As an equity analyst, you are constantly consumed with the latest sector news and trends. You know that what's common knowledge within each sector, may not yet be fully appreciated by the public at large. And then, you get that one piece of anecdotal evidence that confirms that the public narrative has changed. I recently experienced such a moment from my wife’s exasperated reaction to news that Friends and The Office are being pulled from Netflix’s library of content. You see, cord cutting is nothing new. In fact, almost 4 million households are expected to drop their pay TV services this year alone. But, these announcements represent an unmistakable escalation in the media battle for viewership.

The media landscape has been undergoing a transformation for several years now. It has been a transition marked by aggressive, debt-fueled merger and acquisition activity. Traditional telecom companies have become media behemoths with wireless and cable carriers now housed under the same roof as Hollywood studios. Comcast’s $6.5 billion announced acquisition of NBCUniversal in 2008 jumpstarted this process. And, in just the past couple years, we’ve seen a new wave of M&A: AT&T has acquired DirecTV and Time Warner for a combined $172 billion, Disney purchased Fox assets for $71 billion, and CBS and Viacom recently announced a merger of nearly $27 billion in market cap, among other deals.

This wave of M&A ultimately led to last year’s creation of the Communication Services sector. This new sector is a combination of traditional telecom companies with several widely recognized consumer discretionary and tech companies. Alphabet, Facebook, and Netflix make up ~50% of the sector’s market capitalization, AT&T and Verizon comprise ~20%, and Disney represents ~9.3%. It is currently the 4th largest sector, representing ~10.5% of the S&P 500. Far from the static reputation of traditional telecom, this sector is marked by innovation and transformational competition that produces clear winners and losers. More than ever, this is a sector whose trends cannot be ignored. We believe continued disruption and heightened competition will present unique investment opportunities in this space.

Cord cutting is a well-documented trend that is reshaping the media landscape. Consumers are increasingly replacing their expensive cable subscriptions with internet based streaming services. According to Leichtman Research Group, 74% of households now subscribe to Netflix, Amazon Prime, or Hulu, and more than 50% subscribe to multiple of these services.

Figure 1: U.S. Households with SVOD Service

74% of U.S. households have an SVOD service - up from 64% in 2017, and 52% in 2015.

- 51% of U.S. households have more than one SVOD service - compared to 33% in 2017, and 20% in 2015.

- 33% of adults stream an SVOD service daily - compared to 29% in 2017, and 16% in 2015.

Sources: Leichtman Research Group, RIM
Cord cutting even appears to be accelerating, with nearly 4 million households expected to cut pay TV subscriptions this year, an annual decline of 4.2%. In 2Q19 alone, major U.S. TV providers lost a combined 1.53 million subscribers, more than any previous quarter. The number of households without a traditional pay TV subscription is quickly approaching those that have one.

The battle is on for viewer eyeballs within the streaming space. As mentioned, NBCUniversal (Comcast) announced it is reclaiming its rights to The Office when its $100 million a year deal with Netflix ends in January 2021. Time Warner (AT&T) also announced it is reclaiming its rights to Friends when its $80 million a year deal with Netflix ends in the spring of 2020. These moves are part of a larger trend of bringing proprietary content in house and offering exclusive viewership through new streaming platforms. There are already over 100 streaming services, including Netflix, Hulu, Amazon Prime, DirecTV Now, HBO Now, CBS All Access, among many others. And the competition is only ramping up with upcoming launches of an NBCUniversal service in April 2020, HBO Max in Spring of 2020, and Disney+ on November 12, 2019. NBCUniversal’s platform will house The Office, Parks and Recreation, and a host of other Universal Studios movie and television series. HBO Max will house HBO and the recently acquired Time Warner assets, which include Friends, Warner Bros studios content (DC comics, Harry Potter, etc.) and Turner content (TBS, TNT, Cartoon Network, etc.). But as big as the NBCUniversal and HBO Max launches may be, nothing sent shockwaves through the industry like the announcement of the Disney+ streaming service. Disney is a brand in itself and has a variety of ways to monetize its characters and franchises. Its streaming service can afford to lose money because Disney’s goal is not viewership, but building closer relationships between its customers and its characters. The Disney content serves as the engine that drives revenues throughout all the other business channels (merchandising, theme parks, music, magazines, etc.)

Disney+ launches on November 12th for $6.99/month or a $12.99 bundle for Disney+, Hulu, and ESPN+. The service will include Star Wars, Marvel, and National Geographic libraries. While Disney+ will house the premium content as a ‘destination’ service, Hulu and ESPN+ will act as ‘filler’ services offering Disney’s Fox assets (ex. Family Guy) and replays of sporting events. These new streaming services mark a stark departure from previous years in which content owners were happy collecting huge licensing fees from Netflix. There’s clearly some remorse among the major Hollywood studios in having allowed Netflix to build such close relationships with their customers.

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**Figure 2: Pay TV vs Non-Pay-TV Households in the US, 2013-2023, millions**

![chart](https://via.placeholder.com/150)

*Source: eMarketer, RIM*
So, what does the future of television look like? It seems clear to us that traditional TV providers are facing a prisoner’s dilemma: They can increase their pricing to improve profitability but risk accelerating cord cutting. Or they can cut costs by removing some of the less watched channels which also risks driving away customers. Either way, we see a traditional TV industry in continual decline. Ultimately, we think cable/internet providers will package their high-speed internet with “skinny” TV packages of news and sports. Interestingly, news and particularly sports continue to be best suited for traditional television. Sporting events have natural breaks in action, which suits an advertising based video model. Sports are also highly differentiated and viewers place a premium on reliability and speed. With the growth in Twitter and other social media platforms, live and immediate discussion of sports complements the actual viewing. Viewers can’t afford to miss any big moment in sports and even a few seconds of delay can detract from the viewing experience. Regarding streaming, we believe the next few years will see a continued growth of new streaming options, followed by years of contraction. There are particular services that have either ingrained brand loyalty or scalable customer bases that provide distinct comparative advantages. The question analysts continue to grapple with is whether Disney and Amazon represent direct competition with one another or can exist as complementary products that address different consumer needs. Ultimately, there will be clear winners and losers in these streaming wars and we are focused on positioning accordingly.

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