

# Closing the Digital Gap

The Impact of Over-The-Top Platforms on Home Entertainment



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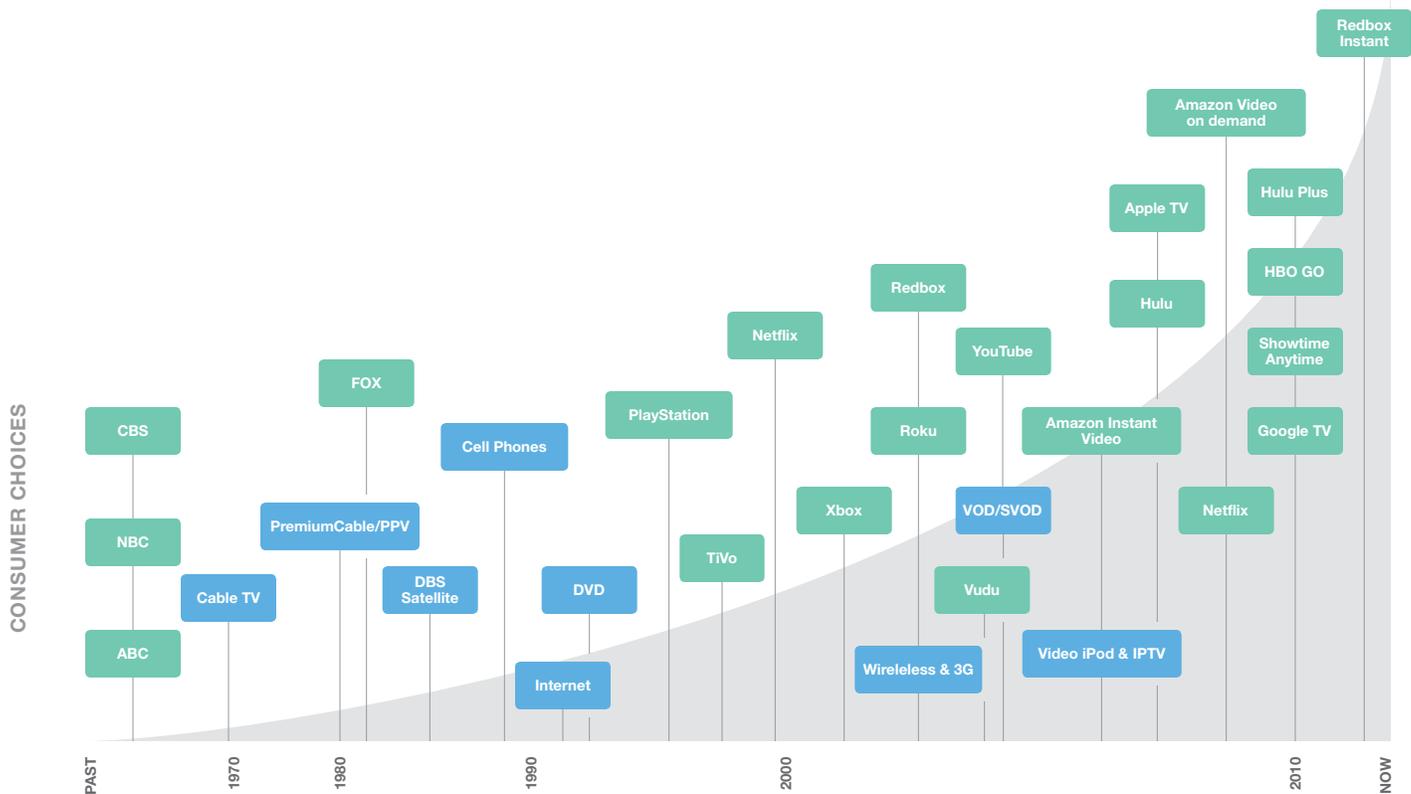
# Closing the Digital Gap

## The Impact of Over-The-Top Platforms on Home Entertainment

As Over-the-Top (OTT) platforms continue to proliferate, consumers today have access to a vast selection of entertainment content at their fingertips from a growing array of delivery platforms globally as shown in **Exhibit 1**. With this explosive growth, it appears virtually certain that electronic distribution platforms soon will become the delivery platform of choice for most consumers of filmed entertainment content.

### EXHIBIT 1

#### Evolving Distribution Platforms and Consumer Choices



EVOLUTION OF CONTENT DISTRIBUTION

One of the primary issues affecting the long-term growth and profitability of the filmed entertainment industry (as well as broadcast and cable television) is whether the conversion to electronic distribution platforms ultimately will accelerate growth in consumption, capture improved margins and create incremental value for rights holders or whether it simply represents a change in format preferences at lower price points that will not be able to replicate revenues earned by traditional mediums such as

How will OTT options impact consumer behavior over the long haul? What are the lasting ramifications of OTT platforms for industry profitability? **Exhibit 2** highlights the split between electronic and physical receipts in the North American home entertainment marketplace, which includes subscription services such as Netflix but excludes traditional Pay-TV platforms.

