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Future of Sports Media: An Update

A Guiding Framework for the Brave New World

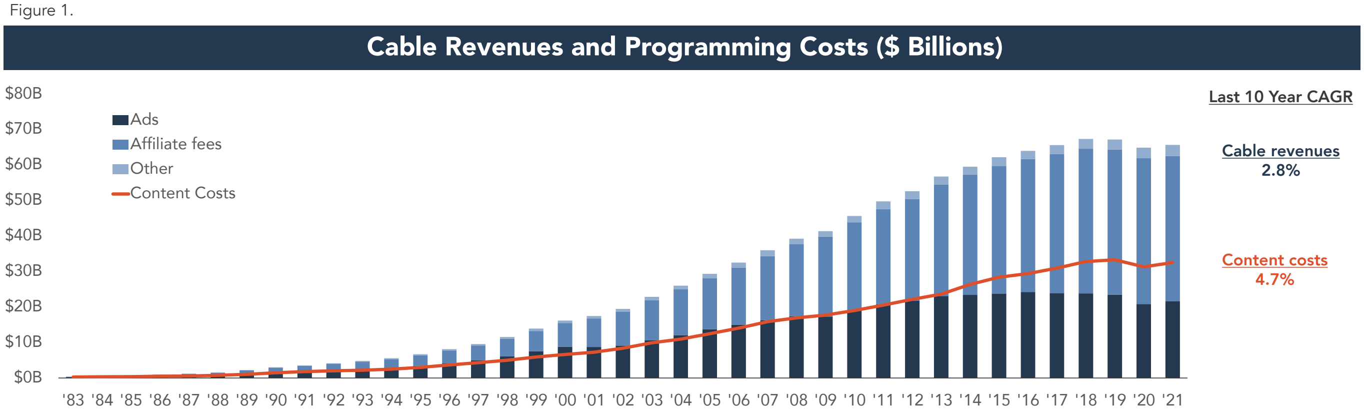
FUTURE OF SPORTS MEDIA: AN UPDATE

Decline of the Megabundle

All sectors of the economy focused on distribution are dealing with some form of "cord cutting" or "cord nevering," or customers shifting their spending to digital substitutes. In retail, this manifests as rising ecommerce market share. In financial services, commercial banks must compete with online challengers who are not burdened by a legacy branch network.

However, **for the media business, disruptive innovation in terms of channel shifting isn't new.** Due to technological innovation, the media industry has – about every 20 years, give or take 10 – destroyed its established distribution channel via new entrants that use the "next gen" pipes to the consumer. In the 1950s, broadcast television terrified the film industry. In the 1970s, cable television – originally pitched as "ad-free subscription TV" (sound familiar?) – spooked broadcasters. In the 1980s, satellite television was supposed to disrupt the growing cable systems (but didn't). From then on, until the mid-2010s, there was a "Golden Age of Cable" during which television programming was distributed by a mix of cable, telecom, and satellite businesses that offered a homogenous product under conditions of natural monopoly (or at least regional oligopoly): these companies spent enormous sums on the infrastructure required to serve cable television at scale and thereby gained leverage with local municipalities, customers, and to varying degrees the content providers themselves. There was little-to-no consumer choice or competing substitutes other than traditional broadcast television (think "rabbit ears"), whose offering was limited in comparison. The product on offer was undifferentiated – all distributors (MVPDs) sold the same product, which was effectively a bundle-of-bundles or megabundle, with networks offering bundles of channels to distributors in exchange for carriage fees. During this period, the pay TV industry enjoyed significant growth, with cable TV homes tripling and the basic cable package growing from ~$9/month to almost $70/month from the early 1980s to the mid-2010's. **This generated a virtuous cycle in which everybody won, both programmers and content providers** (Figure 1). As a result, the "balance of power" between content – including sports leagues and teams – and media companies was in equilibrium.

Figure 1.

