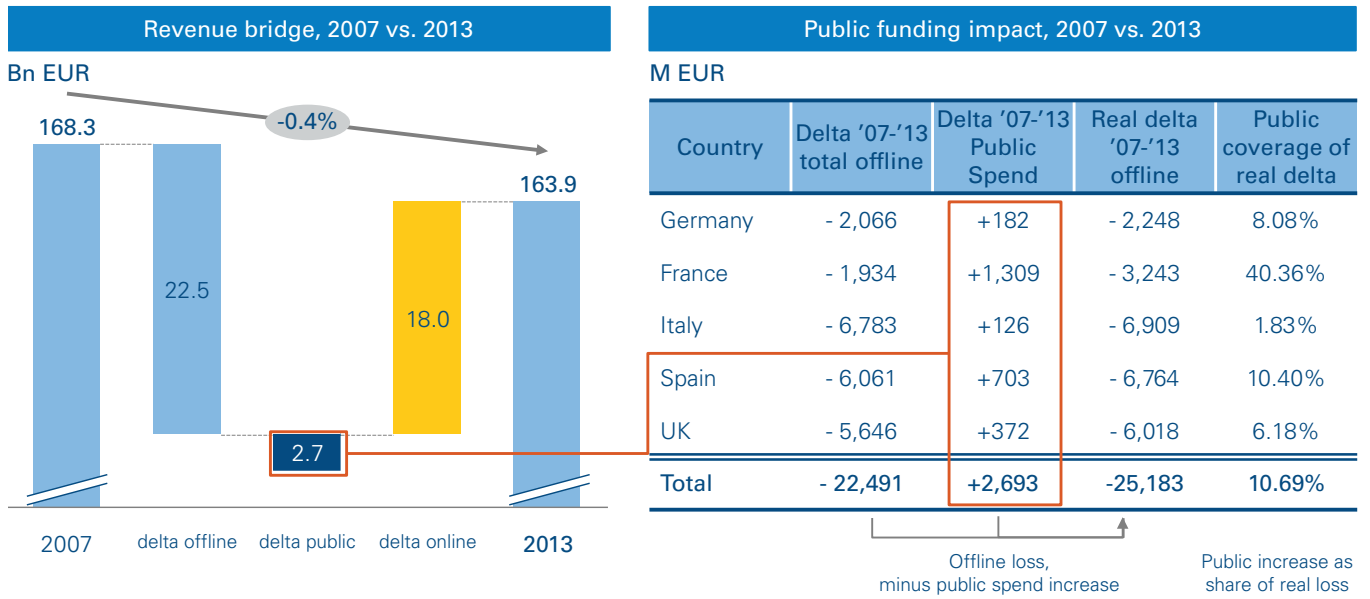


Source: Arthur D. Little analysis
EU5: UK, Germany, France, Italy, Spain

In summary, public funding plays an important part in the industry's transformation, as it can limit unwanted effects, such as a degradation of editorial activity or reduction in media diversity, while the industry adapts to new business models. However, the size of interventions should be carefully considered as not to distort market realities.

Public FTA television needs to focus on fulfilling its public service goal, while also benefitting from significant cost reductions. Public service broadcasters could be a major engine to drive the online market, as has been illustrated by the tremendous success of the BBC's iPlayer which paved the way, through early user adoption and education, for many other online video initiatives in the UK.

Figure 15: Impact of public funding increase, 2007–2013



Going forward public spending in media will be under increasing pressure from tighter government budgets. Public broadcasters will, therefore, have to reinvent and adapt themselves if they do not want to see their market position erode severely. In addition, policy makers should reconsider the distribution of their funding. Imagine what could be achieved if a significant part of the funds currently spent on public service broadcasting were instead spent on creating a vibrant online media ecosystem in Europe.

2. Challenges and strategic imperatives for individual value chain steps

At the core of Arthur D. Little's analysis of the EU5 media industry is a detailed financial modeling of the flow of funds from consumers, advertisers and public funding through various value-chain steps to the content producers and rights owners. In this chapter, we will assess the impact the Flow of Funds is having on the various market players, including traditional retailers, traditional aggregators, content producers/rights holders and online players.

While physical media retailing, printed press and radio/music has suffered the most, the reduction in spending by consumers and advertisers also trickled through the entire value chain, significantly affecting the ability of some players to capture part of the value.

TV & Video is, overall, the largest segment of the industry and has created incremental revenue through the industry's digitization. This segment also has among the highest online growth rates, relative to its size, and the lowest declines in the traditional media flow of funds (+0.1% CAGR from consumers to retailers, while all other segments show negative growth). The book industry is also holding steady for now; the growth rates for online flow of funds are among the highest (CAGR: +78% in consumer spend), while the decline in traditional flows are among the smallest (behind TV & video).

The major shifts between 2007 and 2013 are:

- Online players added €12 billion or +116% in value since 2007, and now account for €22.1 billion
- Traditional retailers lost €12.2 billion or -11.4% in value since 2007
- Traditional aggregators lost €16.9 billion or -25.3% in value since 2007
- Content producers and rights holders added €2.0 billion or +3.4% in value since 2007, accounting for more than €63.7 billion

2.1. Physical media retail has been a blood-bath, but Pay TV is holding up

Traditional distributors lost €12.2 billion of incoming funds since 2007 (CAGR: -2.0%), and the decline in retained value amounted to 4.2 billion. Their main source of incoming funds is consumer

spending. Traditional distributors thus were strongly impacted by the shift of consumer spending towards online media. Hardest hit were radio and music (CAGR: -4.2%), followed by newspaper and magazines (-4.1%), videogames (-2.4%), while books (-1.7%) and TV & video (+0.1%) fared better.

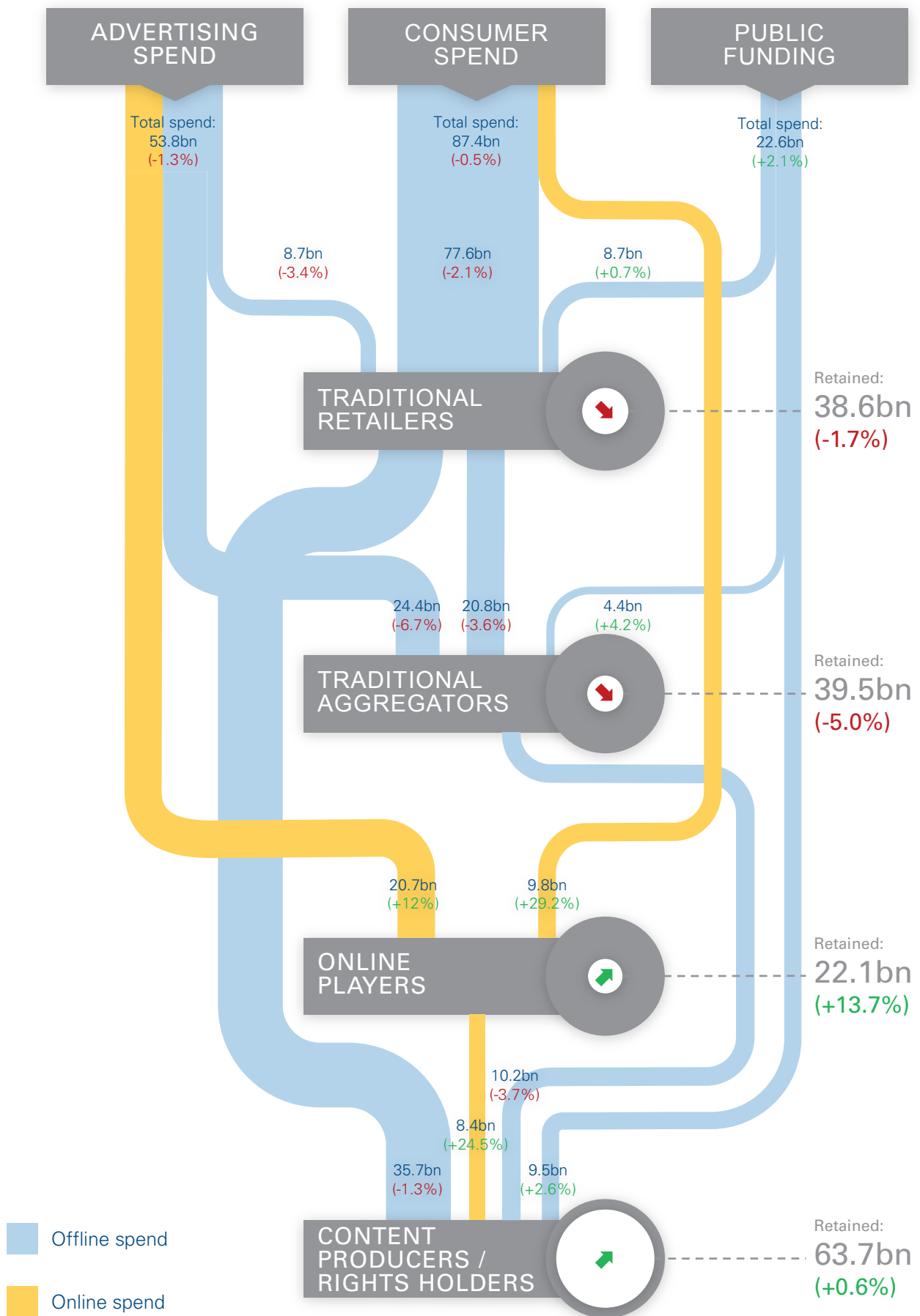
The speed of transformation of traditional retailers is best illustrated by the rapid demise of Blockbuster Inc., a major player in video retail and rental in the US, UK and other territories. In 2004, Blockbuster had more than 60,000 employees and 9,000 shops and was part of the Fortune 500 index of companies. In 2010, less than 6 years later, Blockbuster Inc. had to file for Chapter 11 protection. This should be a dire warning to traditional retailers not to underestimate the disruptive power of new technologies or innovative business models (Netflix, in this case). Blockbuster considered subscription video-on-demand (SVOD) too long as a niche it could ignore.

In this tough environment, some players have simply disappeared, others, such as HMV, called in administrators and many have concentrated their physical presence in the most profitable stores. Some players have not ignored the shift to online retail and have tried to establish a position there, but more failure than success stories are being told so far. It is also not easy to build an online retail position when large international competitors, such as Amazon, benefit from lower entry barriers and scale. Some examples to illustrate this are Tesco's Blink Box (OTT video service discontinued in October 2014, 3 years after its acquisition in the UK), Seesaw (OTT video service by Arqiva discontinued in 2011) or Verizon's Redbox (which combined physical video rental and streaming and was shut down in October 2014 in the US).

Pay TV, the largest retail segment by size, has so far successfully defended itself against online competition and even create incremental revenues. This is due to barriers of entry as a consequence of territorial rights and aggressive moves by traditional Pay TV operators.

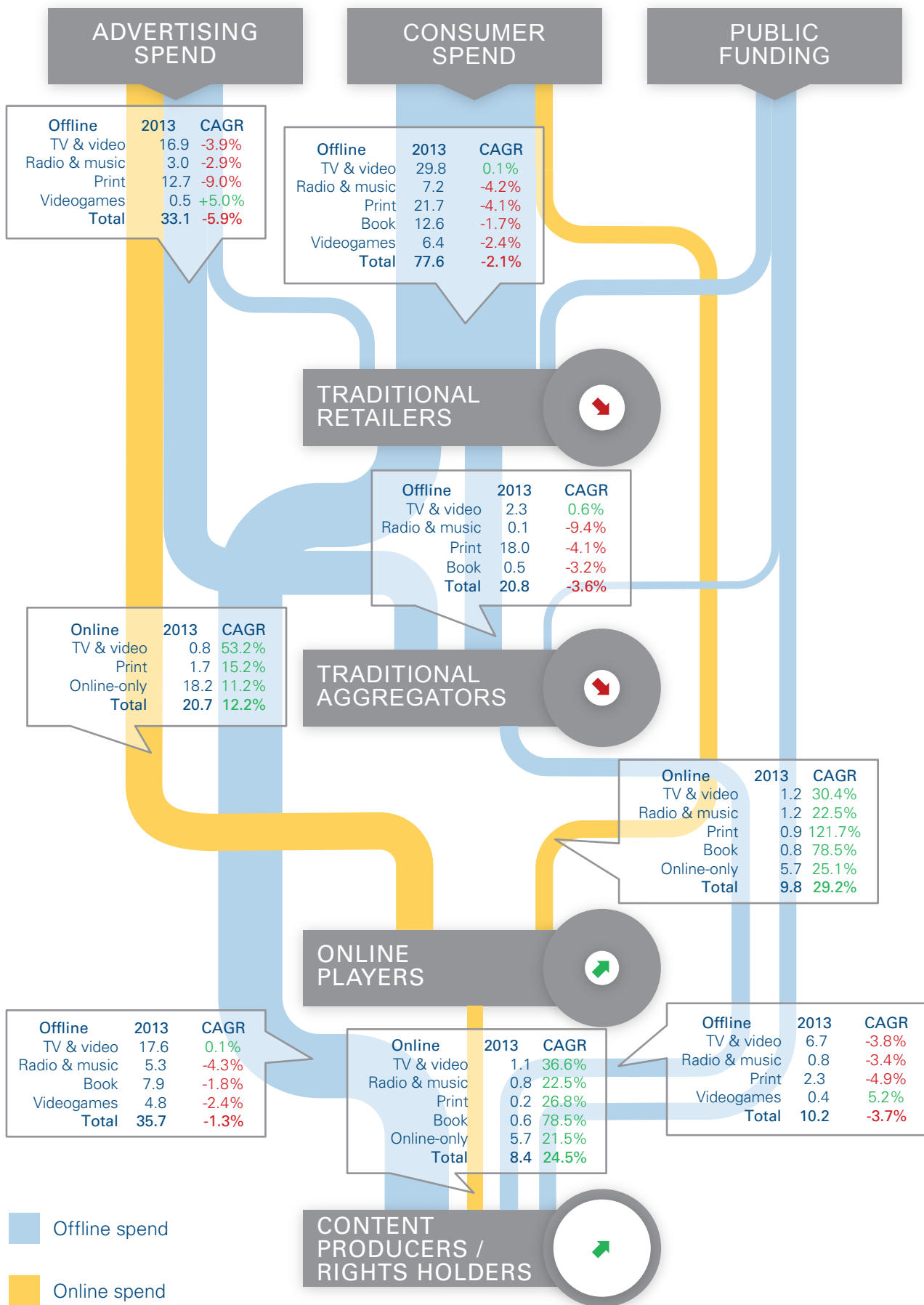
The experience in advanced markets, such as the U.S., shows that on-demand services are cannibalizing physical home entertainment rather than live premium Pay TV. As can be seen in the Figure above, Pay TV, TV advertising and even box office revenues were growing between 2009 – 2014. At the same time, home entertainment overall remained flat while OTT