As indicated in Exhibit 2, electronic platforms continue to grow rapidly and to

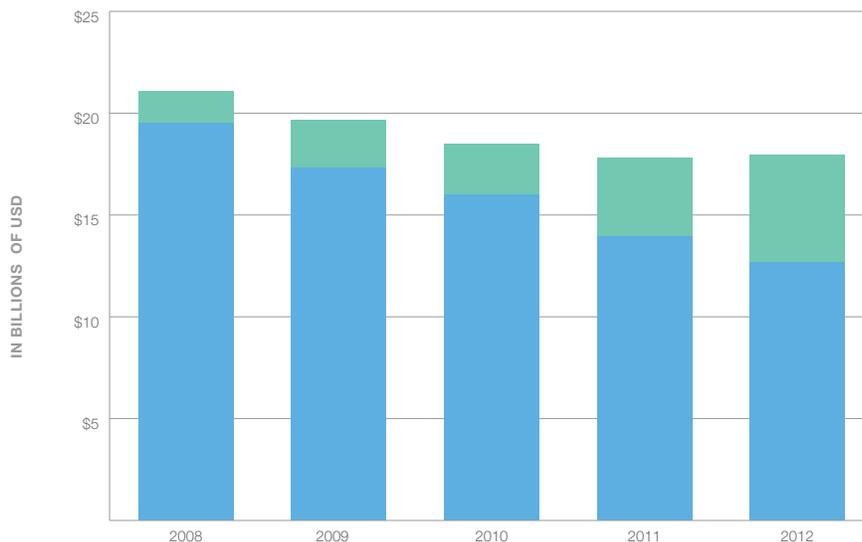
electronic sales yield 85 percent contribution margins based on our observations. We would expect margins to decline slightly over time for electronic receipts as a larger share of marketing spend during this window is allocated and as competition increases for virtual shelf space on electronic platforms.

According to Sandvine's Global Internet Phenomena Report, Netflix now accounts for 33 percent of peak streaming downloads through a fixed connection, compared with

## EXHIBIT 2

### North America Consumer Spending — Home Entertainment

- Total Electronic Receipts
- Total Physical Receipts



Source: DEG, FTI Consulting Estimates

DVD and linear television broadcasting. With the home entertainment segment stirring up considerable debate over the industry's long-term profitability among its various participants (studios, rights holders, distributors, advisors, lenders and investors) and with so many changes in consumer preferences, we have been studying the impact of OTT platforms on the entertainment industry. Among the issues considered were: When will electronic receipts surpass traditional or physical receipts?

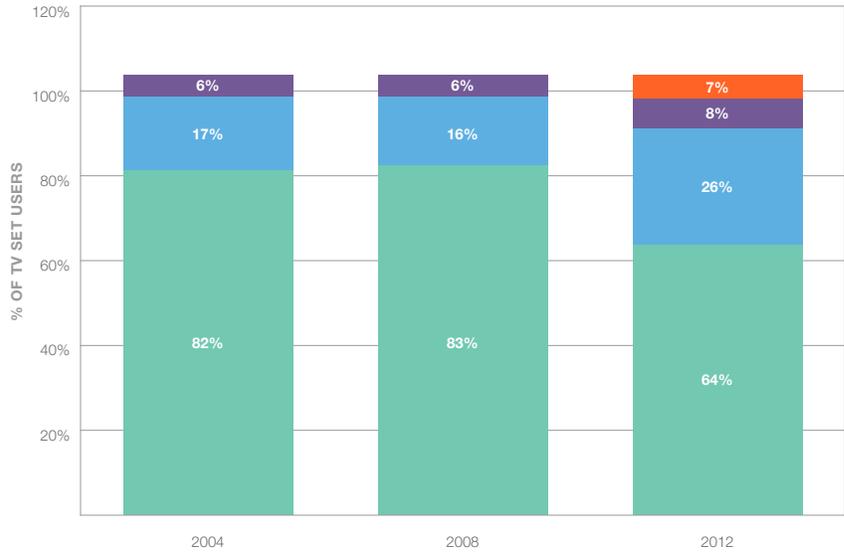
capture an increasing share of consumer spending on home entertainment in North America. For example, the aggregate amount of incremental growth in North American electronic receipts in 2012 was approximately equal to the aggregate amount of reduced physical receipts. As electronic receipts continue to represent a larger share of total home entertainment spending, margins for the entertainment industry at the distributor level should improve, as physical sales yield an estimated 60 percent contribution margin while

1.8 percent for Amazon, 1.4 percent for Hulu and 0.5 percent for HBO GO, among other similar services. Increased subscribers have driven online data usage in North America up by 120 percent since 2011, as audio and video streaming services currently account for 65 percent of online traffic between 9 p.m. and midnight. As detailed in **Exhibit 3**, consumer behavior among television viewers 18-49 years old has shifted considerably since 2004, with streaming becoming an increasingly popular viewing alternative.