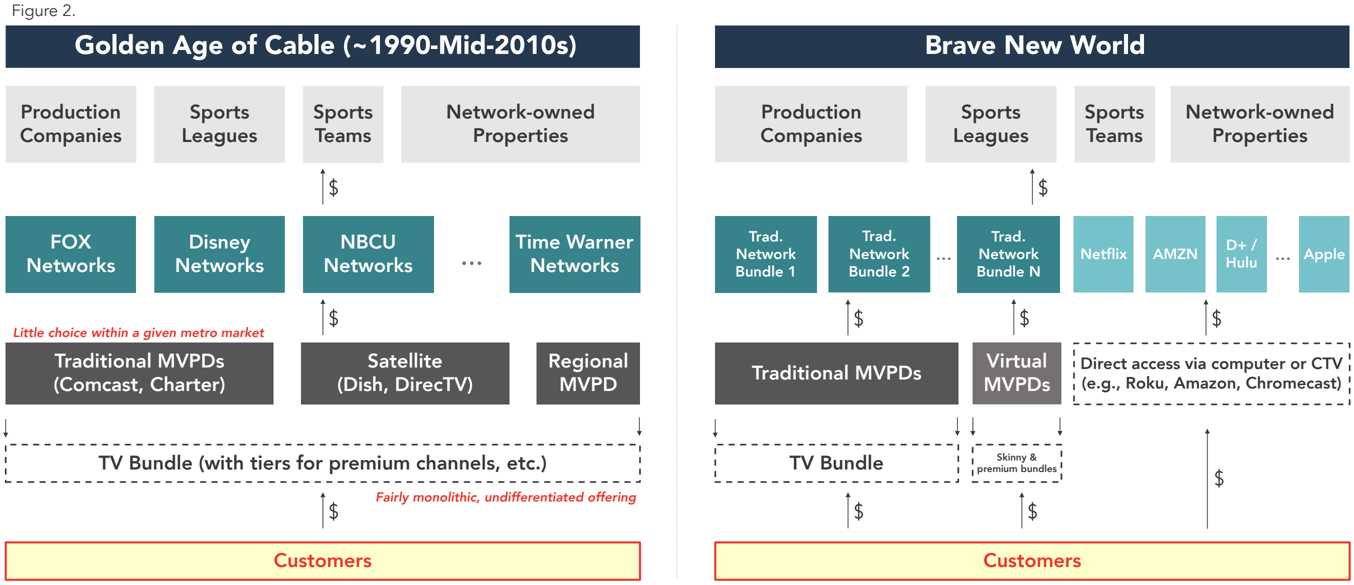


Source: SNL Kagan. As of December 2021.

Today, there is a new distribution disruption. This time, the "next gen pipe" to the consumer is high-speed internet. Due to increasing penetration of broadband and the successful launch of Netflix, streaming emerged as a genuine challenger to the Golden Age industrial set up in the mid-2010s.

Streamers operate in a competitive, fragmented marketplace, where competition is just one click away. **Due to competition and low switching costs, it has been difficult to replicate anything close to legacy cable's Golden Age distribution moat without simply competing for content.** Now, nearly all network incumbents have a streaming service that competes with other streaming services and traditional cable, from which customers can self-curate a selection of "channels" depending on their own willingness to spend and their content preferences. Churn has been high (~50% annually for the average service[1]) – subscribers generally top out at 3-4 streaming services, possibly also a skinny bundle for live TV, and generally add or subtract services as their favorite programming is launched, wherever it is. This is the Brave New World (Figure 2).

Figure 2.



Source: Arctos Analysis. Box sizes are not to-scale.

Going forward, as we will argue in the below, the economics of video distribution will be different. **The Golden Age's quiet equilibrium between content and networks is broken.** The leverage that cable networks had over customers is gone; the implicit partnership at the heart of the legacy bundle is converting to rampant competition; and content's power to determine who wins and who loses in the "streaming wars" is growing.

Importantly for the sports business, the leverage that the network ecosystem had over content creators – there was only one place to get content to fans! – is gone. That, plus the advent of the "streaming wars" and the need for must-have content, has fueled growth in media rights values even as sports viewership has grown only modestly and declined via linear channels.

We want to explore what all of this means for video economics long-term, especially as it relates to the sports business. Specifically, we will tackle the following questions:

- What does the advent of direct-to-consumer suggest will happen to the fundamentals of media?
- What does the changing landscape mean for sports rights?