Figure 16: Flow of Funds in the Media industry (total), 2013



Source: Arthur D. Little analysis
 Note: All figures in EUR, all percentages are CAGR 2007 - 2013

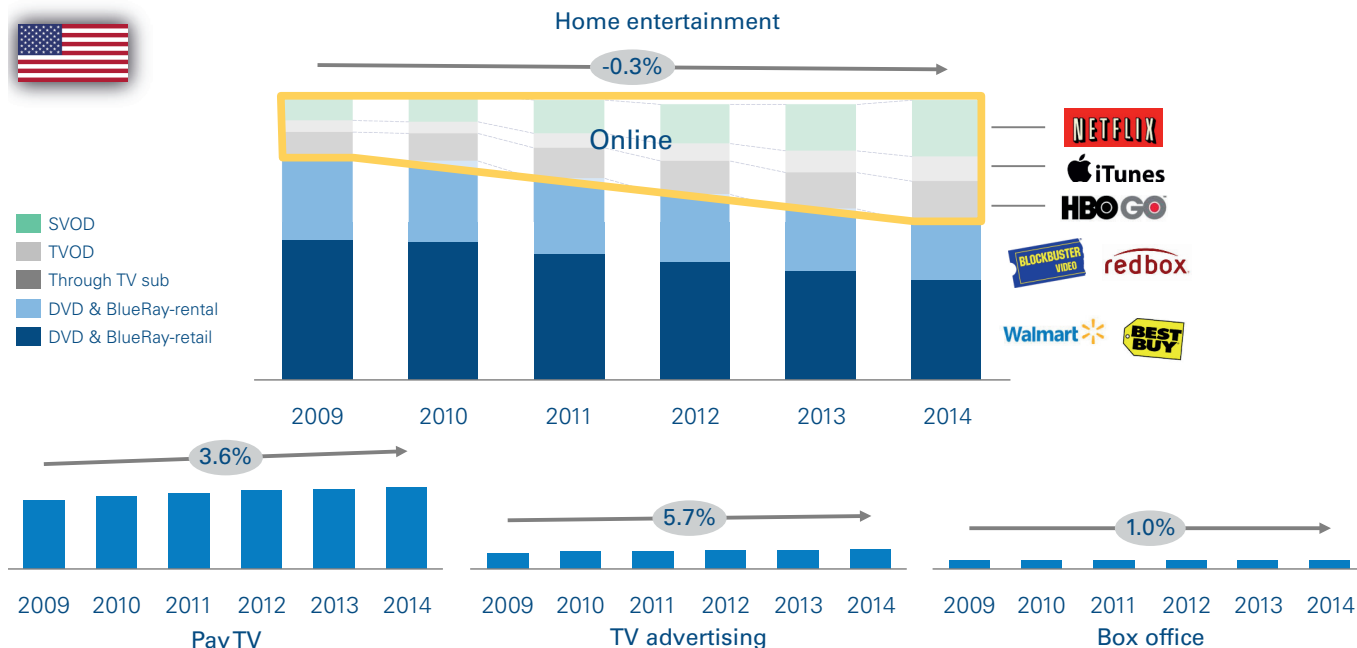
Figure 17: Flow of Funds in the Media industry (segment details), 2013



Source: Arthur D. Little analysis

Note: All figures in EUR, all percentages are CAGR 2007 - 2013

Figure 18: Cannibalization of home entertainment, 2009–2013



Source: Arthur D. Little analysis

video took an increasing share of this segment's revenues. OTT video is thus a substitute for home entertainment, rather than classic pay TV. Furthermore, despite numerous attempts at harmonization in the EU, content rights are still sold on a territorial basis, thereby limiting the progress of pure online players in the TV and video segment. Thus, the best-placed players to address a successful OTT video offer, in terms of content, are still traditional Pay TV leaders, although their window of opportunity is rapidly closing.

Sky is following an aggressive strategy in all its markets, first having launched an OTT video platform for exclusive use by their linear Pay TV subscriber base (Sky Go), followed by a dedicated OTT services for non-subscribers to their linear Pay TV channels (Now TV in the UK, Snap by Sky in Germany). Sky is also ready to fight head-on if required, as has been indicated by their aggressive price cut of Snap by Sky prior to the entry of Netflix in Germany (€3.99/month, down from €7.99 before). The latest move by Sky Germany fully disintegrates their linear Pay TV offering from traditional platforms, such as IPTV, DTH, and CATV, as the service "Sky Online" gives its subscribers full access to Sky's linear Pay TV bouquet via internet streaming on PCs and iOS devices. Their premium sports channels can be added to an existing Sky Online subscription via daily passes.

Besides moving aggressively into online distribution, Pay TV operators also focus their investments in content. Historically, Pay TV channels have been successful in providing both (a)

exclusive cinema content and (b) live sport content. The former has been recently preyed upon by OTT players, which have been successfully offering an abundant (albeit dated) catalogue available anywhere, at any time, at an attractive price point. As Netflix is currently expanding to Europe, many European Pay TV providers fear the so-called "cord-cutting" or "cord-shaving" phenomenon when people give up or downsize their cable subscription for a Netflix-like subscription. To preserve differentiation, Pay TV operators are expected to further push live premium sport content in their offerings due to three important characteristics that makes this content particularly valuable. First, a domestic football league game cannot be replaced by a foreign one (non-interchangeable). Second, rights owners are located all over the world, content is in local language, which makes it difficult to broadcast on a global scale (highly related to domestic markets). Thirdly, sports events are live and thus don't fit the non-linear system of OTT players (live product). Thus, live content in general and premium sports content will be the ultimate differentiator in the Pay TV market.

Partnerships are another clear trend that has emerged in retail and distribution. The classic Pay TV business model in which content rights owners, such as Hollywood studios, receive a fee per subscriber (CPS) from a distribution platform, such as Sky, is likely to be the modus operandi between distribution platforms and OTT players. The recent entry of Netflix in a commercial bundling partnership with a number of telecom

operators in Germany and other European markets shows that there is significant value for both parties in such deals. The OTT gets immediate access to a large existing subscriber base, while the telecom company does not have to worry about building and maintaining its own content offering. In the future, major retailers will aggregate a diverse set of online brands, which will in turn have *dis-aggregated and re-aggregated* their respective segment (see next chapter for details on this concept).

Only a comparably small part of consumer spending, 19% of total consumer spend in 2013, has moved to online media so far. This is a key call for action to existing retail players to embrace online business models in order not to get “netflix’ed” like Blockbuster did. The large-scale declines in revenues during the period of 2007 to 2013 are thus to be considered as the beginning of a much larger transformation yet to come. The game for the current generation of online players is not to increase ARPU for existing subscribers, but for now it is rather converting non-user into paid subscription models. Once saturation is reached in 5-10 years’ time, a new generation of online businesses might challenge today’s online incumbents focusing on utility-type services (e.g. Facebook, Netflix, Google) with new business models, focusing on average revenues per customer rather than penetration.

“*net-flix*

1. to cause disruption or turmoil to an existing business model

2. to destroy a previously successful business model

3. to displace the way value is currently created, delivered, and captured ”

Source: fortune.com

2.2. Dis-aggregate, then re-aggregate – how online aggregators are winning over their traditional peers

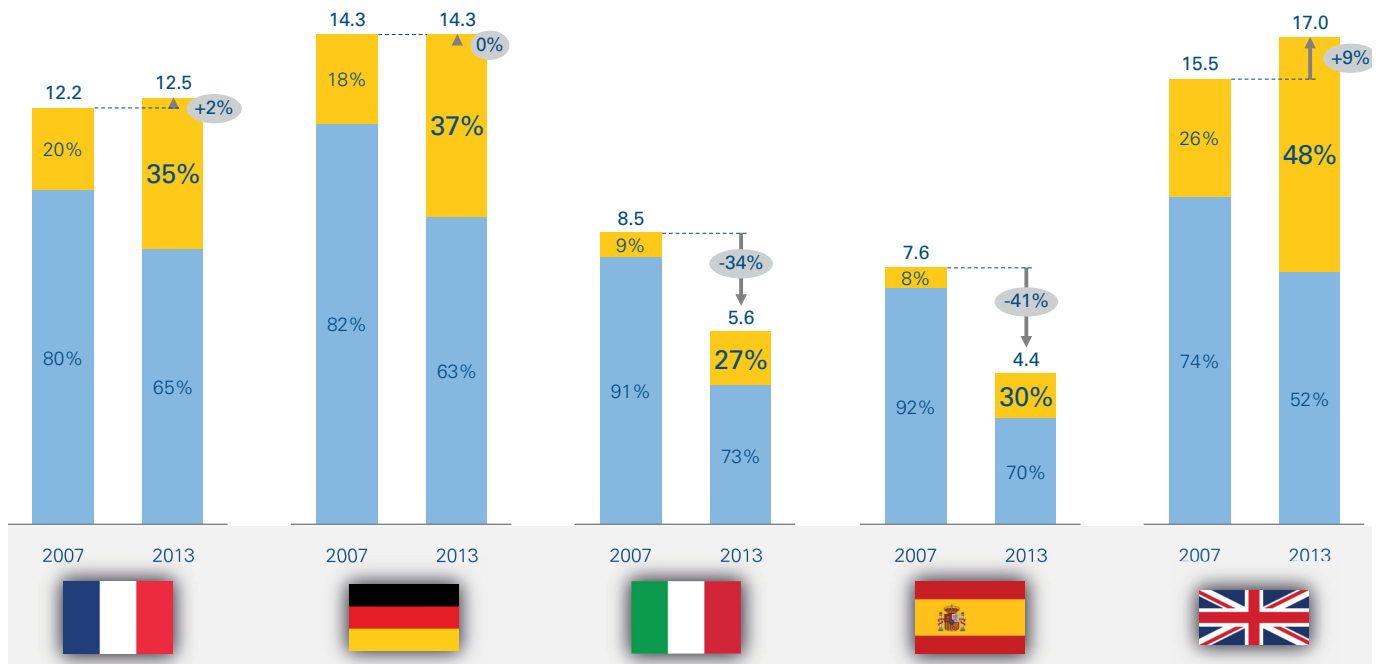
Traditional aggregators are on the front lines of the industry’s transformation. Since 2007, aggregators lost 16.9 billion in revenues, a decline of -25.3%. Their main source of revenues is advertising, the segment that has seen the fastest transition to online (38% of total advertising spend in 2013). In all EU5 markets, online advertising already accounts for close to or more than 30% of total advertising. This is 10 percentage points ahead of the online share of the overall media industry. In the UK, nearly half of all advertising has moved online; the growth in online advertising more than compensated for the decline in the offline advertising market in the UK, France and Germany. However, in Spain and Italy advertising markets contracted enormously, and online advertising could not compensate for the steep decline. Although distribution is extremely fragmented, the booking of online advertising is already concentrated on a few major ad exchanges (Bing ads owned by Microsoft, RightMedia owned by Yahoo! and DoubleClick owned by Google). The online share of 48% in the UK clearly shows that online advertising is close to competing with mass media on reach.

In Spain and Italy, traditional aggregators had to bare the brunt of the financial crisis while online aggregators saw their advertising revenue unaffected, and even grow, despite the crisis.

Traditional offline players are gradually moving into digital, but are not yet able to compensate for the revenue attrition in their core markets. Many of these players are still engaged in online business models that are rather an extension of their traditional business models, and are often not well adapted to new uses. Furthermore, a detailed study by Arthur D. Little on the organizational readiness of integrated media companies to exploit online channels and cross-media opportunities has shown that most media groups are still structured along vertical product silos (books, TV, magazines, newspapers, etc.). This was a successful organizational model for the 1980s and 1990s when scale in traditional media was important, but is a significant disadvantage in today’s rapidly evolving media landscape where speed, flexibility, and cross-channel delivery trumps benefits gained from economies of scale.

For traditional aggregators, the main issue is the significantly lower value (measured in CPM) of online advertising versus offline advertising. As the latter is based on a finite inventory (only a limited amount of minutes of TV programming can fit into 24h) and still has significant reach, this comes at a significant premium to online advertising even though the former in theory could be better targeted.

Figure 19: Online vs. offline advertising, 2007 and 2013



Source: Arthur D. Little analysis

■ Online revenues ■ Offline revenues

The fundamental dilemma for traditional aggregators thus is not the end game of being a profitable scale player in the online arena, but finding the right way to get there. For them, the transition cannibalizes the revenue in their core business and dilutes margins considerably.

The TV broadcasting segment has suffered considerably in particular in countries hit by the financial crisis. Although they experienced severe hits to their revenues, traditional aggregators in TV have managed to pass the majority of the impact through to the content creators. How have they managed to do so? The answer, in most cases, is consolidation.

FTA aggregators across Europe have built de facto duopolies, with market shares close to 83% of TV advertising, in the countries more affected by the crisis, as well as in countries like Germany (83%) and the Netherlands (75.5%), see Figure 21 overleaf. In Spain, for example, from four major groups only two, Atresmedia and Mediaset remain, after acquiring La Sexta and Cuatro, respectively, during the crisis.

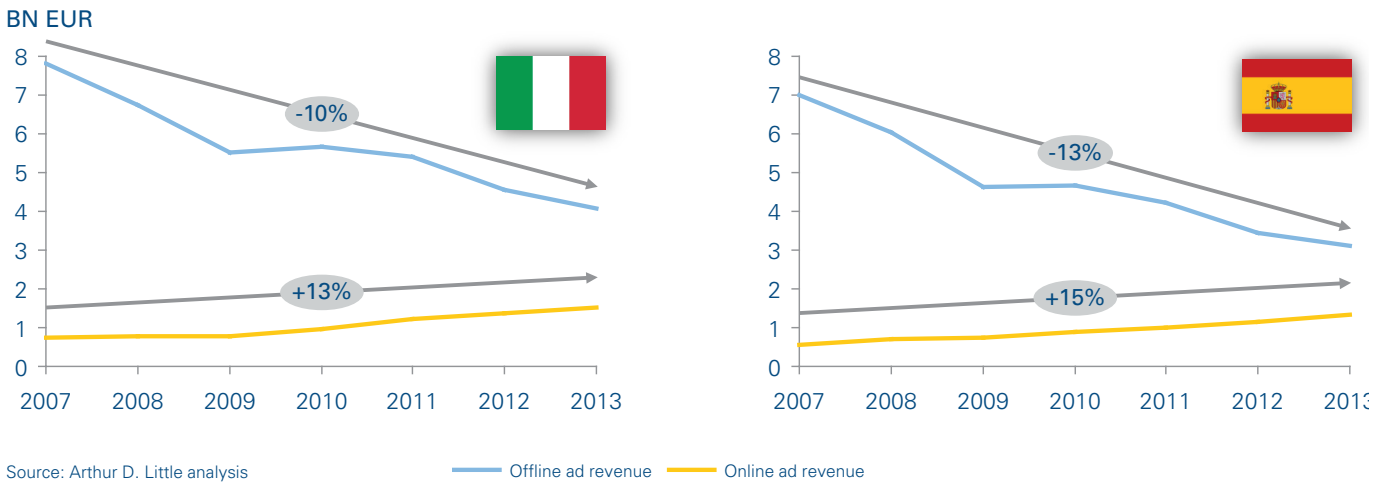
The market power achieved through consolidation has allowed aggregators to lower prices paid to content producers and rights holders. Online players have not yet been able to participate seriously in the bid for the rights as they still lack the critical size.