**EXHIBIT 3**

U.S. Primetime TV Viewing<sup>1</sup>

- Live TV
- Recorded TV
- Video Game
- Streaming Video



Source: Business Insider

In addition to the proliferation of streaming and on-demand platforms over the past few years, the impact of a weak economy on consumer spending for home entertainment, high adoption rates for internet-enabled smart phones and tablets, some other factors that have coincided with the growth of electronic distribution relative to physical, include:

**• Shuttering of Retail Rental Stores**

The bankruptcies of Hollywood Video and Blockbuster Video stores contributed notably to the further decline in physical rentals of filmed entertainment. Blockbuster Video, under the ownership of EchoStar, is down to approximately 1,000 storefronts from a peak of more than 9,000 in 2004<sup>2</sup>.

**• Reduced Retail Shelf Space**

While DVDs once dominated the square footage dedicated to entertainment content at retail stores such as Best Buy and Circuit City (now liquidated), big box retailers today give it about as much square footage as they do iPhone accessories.

**• Netflix Decision to De-emphasize DVD Subscription Plan**

As Netflix continues to de-emphasize its physical rental subscription business in favor of streaming content, consumers increasingly have been moving towards electronic alternatives. This is evidenced by the decline in North American physical rental subscription receipts for the home entertainment industry from a peak of approximately \$2.3 billion in 2010 to \$1.25 billion in 2012<sup>3</sup>.

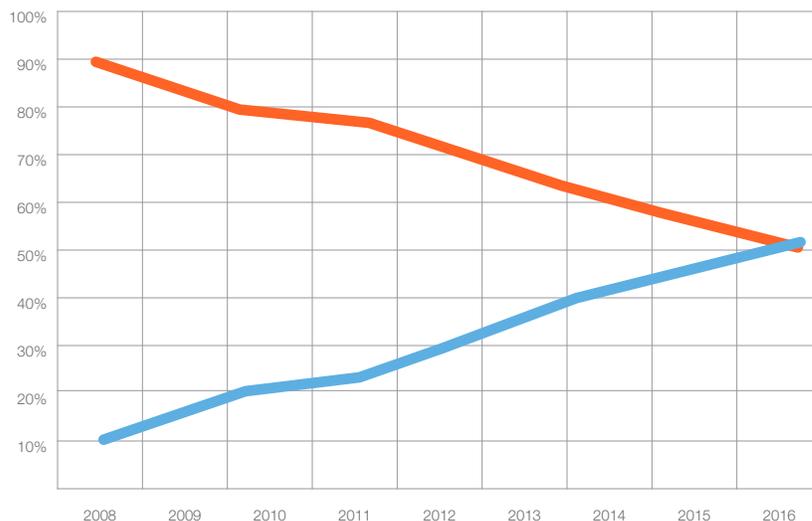
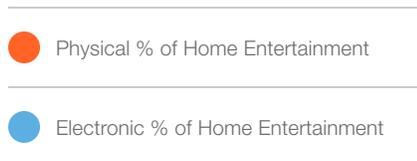
So when will electronic receipts surpass physical receipts? To answer this question, we studied a portfolio of major studio first cycle film ultimates for films released between 2008 and 2012 (where home entertainment receipts largely have been achieved) and analyzed the trends in electronic receipts relative to physical receipts. We recognize that performance of any given individual film within this portfolio may vary, as traditional retailers frequently adjust physical levels of inventory in stores when considering a broad slate of releases, studio release patterns and consumer interest in a title. For films released in 2008, we observed that electronic receipts represented approximately 9 percent of total North American home entertainment receipts compared with approximately 30 percent for films released in 2012.

<sup>1</sup> % of 18-49 year old TV set users during 8:00-9:00 P.M. hour, multiple responses permitted.  
<sup>2</sup> Source: DEG, FTI Consulting estimates  
<sup>3</sup> Source: Digital Trends, February 2012

Based on the factors addressed above and other current trends we are observing in film ultimates and the overall industry, we believe the crossover point when electronic receipts will surpass physical home entertainment receipts in North America will occur in 2016 as shown in **Exhibit 4**.

**EXHIBIT 4**

Domestic Home Entertainment Trends — Where Is the Crossover Point?<sup>4</sup>



Source: FTI Consulting Estimates

Additionally, we believe international markets will lag North America by three to four years; this will vary by territory and is a function of market maturity, culture, economic conditions, and technology and territorial restrictions, as applicable.

We believe that growth in electronic distribution platforms will remain strong as consumers continue to demand access to content on their terms: how they want it, when they want it and where they want it. Both the challenge and the opportunity for the industry will depend on

its ability to adapt to this rapidly changing environment and develop new business models that maximize value for industry participants. Lastly, as we will discuss in upcoming articles, there are several other developments on the visible horizon, such as a la carte subscription TV, Google Fiber and the prospect of platforms like HBO GO and Showtime Anytime de-linking from their traditional Pay-TV platforms, that will also have a profound impact on the industry.

The views expressed herein are those of the author and may not necessarily reflect the views of FTI Consulting, Inc. and its other professionals.

<sup>4</sup> Excludes Pay-TV platforms

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