[1] Source: Antenna. Link: https://www.latimes.com/entertainment-arts/business/newsletter/2022-04-05/here-are-four-charts-that-explain-future-of-streaming-the-wide-shot. Figure derived by annualizing 5.2% monthly churn rate.

- What should leagues and teams be focused on to thrive in the coming decade?

Tackling these questions will illuminate some puzzling aspects of the current market, like why sports rights have continued to escalate despite cord cutting.

The Future of Video Margins and the Middleman's Take-Rate

Ultimately, media networks are curators – they are analogous to consumer retailers. This analogy is simplistic – there are also important differences – but to a first approximation this is accurate.

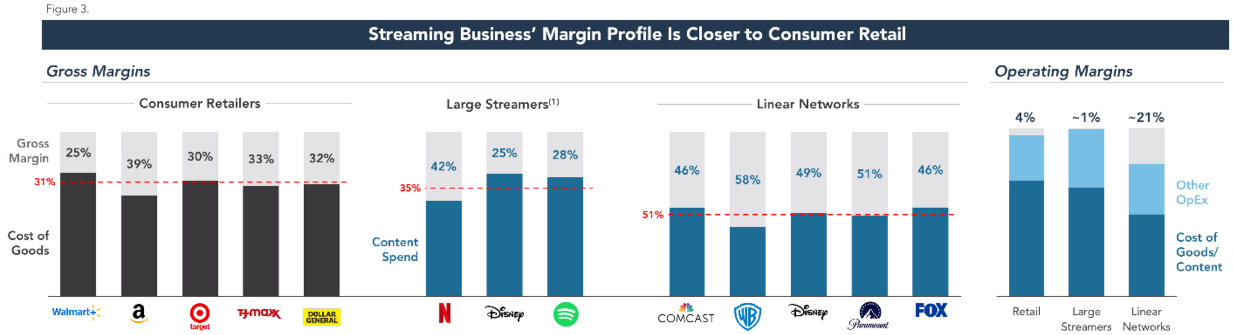
Intuitively, media networks and consumer retailers share the same key levers of value creation:

- **Selection**: at their most basic level, retailers bundle and market options
- **Convenience and ubiquity**: retailers reduce search costs, provide access, and offer easy comparison shopping
- **Leverage with suppliers**: via scale, retailers can often extract better terms from suppliers (e.g., underlying brands, contract manufacturers, etc.), which they can then pass on to their customers
- **Leverage with customers (e.g., brand equity, customer loyalty, scale, etc.)**: retailers can create value for their suppliers by offering a reliable source of demand at scale, especially if the retailer enjoys pricing or customer loyalty advantages or has other sources of brand equity

By their nature, retailers are subject to constant competitive threat. Retail margins have never been particularly high – historically 8%+ EBIT margins, now closer to 4%, with gross margins in the ~30% range – i.e., margins after the costs of procuring and selling inventory. Hence, **firms in retail need to develop durable competitive advantages to combat what would otherwise be persistent margin pressure** – typically achieved via scale, both horizontal and vertical, or unique technology or know-how in supply chain and inventory management.[2] While operating a media network introduces several unique challenges not shared by typical retailers (especially online retailers)**, we believe it is unlikely that run-rate margins can remain at this level without a dramatic reduction in competition for subscribers.**

Where will long-term margins end up? For an indication, we can look to (a) currently scaled or near-scale streaming platforms and (b) large retail comps (Figure 3). We focus on gross margins, which we are

Figure 3.