The transfer of value from offline to online generates a reshuffle within the ecosystem, and allows the emergence of new

business models. However, cycles of dis-aggregation and re-aggregation exist in all major media segments and so far only purebred online players excel in this virtuous game:

- **Print industry:** The internet enabled an explosion of online distribution of breaking news, with online portals exploiting the legacy time delay between editorial activities, printing and physical distribution. Meanwhile, twitter appears to be successfully re-aggregating the breaking news segment again (e.g. Kobane, Ukraine conflict,...).
- **Music industry:** the move from physical to digital music resulted in the collapse of the standard aggregation album model. After a period of single track download-to-own (DTO) as predominant distribution choice, online players like Spotify and Deezer further re-aggregated individual tracks to playlists and personal radios.
- **Film/TV industry:** the move from physical to digital resulted in an explosion of availability of home video titles, both on legal and, more extensively, also on illegal platforms. In TV, the emergence of catch-up TV and other online offerings strengthened the show/series brand over the TV channel's brand. Currently, this segment is highly fragmented with Video-on-Demand (Netflix, Amazon Prime Instant Video and maxdome) and Download-to-Own (iTunes and many illegal offerings) segments, as well as Linear streaming (Zattoo, Magine) vying for consumer attention. However, the business exhibits clear signs of being ultimately about

Figure 20: Advertising revenues, 2007–2013



Source: Arthur D. Little analysis

scale, thus the relentless ascent of Netflix, and associated consumption behaviors, such as binge watching, can be seen as the beginning of the re-aggregation.

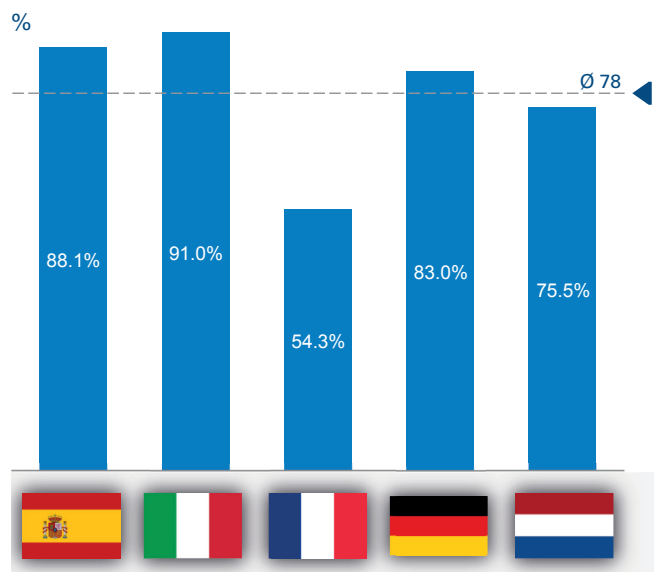
Pure internet players appear to be more successful in this game as they are free to develop innovative monetization/business models, without endangering legacy business lines. The newspaper industry, the first segment to be hit by the ascent of online, is an example of how long traditional players might take to find the right strategy. Twenty years into the transition and after applying the classic monetization models (banners, subscriptions), the major players in the press segment are only now starting to move into models more suited to new uses (targeted advertising, branded content, payment by article, market places).

Nearly all successful, internet business models are based on economies of scale and network effects. Scale players in the online business can wield significant power and have the potential to outcompete even dominant national media players. As only one of many examples, Netflix clearly proves that their online segment (online video) is a scale business resulting in a winner-takes-all competition. Netflix operates one central platform for a user base in excess of 50 million subscribers and can afford to invest \$100-200 million in the Graphical User Interface (GUI) and functionality of its product and in knowing its customers. Matching this scale of investment is difficult for players active in only one market or region, even if they are dominant. In the US, where Netflix clearly is a scale player, contribution margins are close to 30% and still grow exponentially. In their international business, they are in full expansion mode and accept measured short-term losses to achieve long-term leadership positions in key markets. The

Netflix business model, therefore, provides sizeable returns when running at scale and all that at a \$7.99 price point, which is nearly impossible for market followers to challenge.

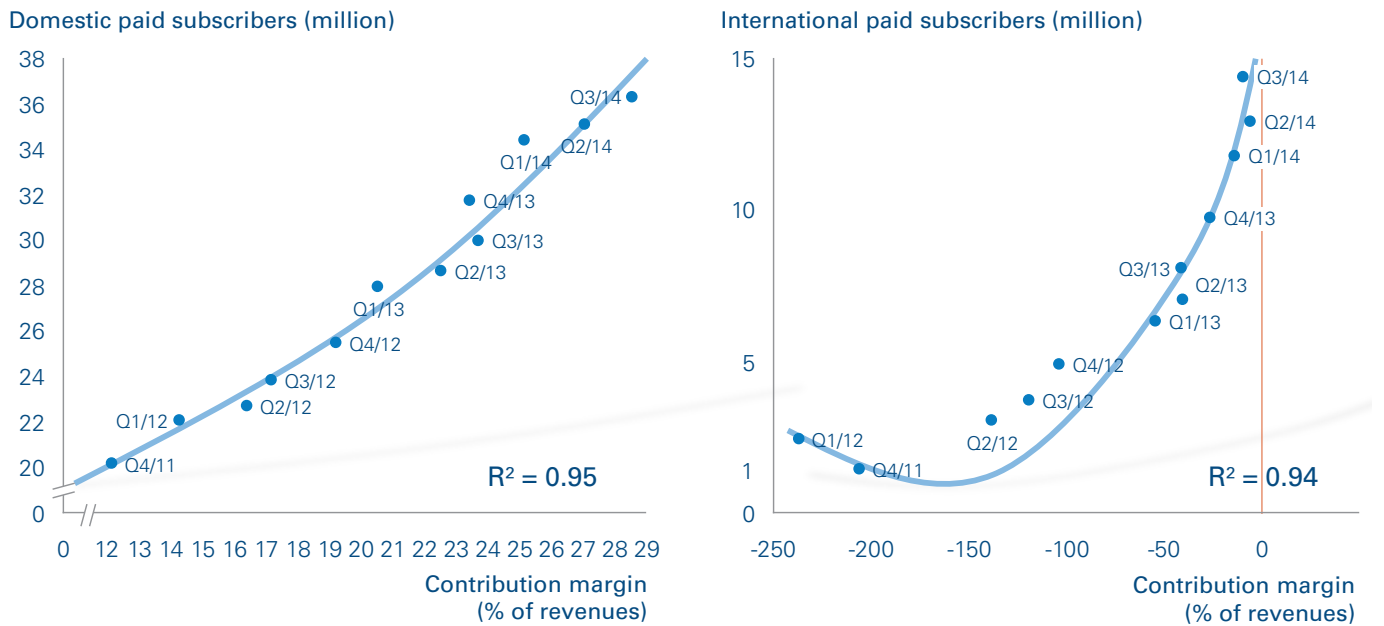
Many traditional players are, therefore, moving towards a hybrid business model that intertwines physical and digital activities. This requires significant organizational change including high online-media readiness and a high cross-promotion readiness. The New York Times, the Finnish group, Sanoma, and The Walt Disney Corporation are among the best-practice companies in this field. In particular, the latter is a brilliant

Figure 21: Market share of TV advertising revenue among the 2 main players



Source: Pnetworks

Figure 22: Netflix streaming subscribers and margin, 2011–Q3/2014

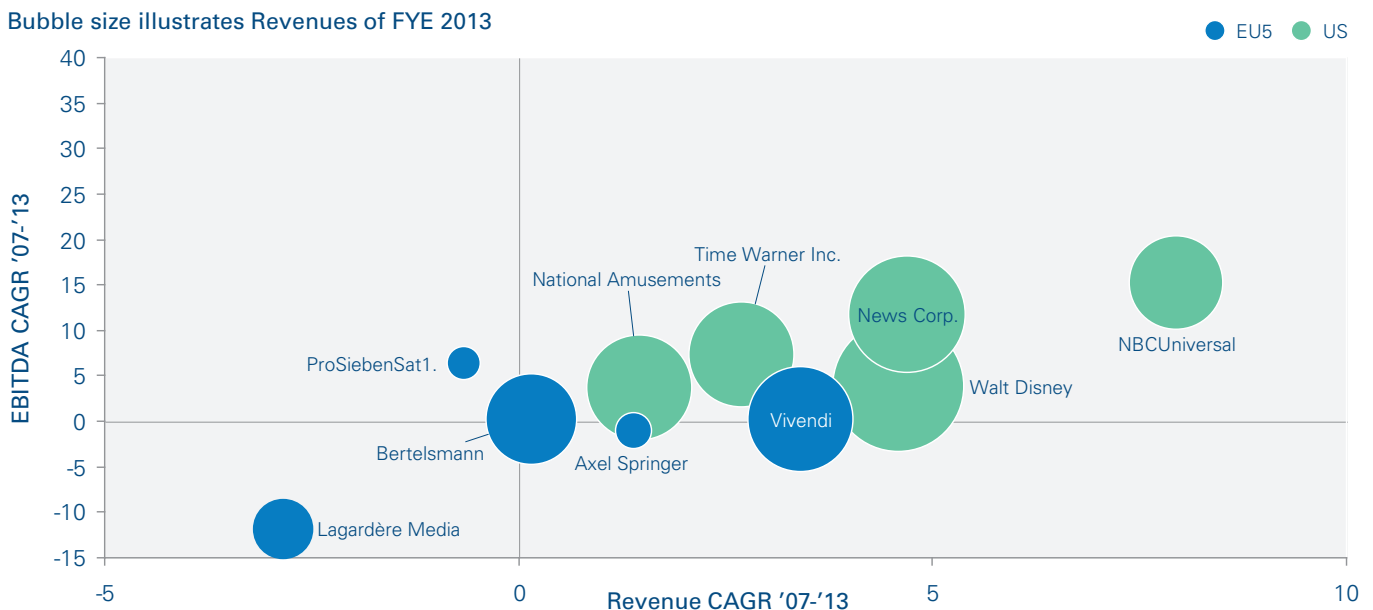


Source: Investor Relations, Arthur D. Little analysis Note: R² is a measure of accuracy of a trendline, with 1 being a perfect match

example of how a global, integrated media conglomerate can develop comprehensive product concepts maximum benefit of the media channels at their disposal. The concept *theme entertainment* (in filmed entertainment also called “*franchise*”) aims at forming a close and lasting relationship between the consumer and producer of a given media product. The

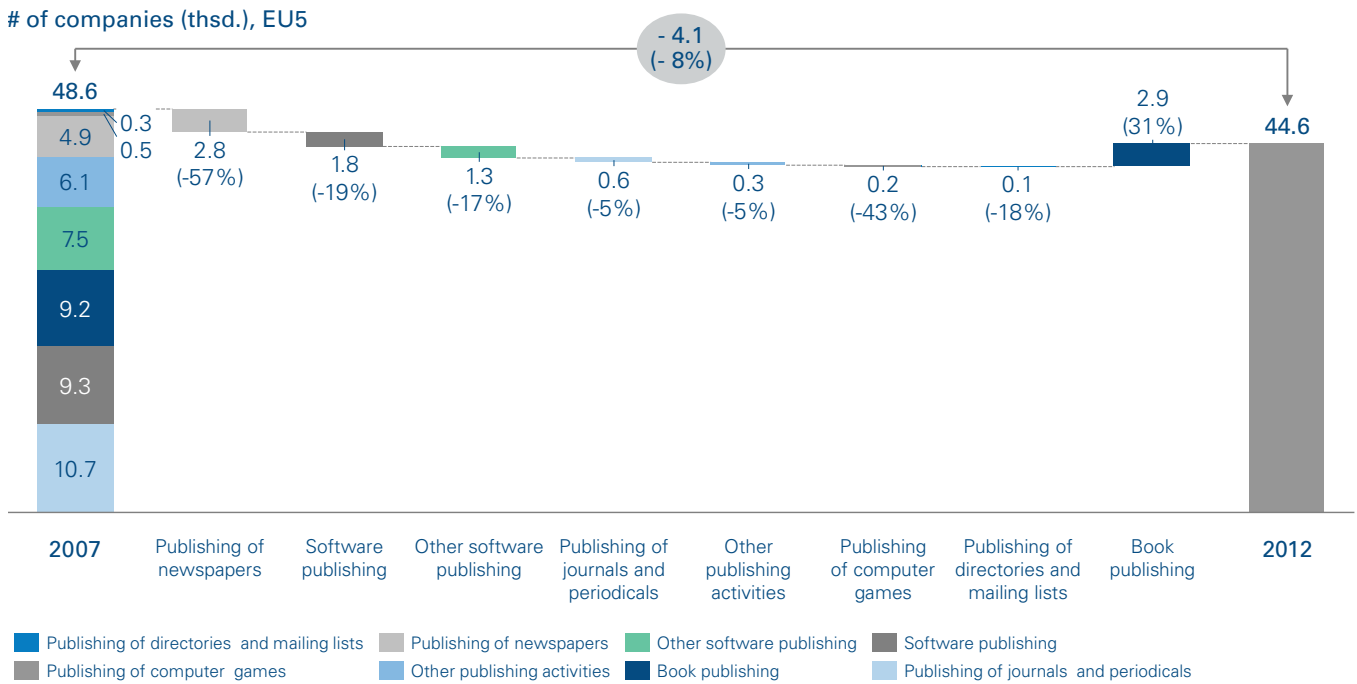
integrated media company creates a network of intertextuality constructed around a specific theme, thereby creating a self-referential world in which every channel (video game, motion picture, website, mobile apps, books, magazines,...) promotes the other. Miley Cyrus and the resurrection of Star Wars are just

Figure 23: Revenues and EBITDA CAGR, Top 5 USA, Top 5 EU media groups, 2007–2013



Source: Arthur D. Little analysis, Company reports, ThomsonONE NBCUniversal EBITDA growth for '09-'13 due to absence of earlier data

Figure 24: Registered companies EU5, publishing



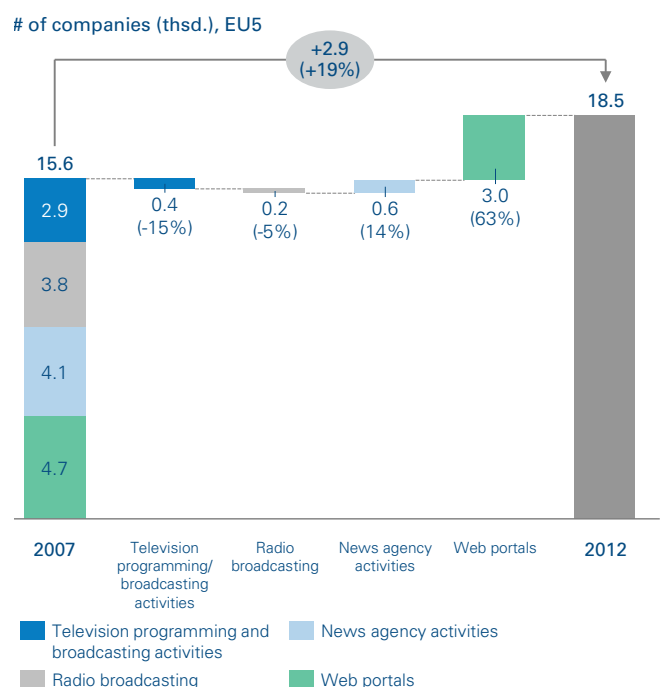
some of many examples of the multi-channel power of The Walt Disney Corporation.

As part of an extensive study on organizational design of large media groups, Arthur D. Little evaluated the financial performance of the world's top 10 media groups. With regards to revenue and profitability growth, US media corporations clearly outpaced their European peers between 2007 and 2013. Their focus on integrating individual media channels, a more prominent position of digital channels in the corporate hierarchy and a greater exposure to content production versus aggregation are key factors for the strong relative performance. European media groups are still struggling to create "theme worlds," online/digital channels are buried in level 3 or 4 of the organization and the operational focus lies mainly on aggregation rather than production.

This is a tough environment for traditional aggregators in Europe, as can be seen in key figures. In the publishing segment, the hardest hit were newspapers, software and games and directories, while there appears to be a small renaissance in book publishing, mainly in France and Germany.

A similar trend can be witnessed in the audiovisual segments with companies in television programming and broadcasting activities declining, while news agencies and web portals are increasing in numbers.

Figure 25: Registered companies EU5, broadcasting



2.3. The transformation works to the advantage of content producers and rights owners

Currently, content owners are the clear winners of the media industry transformation. Our quantitative analysis reveals that content producers and rights owners were able to increase the inflow of funds from previous value chain steps. In all EU5 markets, they are the second largest segment by revenues, except for France where they are the largest segment. Since content producers are the last step of the value chain and do not disperse funds back into the eco-system, they typically also retain the highest share of total value. The good news for these players though is that both indicators increased during the last 5 years.

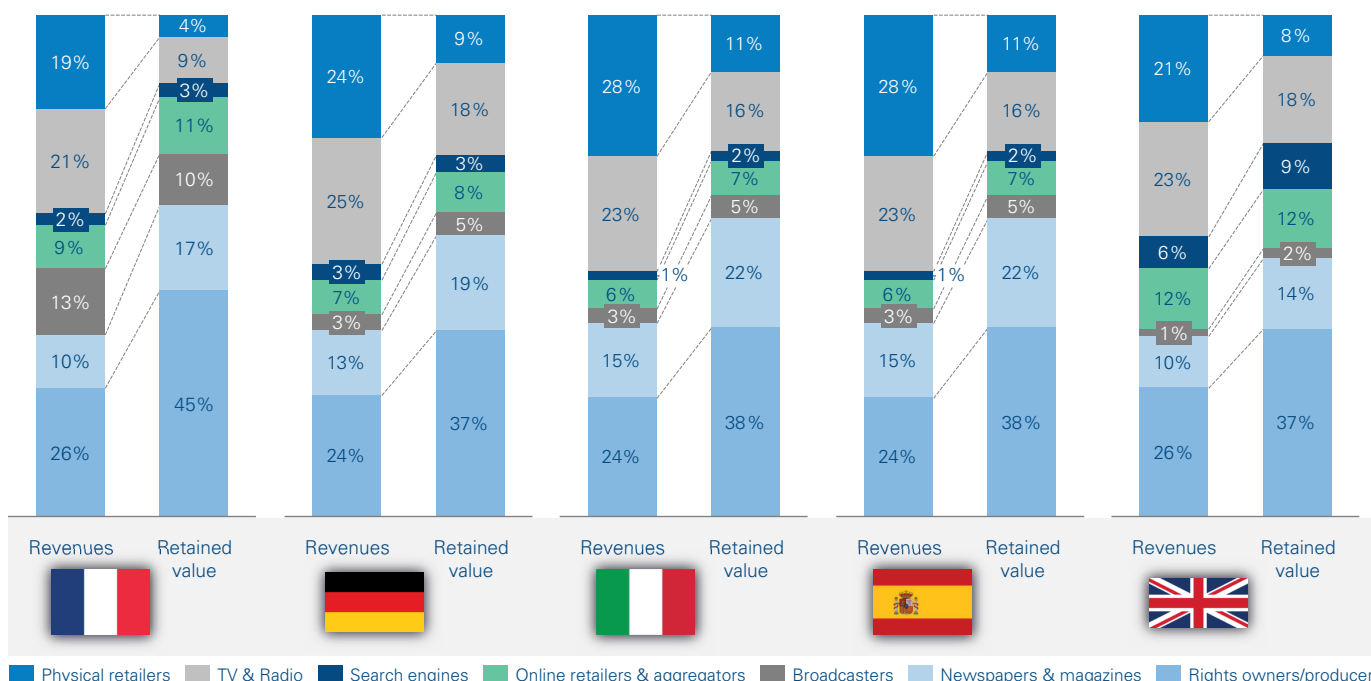
This advantageous situation for content owners is driven by a number of key trends: overall volume growth, more buyers, and consumer demand for higher quality content.

The industry is currently experiencing significant volume growth in consumption; the growth in online unit consumption has fully compensated for offline volume decline. This is driving value for content producers and rights owners, as many online business models are transactional (e.g. iTunes, TVOD, print, etc.), thereby directly benefiting from this volume growth.

With the emergence of online distribution and aggregation players, content producers and rights owners got new customers for their products. More buyers of content thus translate into more revenues. In addition, these new buyers are experimenting with multiple business models (subscription, transaction, free-mium) at the same time. So far, traditional players have been shielded by their size and higher profitability from direct competition from pure online players in content sourcing. However, as soon as pure online players (OTT) gain more scale and reach they will become serious competitors on the content wholesale markets and potentially even acquire content rights that were so far “reserved” for traditional players (e.g. exclusive sports rights).

Competition in both traditional and online segments is becoming more sophisticated. In the traditional segments, higher quality content is used as a key differentiator against existing and new competitors. In online segments, platforms are no longer focused on aggregation of free user-generated-content while leaving high-quality content to piracy. Legal music and video streaming/download services illustrate how competition moved to large catalogues and increasingly high-quality content. At the top-end of competition in music-on-demand (MoD), and to some extent also in video-on-demand (VoD), libraries are comparable in size and content. This is a result of pricing strategies of content rights owners, who are greatly favoring non-exclusive over exclusive licensing. As a result, a number of online players

Figure 26: Revenues vs. retained value, 2013



Source: Arthur D. Little analysis

Figure 27: Overview of selected VoD & MoD providers, 2013

	USA	Germany	UK	France	Italy	Spain
VoD	 	 	 	 	 	
MoD		 	 	 	n/a	

Source: Arthur D. Little

have started to invest in own content development in order to avoid price- or feature-based competition. The VoD segment is at the forefront of this development, with Netflix having recently announced the commissioning of a substantial amount of original programs for 2015. Amazon has also started to directly invest in content, both in its traditional book, as well as in its VoD business. This trend could also extend into other online segments, such as music or gaming.

Furthermore, our market interviews suggest that content producers and rights owners currently exploit their negotiation power vis-à-vis online players, and thus are able to charge higher content prices (measured in CPS in subscription models), than they charge their traditional customers. In some segments, unit prices can be up to 4-5 times higher for online content buyers. However, this pricing power will erode eventually and these benefits appear to be transitory.

Content spending by traditional Pay TV operators is still one of the most important growth drivers of overall content revenues. With the emergence of major VoD players and the weakening of FTA TV channels, the importance of premium sport rights for Pay TV operators has increased significantly. Therefore, auction results for key premium sports rights have seen new heights, growing strongly even during the height of the financial crisis. However, this trend could prove transitory if the consolidation in Pay TV distribution continues at the current pace.

Contents markets are quickly moving from an 80/20 to a 95/5 rule of distribution of revenues. While the dominance of “mega-properties” has always been the case in the TV and video segment, but these mega-properties are concentrating more and more of the available margin pool. On the other end of the spectrum, the number of free or freemium and user-generated content has grown exponentially. These two trends put additional pressure on all types of aggregators and also on content producers to bet on the right horse, while not being too dependent on one single product. This was one of the main worries of the management team of The History Channel, after the run-away success of their hit series “Vikings”.

The overall positive climate for content producers and rights owners is clear in company registrations (Figure 30). In the audiovisual segment, film/TV distribution is collapsing (51% of companies closed since 2007), while production and in particular post-production is booming.

Figure 28: Overview of selected Music-on-Demand providers, 2013

Content library (million tracks)

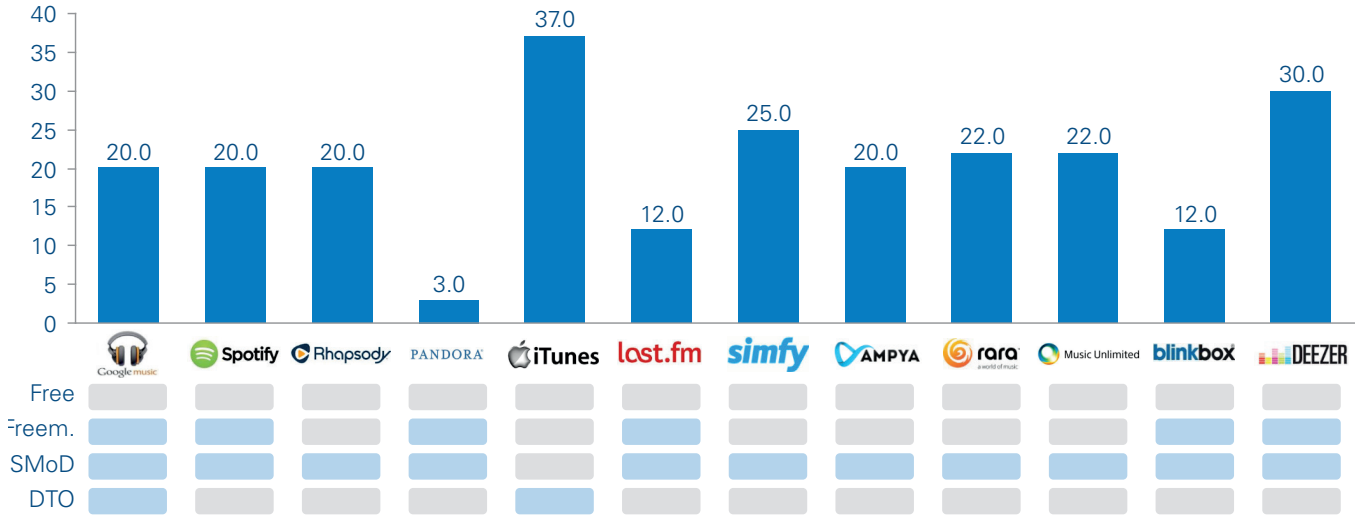
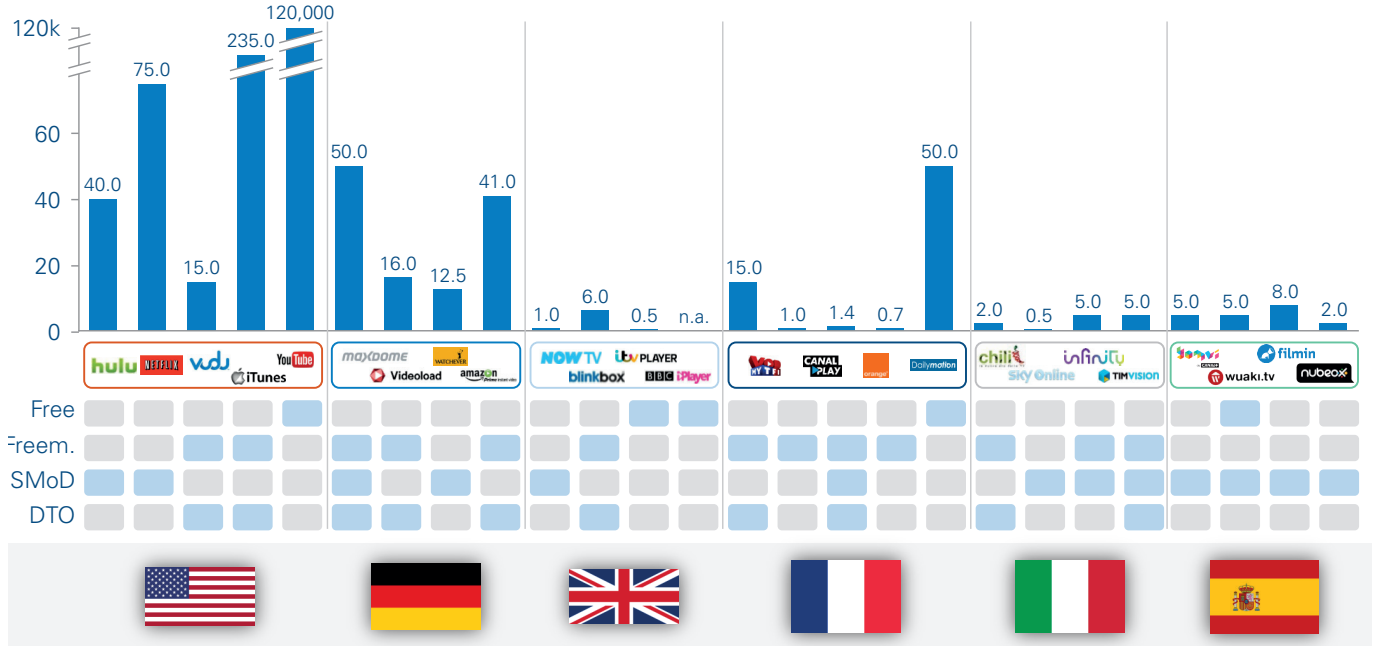


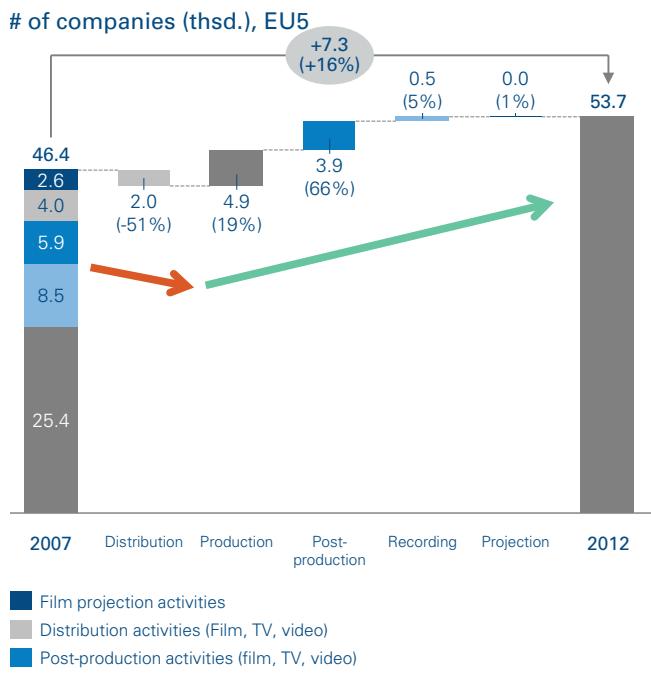
Figure 29: Overview of selected Video-on-Demand providers, 2013

Content library ('000)



Source: Arthur D. Little analysis 1) n.a. – 1.500 hours at launch 2007 2) incl. Warner Bros., Walt Disney; Universal Studios, Sony Pictures, CBS, HBO

Figure 30: Registered companies EU5, audiovisual segment



3. Highlights by Country

The key trends in the media sector over the last several years have not impacted the EU5 markets in the same way. In this section, we will provide an analysis of each market individually, assessing the trends in sources of funds, growth per media segment and per capita spending.