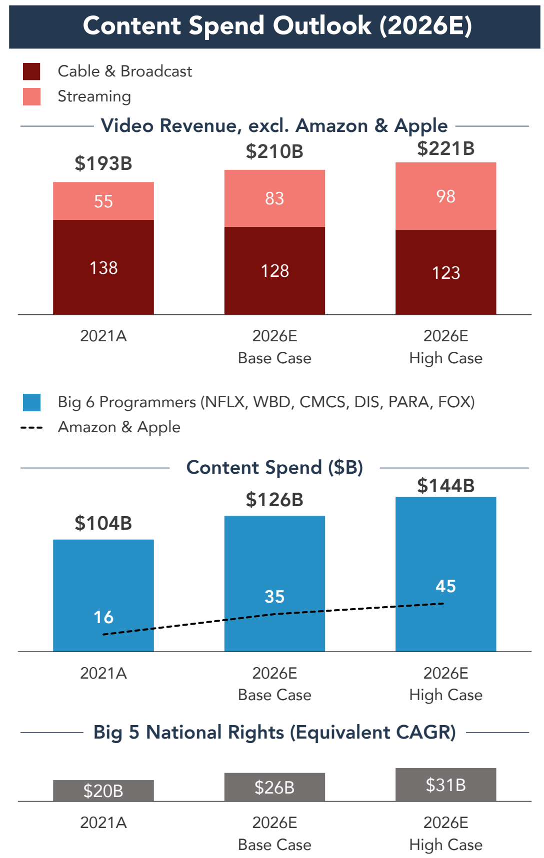
Source: S&P Capital IQ, Wells Fargo, public filings, Arctos estimates. Amazon margin reflects estimated gross margin of just Amazon.com and Amazon Marketplace.
(1) Disney streaming margins estimated using analyst reports and public filings and excludes Hulu + Live TV offering (estimated gross margin is 19% if included). Peacock, Paramount+, and HBO Max have lower margins (lower subscriber bases / sub-scale).

[2] Walmart is legendary for maximizing both levers. T.J. Maxx enjoys 10%+ EBIT margins driven by investment excellence in the global secondary market for excess inventory. As mentioned, some retailers have captive supply chains that, while they introduce new risks, enable the retailer to capture margin they would otherwise need to give away. A less common differentiator is brand – most retailers have the same, cookie-cutter brand message ("more for less") and need to compete hard on price.

defining as the economic split between content providers and the network. Gross margins for the streamers average 35% – i.e., the percentage of revenue retained by the streaming company after programming costs are paid or amortized. Retail gross margins average 31%. Both are significantly lower than the 51% average gross margins of the five dominant linear programmers (Disney, FOX, Comcast, Paramount, and Warner Bros. Discovery). All-in operating margins (Figure 3, right-hand side) after accounting for other production costs, sales & marketing, and G&A tell a similar story.

Over time, we expect gross margins for media companies across both streaming and linear to converge to 35-40%, not quite to retail levels, given the unique complexities and long-duration risks of running a media company, but lower, driven by the arms race for content. For the five dominant linear programmers, plus Netflix, global media revenue totaled $193 billion on approximately $104 billion of content spend (Figure 4).[3] This represents a 46% gross margin for these media companies on a blended basis – 51% for linear (three-quarters of total revenue) and 33% for their streaming operations, based on our rough estimates. Assuming total media take rates decline to 35-40%, content spending for these providers should go up $20 to 40 billion over the next five years, assuming modest growth in the total revenue pie. In addition, Apple and Amazon are estimated to have spent $16 billion on content acquisitions and originals in 2021, with analysts expecting this to grow considerably. **Depending on Apple and Amazon, content spending should grow by an incremental $40 to $70 billion over the next five years – a 6-9% CAGR**.

Figure 4.



Source: S&P Capital IQ, Wells Fargo, public filings, Arctos estimates. Base Case assumes -1% CAGR for cable / broadcast revenues, 8% CAGR for streaming revenues, and Big 6 content spend resulting in a 40% gross margin. High Case assumes -2% CAGR for cable / broadcast revenues, 12% CAGR for streaming revenues, and Big 6 content spend resulting in a 35% gross margin. Amazon / Apple spending informed by analyst estimates (Wells Fargo).

On top of increasing content spend, there are two other challenges to keep in mind, both beneficial for content suppliers. First, the streaming business requires more reinvestment in sales & marketing, given higher levels of subscriber churn, and requires ongoing investment into video technology. As we have emphasized in past writings, streaming is simply a more expensive business. Higher churn raises the stakes for acquiring and retaining must-have content, which is ultimately what powers successful marketing – in fact, marketing expense and content expense are increasingly hard to distinguish in a fragmented media landscape. Second, as already alluded to, Amazon and Apple are unique challengers: multi-trillion tech conglomerates with uniquely sticky relationships with wide swaths of the global population: 1 billion iPhone users; 200 million Amazon Prime members and 1 million+ business customers of AWS. These companies are not spending on content just to sell content – e.g., Amazon can rationalize content spend by using data gleaned from a user's watch habits to improve its advertising offering (a $31B business) or