France has seen small, but steady growth (+1% CAGR), but an increase in public spending accounts for half of this growth. Online media developed well, compensating for losses in the offline sector. As online media is growing, digital migration remains a crucial point in upcoming years.

Germany, Europe's largest media market, exhibits small but positive growth (+0.7% CAGR), primarily driven by consumer spending and online revenues. However, online shares in all segments are still below most other markets and suggest considerable upside potential.

Italy's media industry had suffered significantly and revenues have fallen by -22,5% since 2007. Advertising, besides online, as well as consumer spending decreased drastically due to the recession, while public funding only increased slightly. The overall severe drop in the industry was compensated to a much lower extent by online media growth, compared to EU5 countries.

Spain contracted the most of all EU5 countries due to the financial crisis and lost more than 25% of its value between 2007 and 2013. Public funding is the only source of funding, which increased, while some segments held steady, others more or less collapsed (press). But the future seems bright, given Spain's high-speed broadband networks, a high penetration of connected devices among consumers, and an improving macro-economic situation.

The **United Kingdom** bounced back after the economic crunch with overall revenue CAGR of +3%. Losses in the offline media sector have been overcome by significant growth in the online sector. The UK has proven the most advanced market in media consumption, with a massive shift towards online, promoting soaring growth of online streaming and online content providers, despite falling sales of offline media.

3.1. France

The media and entertainment market slightly increased in France since 2007 (+6,2% between 2007-2013), however there are many industry dynamics behind this growth.

Non-public funds, such as consumer spending and advertising, remained stable in the period with a 0,4% CAGR growth. However, significant disparities exist between the different media. The press and magazine segment, which is strongly substituted by online offerings, experienced a sharp decline in advertising revenues (approximately -30% in 6 years). On the other hand, online advertising grew strongly (+80% in 6 years).

Public funds have significantly increased since 2007 from €3.1 billion in 2007 to €4.4 billion in 2013. This represents more than half the market growth over the period. This strong growth is due to (i) higher taxes on consumers ("contribution à l'audiovisuel public") and (ii) higher funding towards the CNC (Centre National du Cinéma et de l'Image Animée) coming from telecom operators.

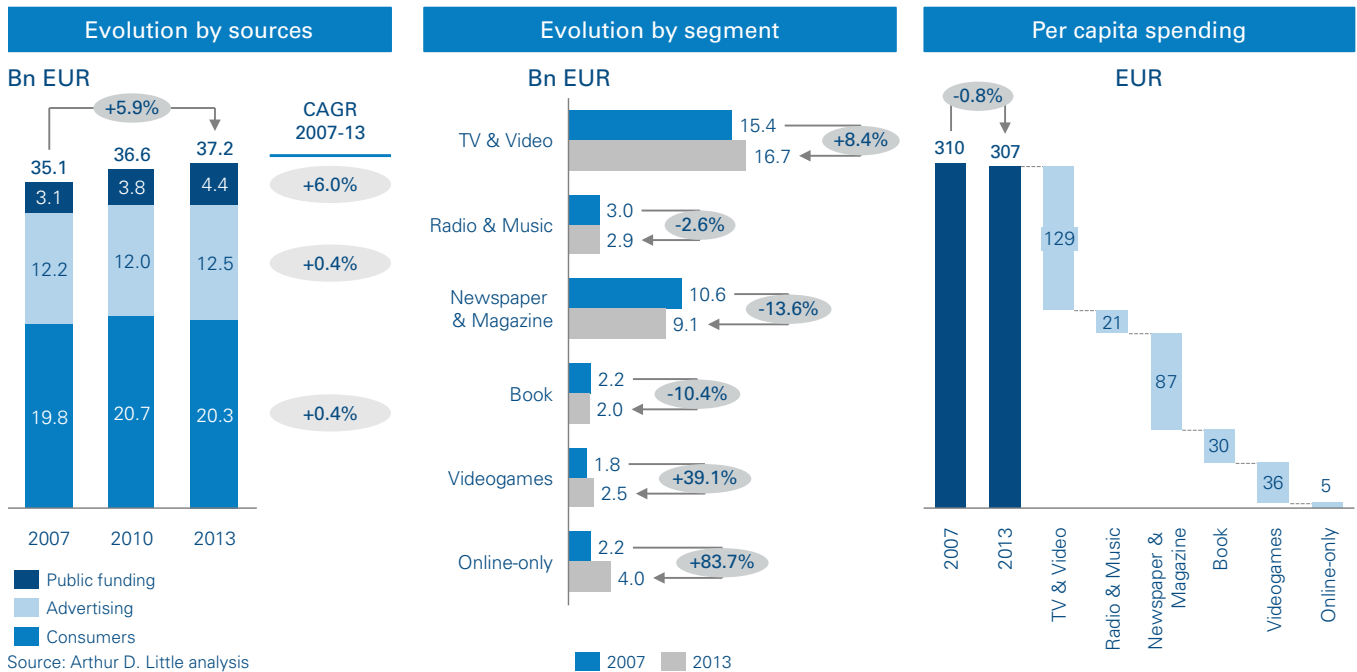
The expenditure per capita slightly decreased in 6 years from €310 per year in 2006 to €307 in 2013 (-0,8%). In 2013, consumer spending remained mostly composed of traditional media: TV and video, music and radio, and newspapers.

In France, the market growth is mainly driven by the development of online media (+ €4 billion in 6 years), while offline media showed a significant decline over the same period (-€1,9 billion). The pressure on the offline market would have been even more pronounced without public contributions.

Media segments are at different stages of their migration. TV & Video are resisting and are moving late on digital migration from a revenue perspective, with only 3% of revenues generated online despite an advanced migration of usage, as illustrated by the success of catch-up TV in France. This low migration is due to the important share of revenues generated by traditional TV. In other words, traditional television monetizes usages much better than online video. In addition, piracy and illegal use continue to be a major challenge for this sector in France.

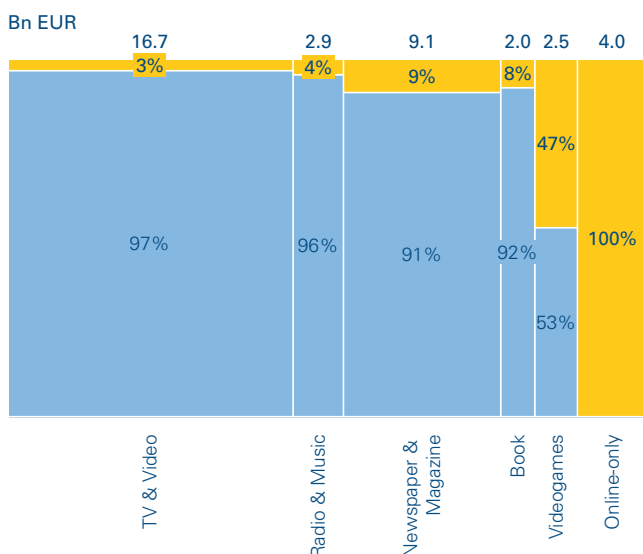
Another segment in full migration is publishing, which combines newspaper and books. This segment generates only 9% of its revenue via digital despite such usage now being democratized.

Figure 31: France – Evolution of sources of funds



Overall, the French media market demonstrated a strong resistance to the economic crunch. This was clearly also helped by governmental and regulatory policy measures. While usage is clearly going online, the market displays varying levels of digital migration from a value perspective. Nevertheless, digital migration remains the key challenge for players over the next few years.

Figure 32: France – Online share per segment



Source: Arthur D. Little analysis

3.2. Germany

After a slight dip during the financial crisis, the German media market has recovered, growing at a CAGR of 0.7% (2007-13) to approximately €49 billion in revenue in 2013. Even though the media market grew only half as much as the overall German economy in the same time period (GDP CAGR 2007-13 of 2.0%), the German media market remains the largest in Europe. However, considering that part of the growth was triggered by a change in the public license fee system in 2013, in order to fight against fraud, the growth outlook appears weaker.

In contrast to the other EU5 countries, German consumers are the key to growth of the industry. Despite the crisis, consumer spending in media continuously grew from 2007 to 2013. With an increase of about €0.7 billion (2007-2010) and a further €1.1 billion increase between 2010-2013, consumers have stabilized the industry considerably. The increase in consumer spending was certainly supported by the strong development of the overall German economy. The media offers for consumers are becoming more diverse and are fulfilling new usage demands more effectively, as a large number of connected devices are already in consumers' hands. In particular, the market for OTT content in Germany has recently accelerated. This can be witnessed in the music segment in the increasing subscriber numbers of Spotify and Deezer, and by international players, such as Amazon Video, Vivendi and Netflix, attacking established domestic players by entering the

Film and TV segment, such as maxdome. These developments are also underlined by the results of our analysis, which shows a clear increase in TV and online-only spending per capita of approximately 6% and 112%, respectively, since 2007.

Traditional print media, such as Newspapers & Magazines, have again seen a significant drop in market revenues of -16% from 2007 to 2013. This result is partially caused by the stagnation in advertising spend in Germany during the same time period. Our analysis clearly shows that advertisers in Germany have shifted budgets online and cut advertising spend. On the other hand, this drop in revenues shows that traditional media players are still struggling to adapt to shifting consumer habits. Only a few players, such as Axel Springer AG or ProSiebenSat1, managed to shift their business model from offline to cross-media effectively, generating considerable revenues online. In their latest investor communication, Axel Springer AG announced strong performance on all financial KPIs (revenue growth, EBITDA growth, net income growth) and their digital business has sharply increased its share of revenue and earnings, now accounting for more than half of revenues and more than two-thirds of EBITDA. ProSiebenSat1 generates more than 20% of its revenues and more than 16% of its EBITDA from digital and adjacent activities.

With traditional and offline media revenues declining and business models changing, it is more important than ever for traditional players to secure revenues and value. Our analysis

Figure 33: Germany – Evolution of sources of funds

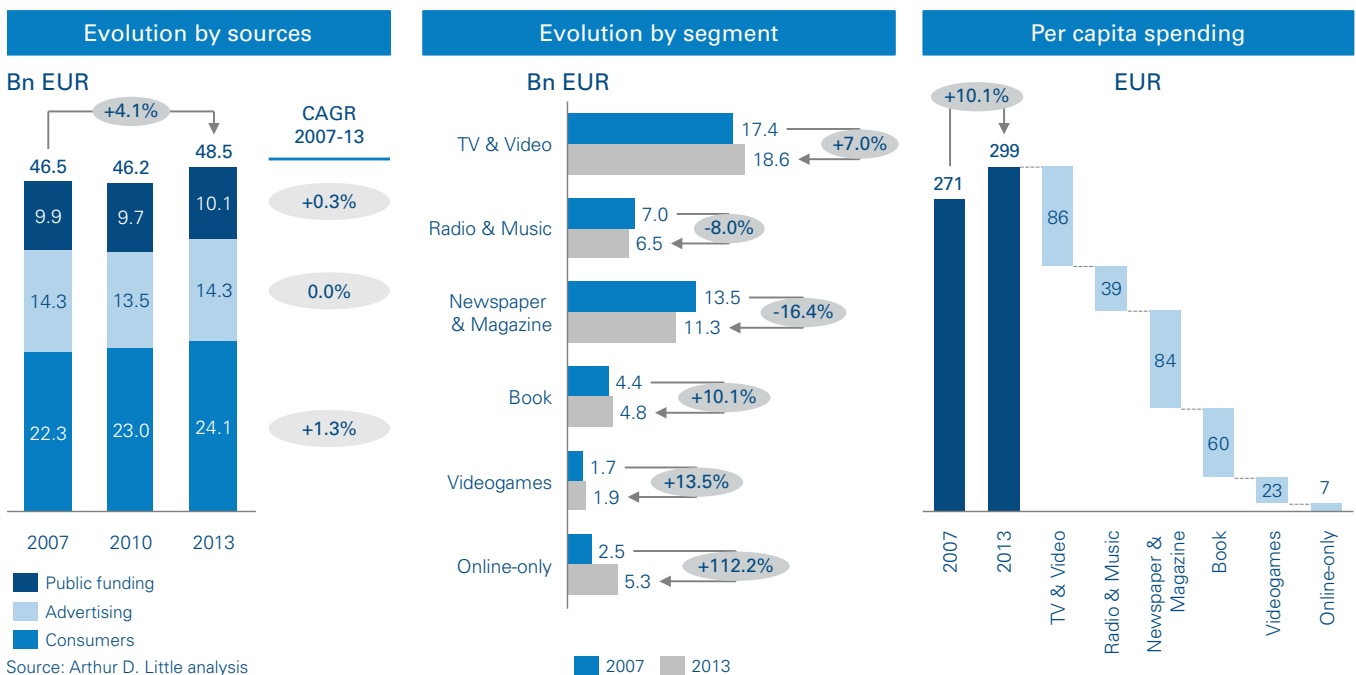
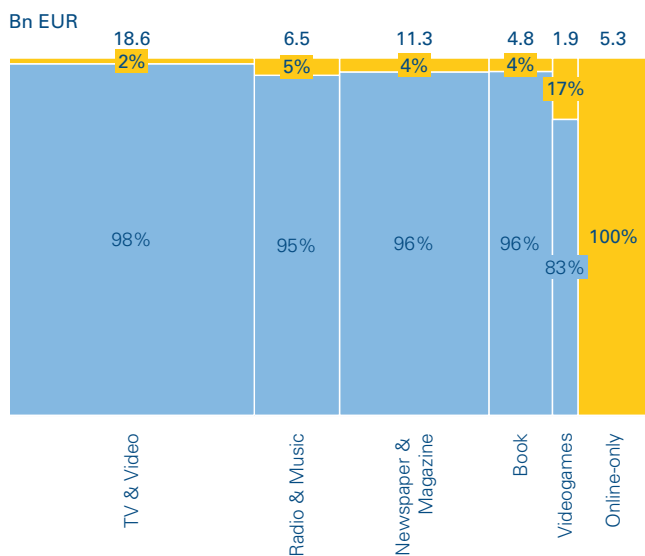


Figure 34: Germany – Online share by segment



Source: Arthur D. Little analysis

shows that content producers and rights owners have been the most successful at securing revenues and retaining value in the media industry. However, one reason for the successful development of content producers and rights owners is the demand for original, local content. In Germany, players will continue to benefit from this global trend.

While content producers have been managing well, other players in the industry are working hard to secure revenues and manage the transition from offline to hybrid or full, online players. Comparably low online shares in all segments versus France, the UK or Spain, suggest solid growth potential in Germany. Overall, the online segment is already strong enough to more than compensate for the drop in offline revenues from 2007-2013. However, it currently accounts for only 14% of total industry revenues, well behind the UK (27%), France and Spain (18%). Hence we expect strong growth in online across all major segments, in particular TV & Video, as well as books and newspapers.

3.3. Italy

The Italian media industry has suffered significantly over recent years. From 2007 to 2013, revenue showed a -22.5% CAGR and reached an overall value of approximately €19 billion, down from €24.4 billion.

Advertising and consumer spending dropped due to the economic downturn, while public funding, which is lower than that of other EU peers, increased only slightly. Advertising was especially affected by the crisis and its contribution to Media dropped from €8.5 billion in 2007 to €5.6 billion in 2013 (-34%). The only good news came from online advertising, which increased from €0.7 billion to €1.5 billion (+104%) during the same period.

Among the media industry segments, Newspaper & Magazines were the most affected (-41.5% between 2007 and 2013), followed by TV & Video (-22.3%); as they are especially linked to the collapse in advertising expenditure and consumer spending. On a per-capita basis, Italians spent €244 in 2007 and just €193 in 2013, a -21% decrease in the 2007-2013 period. TV & Video (30%) and Newspaper & Magazines (34%) are the media in which Italians spend the largest share of their entertainment budget, in which online media still represents an embryonic 3%.

Furthermore, the significant drop in traditional, offline media in Italy has not been – unlike in other European countries - fully offset by the growth in the online segment. In particular, the

digital shift towards online distribution (e-Papers, e-Books, video and music, videogames, TV) has been slower when compared to other European countries. This delay is at least partly due to the lower penetration of broadband (Italy has the lowest fixed broadband penetration rate among EU5) and connected devices, especially smart TVs and tablets.

The online media segment increased by 147% between 2007 and 2013 in Italy, and now represents 14% of the total media revenue, compared to its former 4% in 2007. On a per segment basis, Videogames reached the highest share of online revenues (14%), followed by Radio and Music, which reached 7%. However, online TV & Video is still marginal in Italy and was only able to reach a 2% share in its segment's revenue mainly because traditional Pay-TV operators offer online services, such as Sky Online and Mediaset Infinity, to try to prevent the entry of international OTT players, such as Netflix, in the Italian market.

Online segments are expected to grow in the coming years, but they will still represent a limited volume compared to traditional media, especially considering that some segments, such as TV & Video, are expected to see a recovery in their traditional, offline business, due to the general economic recovery.

Figure 35: Italy – Evolution of sources of funds

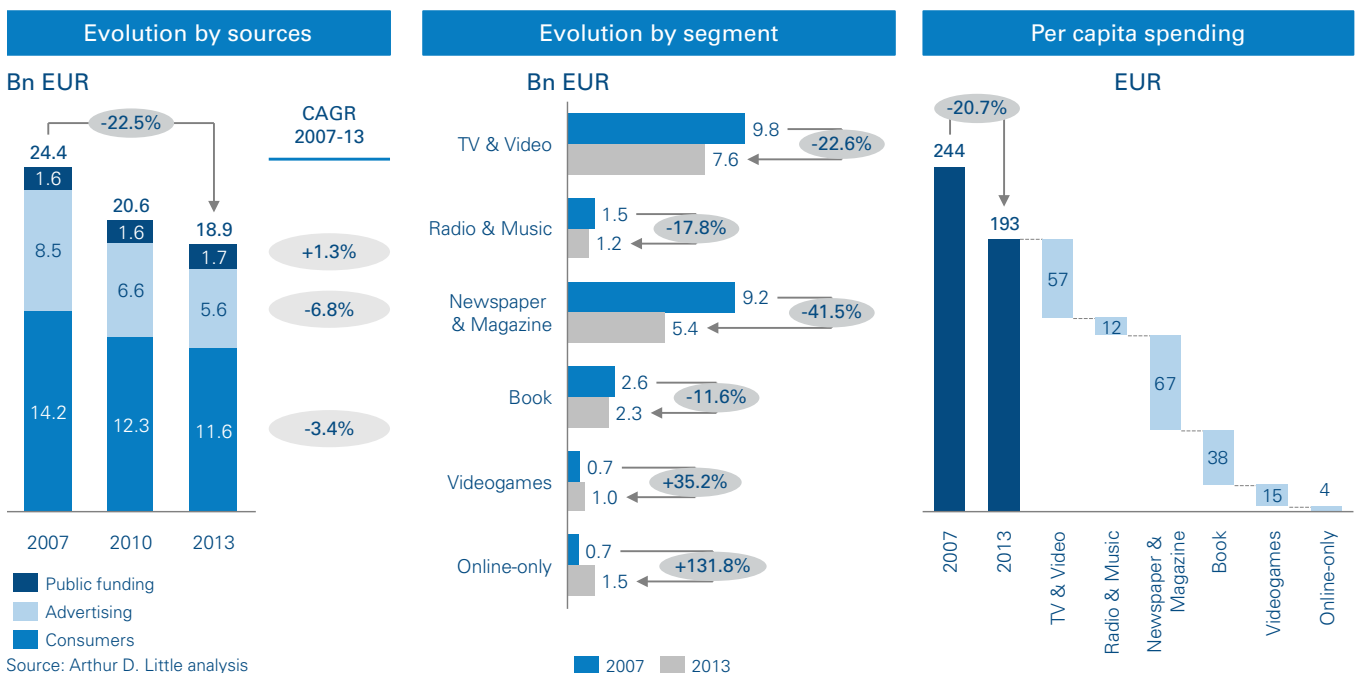
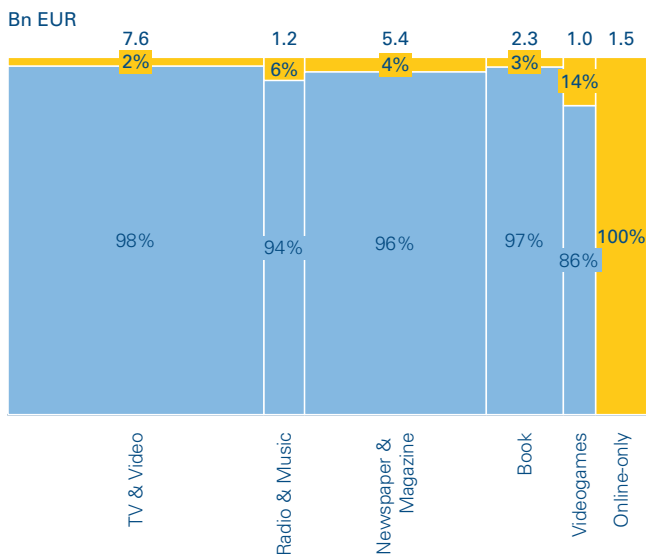


Figure 36: Italy – Online share by segment



Source: Arthur D. Little analysis

3.4. Spain

Spain has been in economic recession since the second half of 2008, with GDP decreasing by around 3% between 2007 and 2013. Meanwhile, revenues in the media and entertainment sector decreased from €17.7 to €13.2 billion, or €4.5 billion

(-25,5%). This sector has been one of the most adversely affected by the crisis, with a decrease in spending between 2007 and 2013 that was more than threefold that of other sectors, such as Transportation or Tourism & Hospitality.

From a sources of funds perspective, consumers reduced their contribution by €2.1 billion (CAGR 2007-13 of -4.3%), but maintained their relative weight in the sector funding. On a per capita basis, Spaniards spent €200 on media in 2007 but less than €150 in 2013. The advertising market virtually collapsed, falling by €2.8 billion (-8,5% CAGR) and driving the overall market decline, while public funding was the only contribution that increased (+€700 million, and CAGR +8,4%, 2007-2013).

The revenue decrease, however, was shared in-equally across industry segments. Online-only segments have been able to grow while traditional ones could not cope with the combined effects of the crisis and digitization. The worst hit segments have been Newspapers and Magazines and Radio and Music, with a decrease of -51% and -38%, respectively. Books and even Videogames lost over a quarter of their revenue while TV & Video lost 20%. Specifically Pay TV performed better than FTA, falling by only 10%, and achieving higher revenue than the latter for the first time ever in the country.

In recent years, the Spanish society has experienced an accelerated transition towards the digital world. As a consequence of this shift, the size of the online media and

Figure 37: Spain – Evolution of sources of funds

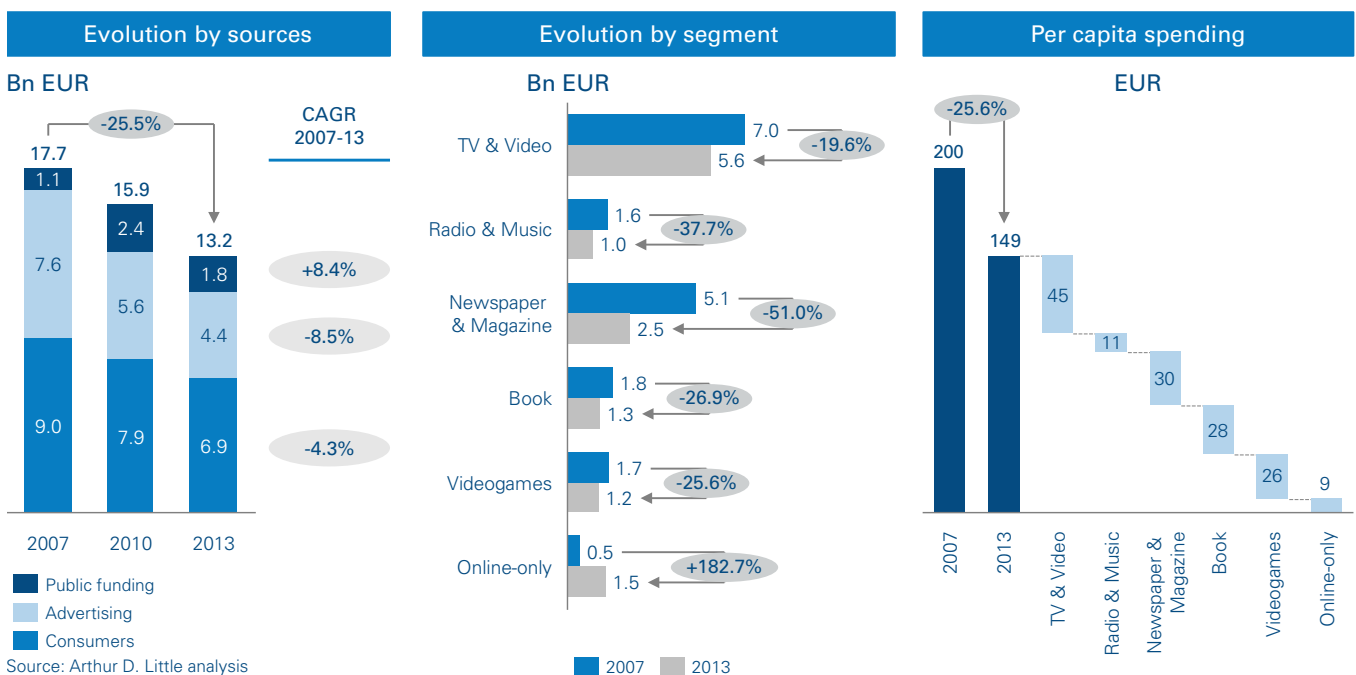
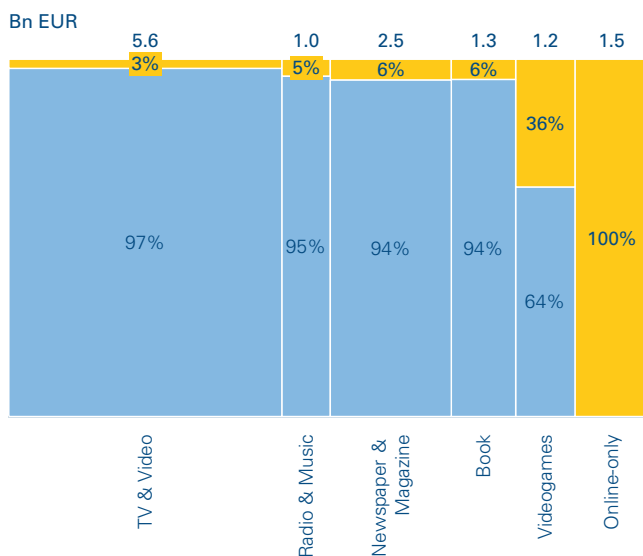


Figure 38: Spain – Online share by segment



Source: Arthur D. Little analysis

entertainment sector increased by 186%, amounting to €2.4 billion by 2013. Online represents 18% of the total media and entertainment market, up from 5% at the beginning of the period. Online growth has not been enough to offset the offline drop, but surely softened the fall by covering 25% of it.

Consumer habits and offerings prove that the Spanish society is advancing towards digitization, in line with other European countries. Nevertheless, the monetization of the online market in Spain is far from that of the major European nations. The fundamental basis for the development of the digital sector exists, but the revenue has not yet arrived. A reason might be the impact of piracy. Studies estimate the Spanish online market would double without piracy, which has the greatest impact on fiction and increasingly premium soccer; La Liga estimates lost revenue from piracy amounts to €150 million per year.

From a value retention perspective, content producers and rights holders have been very successful. TV broadcasters consolidated into two groups that gather close to 90% of the TV advertising market and were able to pass the pressure through to local fiction producers. However, the main premium rights holders managed to increase their revenues. The best example is La Liga soccer rights, which renewed deals with over a 30% increase.

Economic fundamentals indicate that the Spanish economy will recover starting in 2014. Furthermore, telecom operators are competing fiercely to deploy NGA networks, and FTTH is expected to reach over 76% of households in 2016. Analysis

suggests that most of the potential to be captured in the media and entertainment sector will be generated within the digital markets.

The moment to seize the opportunities in the digital world has arrived for all the players in the sector. Telco operators have been the early movers, as they need to justify the need of an NGA access by strengthening their digital video offer. For example, Telefonica is in the process of acquiring the leading Pay TV, Canal+).