[3] We exclude the multi-platforms Apple and Amazon – who together contributed another ~$16 billion in additional content spend in 2021, but for whom content spend is rationalized differently than just subscriber fees and advertising. We will revisit this shortly.

improve sell-through on Amazon.com or use it as a platform to advertise for Amazon products and services directly. Apple has built a fast-growing recurring fee bundle combining third-party app fees processed via the App Store, Apple Music, and other services tied to the Apple hardware ecosystem. Apple TV+ represents the video "leg" of this overall content bundle, which generated $68B of revenue in 2021 – more than any other media company we covered above. Competition from Amazon and Apple is uniquely "cost-insensitive" as they do not need to immediately (or possibly ever) make money on a direct subscription+ad basis to justify major investments.

Ultimately, two factors determine content spend: (1) the size of the revenue pie and (2) competition for content. Over the last few years, the size of the pie has grown modestly, but as the Golden Age's distribution moat faded, differentiation and customer retention once again required competing for content. Forecasting what happens requires answering the same questions: how big will the pie be? and will content creators retain their leverage advantage?

What This Means for Sports

At first glance, what this means for sports is obvious: content spending is going up, so let's rejoice. And it is worth underlining the positives briefly.

Sports, especially in the U.S. and Europe, represent unique, evergreen properties for which subscriber interest is dependable. In this sense, sports rights play the same role in content portfolios as government bonds do in financial portfolios: the assets are expensive (i.e., they trade at low yields), but returns are easy to forecast. **Sports is the "safe-haven asset" of the content kingdom** and has an important portfolio benefit: owning sports gives you a quasi-guarantee of subscribers and hence the flexibility to take more risk elsewhere in the content portfolio, which is required to rationalize entry into the space. Interestingly, the growth of on-demand streaming has catapulted the value of "riskier" scripted programming (think tent pole scripted series or multi-year exclusives with prominent stars), improving the relative value of bond-like content assets of late, and sports betting is new vertical for media companies to monetize engagement that didn't exist until recently and continues to scale.

Sports is a content niche that both (a) enjoys mass appeal and cultural ubiquity and (b) attracts a definable and otherwise hard-to-access audience segment. **And in a streaming world, the best growth strategy is accumulating as heterogenous an audience as possible – i.e., to replicate as closely as possible the Golden Age bundle. Heterogenous audiences unlock bundle economics** – accumulating niches is how you get your hardcore sports fans to pay fees for historical dramas and your young professional, educated female demo to pay for mixed martial arts or motorsports.

But while these benefits are not going away, and are arguably strengthening, media companies trying to reach scale in the Brave New World are aware of this dynamic as much as leagues are. Like all business, the media industry is repeated game, where both sides have access to roughly the same information. **Leagues and teams should expect more consolidation in the media industry over the next few years as a reaction** to the changes in the balance of power**.** More important, just because sports as a class can expect to be buoyed by increasing competition does not mean *all sports and all packages* will equally benefit. Within these two realizations lies strategies for coping with the Brave New World.

Within every current advantage lies the seeds of a potential disadvantage. Let's review what we mean:

- **Advantage**: sports properties are dependable content niches in world of growing subscriber insecurity and demand for niches
  - *Disadvantage*: content niches are proliferating in response to increasing demand, adding new competition to sports, especially from outside the video category (e.g., gaming)
- **Advantage**: several media companies are dependent on live sports programming, and leagues have room to flex their leverage
  - *Disadvantage*: media companies recognize their dependence on sports and are actively positioning themselves to become less reliant on it going forward
- **Advantage**: the two most disruptive, most well capitalized streaming entrants (Amazon and Apple) are both deploying capital into sports
  - *Disadvantage*: leagues should ensure they are not encouraging a marketplace in which only two providers can realistically afford to own rights

On top of this give-and-take dynamic, not all sports and packages are created equal. We would highlight the following:

- The NFL has driven a substantial amount of growth for the next decade or more via its latest media renewal. Prior to the NFL renewal, total pro sports spending in the U.S. was roughly $19 billion in average annual contract value. The NFL comprised $7 billion of that figure, or 38% of the total. After the NFL finds its next Sunday Ticket partner, we expect this figure to be closer to $12 billion, and though it would start low and grow over time due to contract escalators, this is still an incremental $5 billion in annual committed spending. **Assuming no other changes, this brings the NFL to fully half of all professional U.S. sports spending over the next decade.** We think this will have ramifications: other than marquee properties and niches that are relatively small and affordable, mid-tier properties may face challenges. **We are now in a barbell world, with an eroding "middle market" for content rights and a steepening power law curve of outcomes between the haves and have-nots.**
- Local sports rights are most acutely levered to the existing cable superstructure and as is well known, are facing the fiercest headwinds. We think a combination of right-sizing the existing economic set up, introducing multiple distribution channels, recapitalizing the sector, or otherwise encouraging new bidders will be required to bring more certainty to the space. Individual clubs do not enjoy favorable leverage with networks, and over time consolidation of local rights into league-controlled, national packages may make sense to improve bargaining power. The good news that we are likely to soon see a streaming product test the market (Diamond Sports), which will be a great initial case study on how new forms of distribution will perform with cord-cutters.

What should leagues do to get ahead of this? Our advice is that leagues should be looking to use the windfall from the current moment to reinvest in the foundations of their IP and fanbase:

- **Focus on fundamentals.** Sports content used to compete mainly with other forms of live TV and scripted programming on other channels; now it competes with streaming, news, gaming, and other distractions – including multiple distractions at once. The linear world incentivized content quantity over viewer engagement. Now, leagues should be focused on cultivating scarcity value and attention capture. This often means making investments today that do not have readily visible or immediate payoffs – it may even mean making changes to the sport itself (e.g., rule changes, season inventory or scheduling changes, new tournaments or playoff formats, etc.). We are already seeing this take place (e.g., NBA play-in tournament, universal DH in MLB, MLS / LigaMX League Cup), though we believe it should accelerate.

- **Develop your nuclear options.** By this we mean: ensure that you are investing in a robust in-house fan data (and hence advertising) capability that makes credible the implicit threat to "go direct". The point of the nuclear option is to *not* use it – but having it is protective. In a downside case, the media market would consolidate to deal with the added burdens of the streaming business model – effectively a rebundling. In this scenario, the middleman's take-rate would go up again. The only way to preserve the increasingly favorable balance of power would be to credibly threaten a direct-to-consumer option. Media companies will only pay up for rights if: (1) they need to outbid a competitor for must-have programming; (2) they need to pay you more than you could reasonably expect to earn on your own.
- **Create streaming-specific packages and experiment wildly with them.** Your core audience will continue to watch via linear telecast for the foreseeable future. These are typically older fans who just want to watch the game, or younger fans who either watch at a bar with friends or have the game on as background noise. Most hardcore sports fans have not cut the cord; fans outside the bundle who would watch an OTT broadcast are more casual, younger, or need special inducements to tune in that way. We do not believe that the future of live sports is on-demand streaming alone – at least, not anytime soon. But we do think that streaming will pay an increasingly prominent role in future TV rights renewals, as existing TV partners all have streaming services they are trying to grow. Given that this space is new, this gives leagues an upper hand in terms of driving rights fees or even controlling production, if desired. Streaming companies also want global rights, given that their reach is increasingly global. Regardless of the exact approach, **find a way to be an arms dealer in the streaming wars.**

Our recommendations for teams focus on managing the local rights market and tech disruption are:

- **Cultivate +1 bidders.** This is not easy, and in some markets it may be impossible. But as many teams know, most local TV packages only enjoy one bidder (the incumbent). There are other groups circling the space, recognizing the lack of competition, but solving the distribution puzzle is difficult and may require leagues to participate in a "grand bargain" type solution. In the meantime, there are resources and experts who can help teams navigate these challenges.
- **Consider platform opportunities.** Growing a sports club increasingly requires scale to retain talent and build resources for reinvestment. We are moving from a world of fragmented, local individual ownership to institutional ownership with global or at least multi-asset ambition and diversification. A sports team is an agglomeration of eyeballs – it's a community. New ways of engaging and monetizing communities are exploding now – it's never been a better time to be in the community aggregation business and enjoy the scale necessary to experiment with new forms of fan engagement.