3.5. United Kingdom

The UK media industry has bounced back after the financial crisis; primarily driven by growth in the online segment. Between 2007 and 2009, media industry revenues dropped to €40.5 billion (€42.5 billion in 2010), a decline of 9%. Since then, the industry has returned to growth (CAGR of +3%) to reach revenues of over €46 billion in 2013. This growth can largely be attributed to four factors:

- An increase in public funding
- Renewed expenditure by advertisers
- Increasing population, and
- A rise in consumer spending per capita on media services.

There has been an overall decline in per capita spending on media services between 2007 and 2013 that can be largely attributed to a precipitous decline of discretionary spending. Since 2009, while the underlying UK population has increased by 0.9%, the consumer revenues have increased by 1.7%. This additional 0.8% growth can be attributed to higher expenditure by consumers, including higher prices, larger bundles of media services consumed, etc.

Along with the surge in pure online segments, the TV & Video and Gaming (Videogames) sectors are witnessing an upward trend. On the contrary, revenues in the Newspaper

& Magazines, Radio and Music sectors remain in decline on aggregate.

TV & Video revenues have been growing in the UK; however, there are some fundamental shifts in how the Audio Visual content is being consumed. Between 2012 and 2013, the average time spent watching TV was 232 minutes, nine minutes less per day than in 2012. While the time spent on TV by the younger age groups (16-24 years) had been declining steadily since 2010 (169 minutes in 2010 compared to 148 minutes in 2013), in 2013 there was a decrease across all age groups for the first time. Also, more and more media is being consumed away from the TV; tablets and smartphones are increasingly becoming the choice device for some key segments and age groups to engage with content.

The growth driver for the TV & Video sector has been Pay-TV subscription revenues, which have continued to increase at 2% p.a. to reach approximately €6.3 billion. Additionally, online streaming services have become very mature in the UK. There are a large number of diverse service providers, including traditional Pay-TV players (Sky, Virgin), global OTT players (Netflix, YouTube, Amazon Prime), fixed players (BT, TalkTalk), mobile-only players (EE, VF) and retailers (Tesco), which give consumers plenty of choice in how to access content.

Figure 39: UK – Evolution of sources of funds

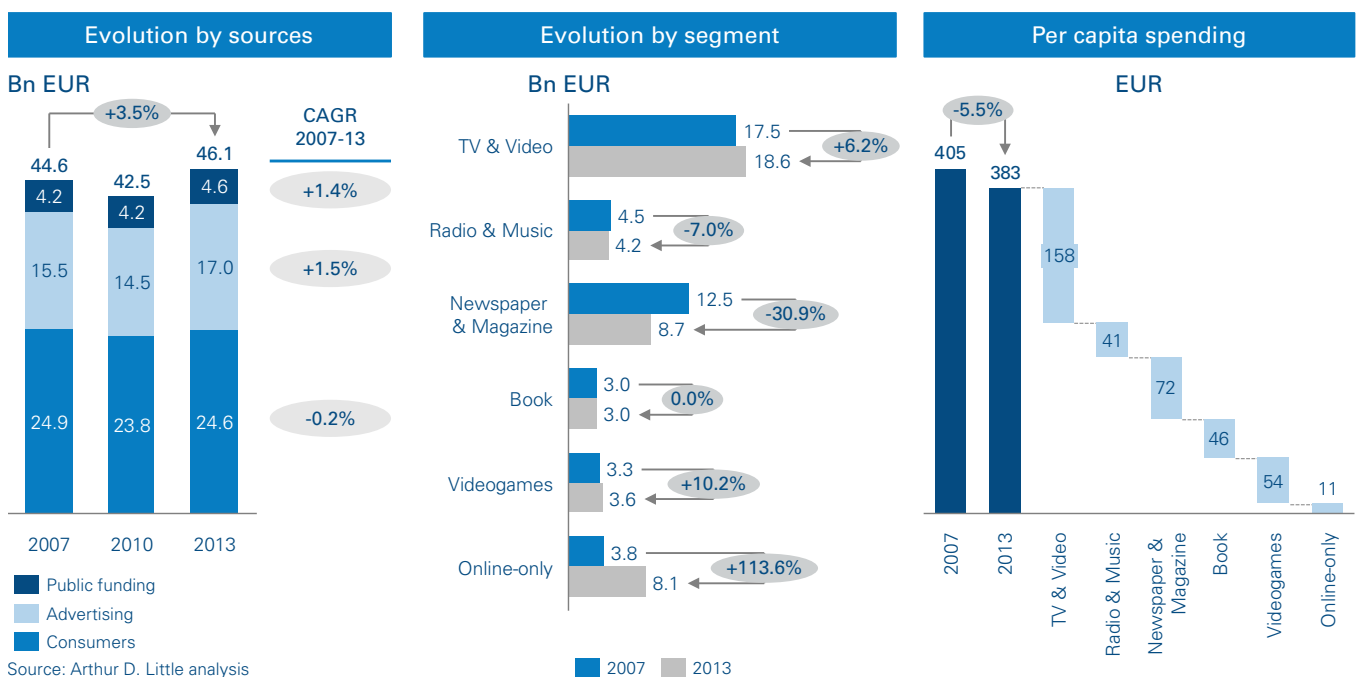
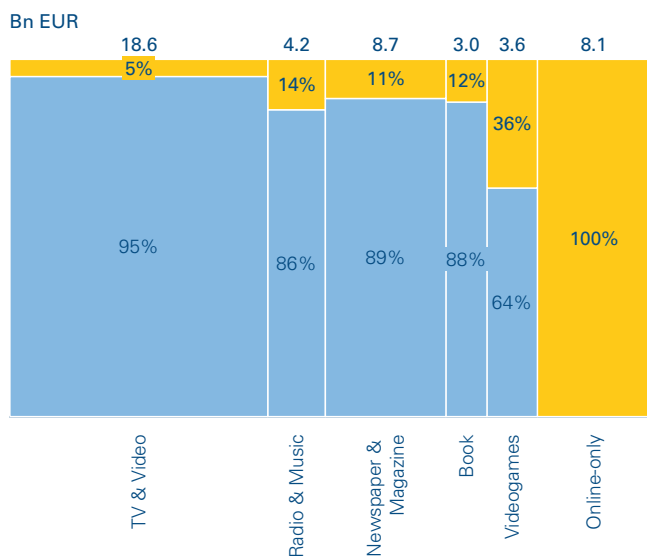


Figure 40: UK – Online share by segment



Source: Arthur D. Little analysis

The growth in streaming music services, like Spotify, Deezer and Xbox music, has slashed sales of physical recorded music with sales declining from €1.5 billion in 2007 to just under €0.7 billion in 2013. However, audiences do continue to visit music concerts and festivals, with revenues remaining stable at €1.3 billion during the time period, as the industry tries to better monetize the live experience.

The Newspaper and Magazine industry has suffered from the proliferation of “free news” via internet and mobile websites. The drop in the number of subscriptions coupled with declining print classified advertising has been a key reason for deteriorating revenues in this industry segment.

The gaming sector has proliferated much beyond the confines of hardware / console games to cloud-based, as well as mobile and tablet gaming. This has also influenced the demographic composition of the traditional gamer; a majority of video game players are now women (52%).

In the UK, online growth (€7.2 billion) has more than offset the drop in offline segments (€5.6 billion), thus increasing the overall market by €1.6 billion. The online segment now contributes over a quarter of total media revenues (€12.2 billion), compared to just 11% in 2007 (€5 billion) representing 150% growth. While it is clear that digitization has created overall growth in the UK, the growth was not evenly split across all segments.

Some segments like online advertising have witnessed revenue growth from €4 billion to over €8 billion over the last 6 years; some other segments, such as print media (Newspapers

& Magazines) have been negatively affected. In the case of newspaper and magazines, offline revenues have declined by €4.5 billion, however the online revenues have only increased by €0.6 billion (approximately 15% of offline decline). The difficulty faced by traditional media houses, such as News Corporation, Press Holdings and Trinity Mirror, in monetizing their readership can be attributed to a number of factors:

- Availability of free news from several sources, such as newspaper websites (guardian.co.uk, metro.co.uk), TV broadcasting websites (bbc.co.uk, news.sky.com)
- Aggregator news sources (Google news, Yahoo News)
- Specialist websites that cater to different user needs, such as sports news (espn.co.uk, goal.com), technology (techradar.com, cnet.com, the register)

Our study on the existing flow of funds in the media sector, from its source to retailers, aggregators and content producers, aims to identify received, retained and transferred values for each participant. This analysis clearly indicates that some sectors are performing much better than others.

- The traditional physical retailer segment has been one of the hardest hit. Even though they receive 21% of overall sector revenues, they are able to retain just 8% of value (a retention ratio of 38%).
- Rights owners and content producers generate 26% of revenues, but retain 37% of value (a retention ratio of 145%).

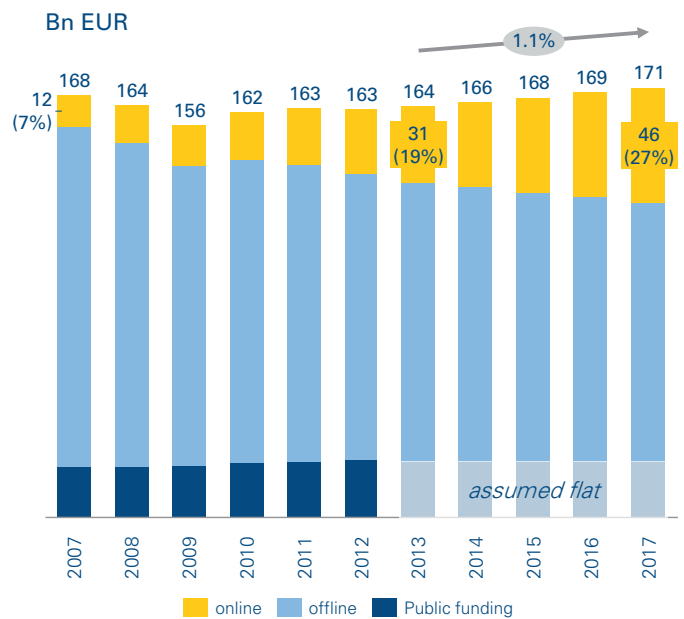
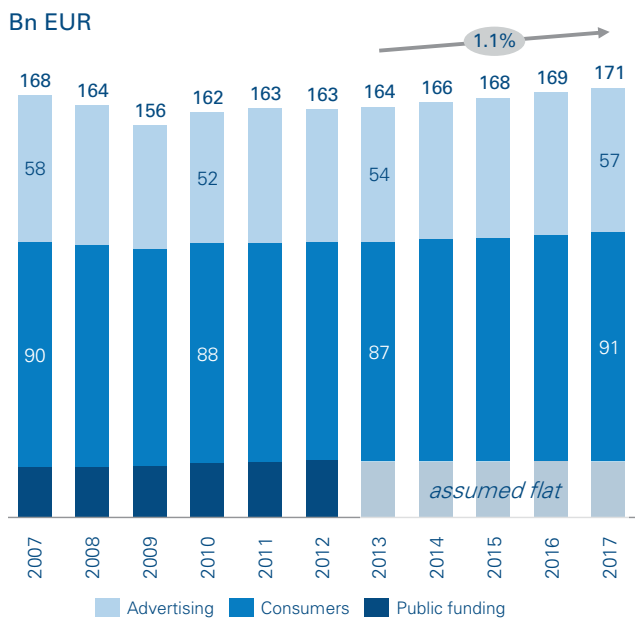
As content becomes central to players’ growth strategy, and thus more expensive, we will continue to see more consolidation, either via acquisition or via partnerships, between traditional broadcasters and online media companies, as well as between content and production houses.

Despite a strong underlying growth in UK’s macroeconomic factors, such as a increasing GDP, growing population, lower unemployment, and average wage rises back above inflation for the first time since the economic crisis of 2008, the growth rate in the media sector might not sustain the trajectory witnessed in the last few years and could moderate. In the short term, the explosion in the choices available to consumers to watch content (via Pay TV players, OTTs, telecom companies, retailers, etc.) will put price competition pressure on players. As content becomes increasingly important, we will see some consolidation in the sector, either between telecoms and PayTV players or via acquisition of content producers. There could be some moderation in the recent rise in content costs as Ofcom makes it mandatory for BSKyB to make available Sky Sports content to BT’s Youview customers. Whether the BBC’s license fee

(currently a £145.50 tax per household with a color TV) continues beyond March 2017 is also uncertain. The BBC's charter will be reviewed, and there may be calls to replace the license fee funding model by either an ad-funded model or a subscription fee, which will most probably have a detrimental effect on the overall inflows on the media sector, at least in the short term.

4. 15.1bn€ of online growth are expected until 2017: grab them!

Figure 41: EU5 media market by type of funds



Source: Arthur D. Little analysis

EU5: UK, Germany, France, Italy, Spain

Based on the observed market trends in the period from 2007 to 2013 and supported by extensive market interviews, Arthur D. Little has developed a granular forecast of consumer spending and advertising revenues until 2017. Public funding was assumed to be flat over the period, given the budget pressure most of the EU5 countries will face during the forecast period. Current market dynamics suggest that the EU5 media industry is headed back to growth, albeit at ~1.1% CAGR. However, the online share of the industry will continue to expand significantly, reaching 27% of total revenues by 2017.

Consumer spending will be the main absolute contributor to this growth. This net growth of €3.8 billion is a result of strong online revenue growth over-compensating the decline in traditional media. However, significant differences across markets in online shares of consumer spending will remain. Spain and the UK are already more developed “online consumer” nations, while Germany, Italy and France will still need to catch-up.

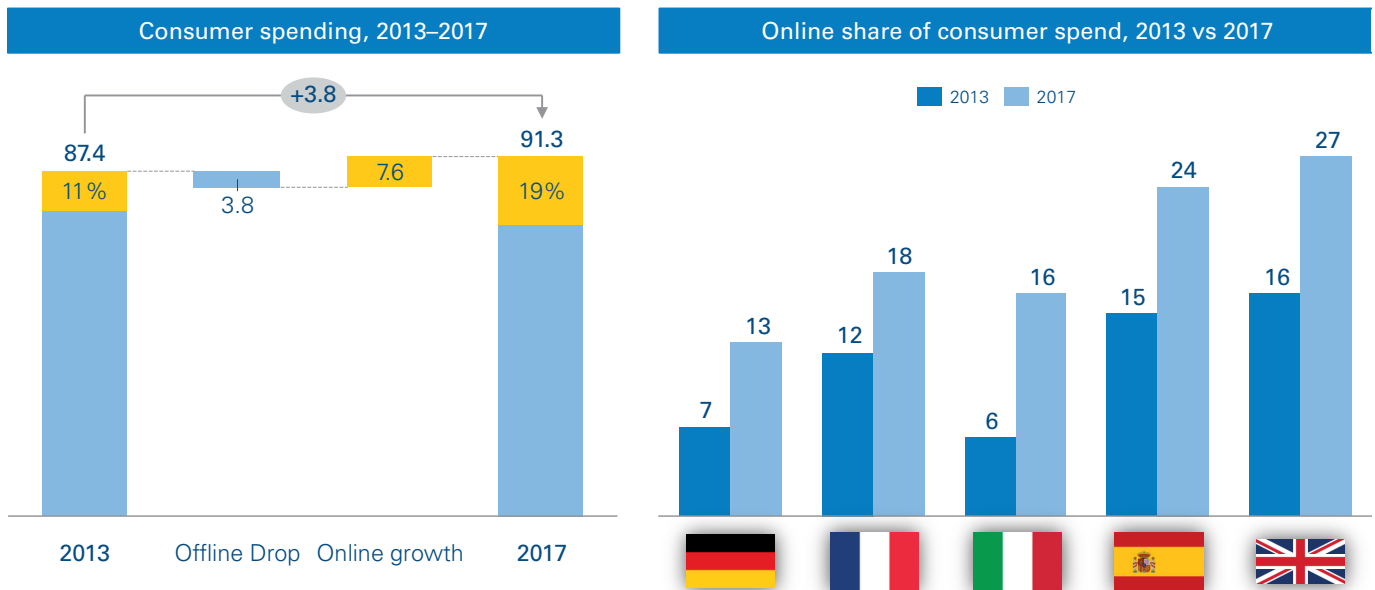
Advertising is expected to grow by €3.6 billion until 2017 mainly due to the growth expected from Italy and Spain, where a

limited recovery is expected after the collapse experienced from 2007 to 2013. The advertising industry has embraced the online world much faster than consumers. Also in the period from 2013 to 2017, the already high online share in advertising is expected to further increase, to reach between 37% - 60% of total revenues depending on the relative starting points.

The window of opportunity is closing up for traditional businesses, on urgent need to act now

We believe in the Digital explosion. Even when its development is diverse among countries and segments, it is still far from its potential and will see strong growth everywhere. Its three pillars – broadband connections and devices, consumer habits and digital offerings – are advancing fast and when all the pillars are in place, it will boost and challenge the offline world. For example, the US book market has already reached higher online revenues than offline, and it should not take long before this occurs in some EU countries as well. Some digital markets show “hockey stick” demand curves and there is constant innovation in the market.

Figure 42: Forecast of consumer spend



Will European players be there to capture the digital value? So far, Europe has only a few global online champions compared to the U.S. or Asia. So far, European companies are clearly on the defensive.

Learn how the digital world works: “Dis-aggregate, re-aggregate”.

Going digital does not mean delivering newspapers in pdf; products have to be truly digital. It also means understanding distribution channels, business models, etc. Most important of all is to know your customer by engaging in customer analytics and big data!

International companies, such as Netflix or Amazon, spend millions in big data, customer experience, talent, etc. Traditional media are known for their coherency and/or credibility, but they are not yet known for their knowledge about their customers. Newspapers, PayTV operators, FTA, etc. still have difficulty answering some questions such as: “Who reads your newspaper? Who reads your books? Who watches your channel? Who is going to the theaters?” Amazon or Netflix are closer to answering them, and this information will unleash its value sooner than later. Traditional media players (from print to TV) are redoubling their efforts and investments in acquiring these key capabilities. In most European markets, the poker game is still to be played, and many telecoms and other established players still have the chance to win if they go “all in”.

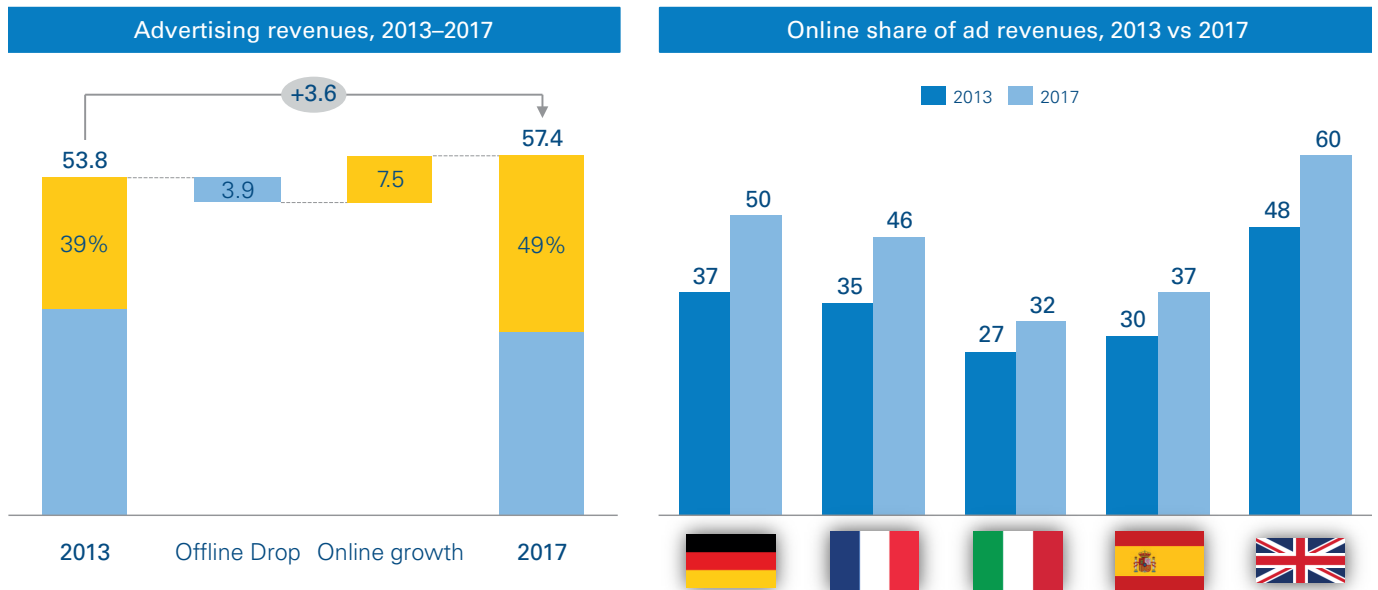
With intimate customer knowledge, integrated media players can build the next wave of “mega-franchises” by the entanglement of their individual media channels especially in the online domain. The consumer is then drawn deeper into a theme world of the media group from several sides. Genres can be based on key customer segments. The company follows the sole target of intensifying the relationship with a given consumer by breaking up silos into horizontal layers/activities.

Furthermore, brands and branding are of key importance in media in general, but particularly so in online markets. This is one of the traditional weaknesses of the European media players vis-à-vis their American peers and should be addressed rapidly.

If you enter, enter bold!

When taking strategic decisions related to the online market, traditional media players should make an honest assessment regarding their ability to achieve economies of scale and to create lasting network effects, both of which are the key ingredients to sustainable success in online media. A gradual organic diversification into online media or buying the 2nd player in a given online segment most likely results in neither achieving economies of scale nor achieving network effects sufficient to be successful in the long-term. In addition, this strategy weakens the core business due to the significant investment requirements and management attention related to the online business.

Figure 43: Forecast of advertising spend



Significant investment is required to get the capabilities, and online offers have a lower level of profitability in the short- and medium-term than those of traditional media, which they substitute. Therefore, this situation is particularly difficult to digest for traditional players.

Instead of all-things-to-all-people online portfolios with limited economies of scale and network effects, media groups should thus focus on achieving global scale in specific parts of the online market.

However, a conscious pass or withdrawal from the online sector could be a radical approach for media shareholder to obtain higher value and to use thereby generated capital for targeted acquisition in the traditional space by creaming out traditional segments, or to buy scale players in the online segment at a later time.

We, therefore, expect more financial investors to buy-out online properties, as illustrated by the acquisition of the Scout24 group, a leading group of classified portals by the major international private equity fund, Hellmann & Friedman.

A need to accelerate organizational transformation

Generally, traditional companies have dealt poorly with organization regarding digitization. This is a hurdle for any initiative. Initially some companies created an online unit, which usually did not have their own P&L. They were perceived as 'the cheap team' by the traditional business units and had difficulties

pushing their initiatives. The situation is even worse when they start to have some success and from then on they are seen as 'co-opetitors'.

Companies need to understand that online and traditional media should be strongly integrated organizationally, even if this proves to be challenging. In some cases, digital natives should reach higher organizational positions and a generational renewal might be required.

Move into original programming – UGC times are over and the rest of the content is non-exclusive.

The first wave of online media products and services focused on user generated contents (e.g. YouTube, Dailymotion, Facebook). In the TV & video segment, the second wave of online products and services focused on professional content on a non-exclusive basis (e.g. Pay TV VOD, Lovefilm, etc.). Currently, the third wave of online products and services in TV & video employs original programming as key differentiator (e.g. Amazon, Netflix). Most audiovisual content is licensed on a non-exclusive basis, thus individual offers are close substitutes to each other. Lack of original content as differentiation would mean that competition could only happen on price or usability.

This trend could also be embraced by traditional and online retailers in other media segments, such as music or books.

Policy makers should ensure same rules of the game for all.

All competitors should face the same taxation regimes. Currently, international companies have a big advantage by choosing the location of delivery of services in low tax countries, rather than where their services are actually consumed. Regulation has to adapt to the fact of media ubiquity to avoid creating artificial competitive advantages. In this sense, European executives do not ask for protection against international companies, they just demand a fair fight.

Annex

Arthur D. Little has carried out a structured study of the recent evolution of the media and entertainment sector in Germany, France, Italy, Spain and the United Kingdom (“EU5”). The analysis comprises the period between 2007 and 2013, distinguishes the sources of funds and their destinations, and separates online and offline consumption.

We have studied the existing flow of funds between the different players in the sector, from its sources to its retailers, aggregators and producers, identifying received, retained and transferred values for each participant. Figure 45 illustrates the conceptual framework of the analysis, indicating which types of players are within the respective value chain steps.

The results of the study have allowed us to develop quantitative arguments in order to understand what has happened in the sector during recent years, and to identify the winners and losers, current trends, important opportunities, and key actions for each player in the market.

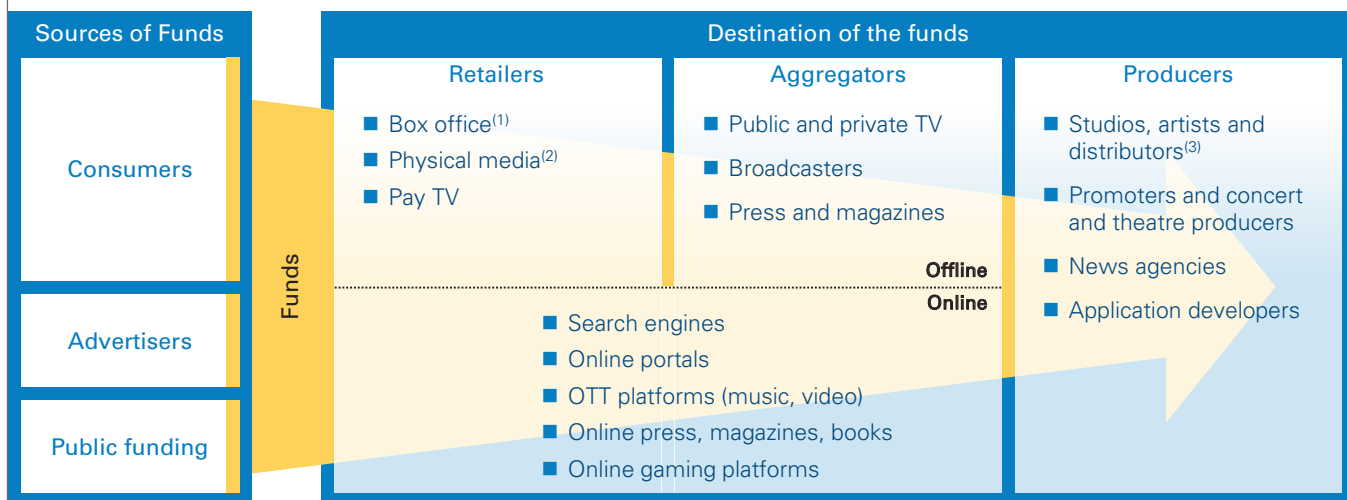
Arthur D. Little relied on selected third party data, investor relation data, as well as own financial modelling. We have built an accurate, highly granular data set of more than 80 subpoints across the EU5 markets. This data set provides insights on a much more detailed level than can be shown in this report.

Figure 44: Research perimeter



Please do not hesitate to contact Arthur D. Little to gain access to the next level of detail in the form of a management workshop.

Figure 45: ADL Media Flow of Funds framework



Notes: (1) Includes cinema, theatre and concerts (2) Includes retail chains, kiosks, etc. (3) Includes record labels (music), editorials (books) and studios (video and videogames)

Contacts

If you would like more information or to arrange an informal discussion on the issues raised here and how they affect your business, please contact:

Austria

Karim Taga
taga.karim@adlittle.com

Italy

Giancarlo Agresti
agresti.giancarlo@adlittle.com

Nordic

Martin Glaumann
glaumann.martin@adlittle.com

Belgium

Gregory Pankert
pankert.gregory@adlittle.com

Japan

Shinichi Akayama
akayama.shinichi@adlittle.com

Poland

Ansgar Schlautmann
schlautmann.ansgar@adlittle.com

China

Antoine Doyon
doyon.antoine@adlittle.com

Korea

Hoonjin Hwang
hwang.hoonjin@adlittle.com

Singapore

Yuma Ito
ito.yuma@adlittle.com

Czech Republic

Dean Brabec
brabec.dean@adlittle.com

Latin America

Carlos Abad
abad.carlos@adlittle.com

Spain

Carlos Abad
abad.carlos@adlittle.com

France

Didier Levy
levy.didier@adlittle.com

Malaysia

Thomas Kuruvilla
kuruvilla.thomas@adlittle.com

Switzerland

Clemens Schwaiger
schwaiger.clemens@adlittle.com

Germany

Michael Opitz
opitz.michael@adlittle.com

Middle East

Lokesh Dadhich
dadhich.lokesh@adlittle.com

UK

Richard Swinford
swinford.richard@adlittle.com

India

Srini Srinivasan
srinivasan.srini@adlittle.com

The Netherlands

Martijn Eikelenboom
eikelenboom.martijn@adlittle.com

USA

John Brennan
brennan.john@adlittle.com



Arthur D. Little

Arthur D. Little has been at the forefront of innovation since 1886. We are an acknowledged thought leader in linking strategy, innovation and transformation in technology-intensive and converging industries. We navigate our clients through changing business ecosystems to uncover new growth opportunities. We enable our clients in building innovation capabilities and transforming their organization.

Our consultants have strong practical industry experience combined with excellent knowledge of key trends and dynamics. Arthur D. Little is present in the most important business centers around the world. We are proud to serve most of the Fortune 1000 companies, in addition to other leading firms and public sector organizations.

For further information please visit www.adl.com

Copyright © Arthur D. Little 2014. All rights reserved.

www.adl.com/mediaflowoffunds2014