5 KEY TAKEAWAYS

The Acceleration Of Trends In The COVID-19 Environment

As Q1 earnings begun shortly after COVID-19 materialized in the US, investors, analysts and executives looked towards results and management commentary to quantify the financial impact and provide insights into trends occurring during the middle of April and May. Across all sectors, the most phrase being repeated over and over was: "this will accelerate trends that are already occurring." While it is difficult to measure the speed of change, as these take years to develop, with numerous factors at play, it's clear to see the ongoing adoption of digital products and services. But this isn't just at a consumer level, it is occurring within businesses of all sizes. Companies (and employees) have been able to adjust to working remotely, some better than others, with limited impact on overall productivity. Furthermore, many tech companies in Silicon Valley have taken actions to allow for work-from-home opportunities on a more permanent basis. There are several nuances to the debate of working from home, with company and employee specific factors making each situation unique. But the fact that this conversation is happening means that the technological capability isn't the inhibitor that it might have been just 5 to 10 years ago.

Broadband, which has always been somewhat of a luxury product, is increasingly becoming a utility for consumers across the country. More so, the speed of broadband is vital with multiple people in the household, with even more devices attached to the network. But broadband only services about 80% of the country, which is partly why the promise of 5G is so appealing. In rural America, consumers may soon be able access wireless speeds greater than any current offering. At the same time, cable companies are quickly improving their network infrastructure to handle more capacity as data usage surges. As time with media increases, the shift to digital necessitates fast broadband speeds to provide a positive consumer experience, whether it be video (OTT), audio (music streaming), or video games (digital downloads).

However, it's not just about the entertainment products offered to consumers, it's also enabling the enhancement of services business can provide. Customers have always dreaded switching cable providers due to long-waits on the phone, setting up appointments, and returning equipment. Increasingly, customers are becoming comfortable communicating with reps via online chats and utilizing self-installation kits on their own. Brick and mortar stores still remain an important sales channel, especially for telecom, but the value of a widespread retail footprint is diminishing. Consumers will always have the desire to see and touch items in real life before making purchases. But even there, the advent of augmented reality as a tool to "try something on" will soon enough add another new reason to stay at home rather than go to a store.

When it comes to sports, fans currently have no choice to watch it from the comfort of their home. With leagues slowly return to action, albeit without fan attendance, there are enormous opportunities for networks to experiment with production. From new camera angles (that previously would have blocked fans' line of sight), to inserting simulated crowd noise, to the layering of digital ads to cover empty seats, there are endless ways to potentially enhance the viewing experience for those at home. Without the same atmosphere from the live event, there is also an expectation to further incorporate sports betting to keep viewers engaged. Tangentially, there will likely be an expedited process to legalize sports betting (particularly on mobile) in more states as a very quick and seamless way to bring in more revenue to improve local budgets.

These are all identified trends, and while it's tough to prove they will accelerate due to the pandemic, they are expected to continue move quickly. Companies will be forced to innovate, and current experiments will eventually become commonplace for audiences and customers.

Virtual MVPDs Are No Longer A Safety Net For Cord Cutting

The suspension of professional sports leagues, starting with the NBA on March 11, and many others soon after, has cast a bright light on the economics of the bundle. The value of live sports has been made abundantly clear as ratings for replacement programming, from old classic games, to Esports to docuseries have largely been underwhelming. *The Last Dance*, which was moved up from its scheduled release in June, has been one of the lone standouts. Sports networks have been able to justify their outsized affiliate fees because they are the only ones that can command large simultaneous audiences. Without live sports, the calls for rebates to customers became loud, with the New York Attorney General becoming involved in the debate. But these complaints, while justified from a consumer point of view, fail to grasp the nuances of the ecosystem. The league licenses their media rights to networks, who in turn charge distribution fees for their channels to MVPDs, who then bill the customer a monthly subscription. An MVPD will not offer rebates until reimbursements at the league level have trickled down. It's important to note here, that the league and networks are long-term partners, not just buyers and sellers. They will work together to solve these disputes and meet any programming requirements outlined in their contracts. With many of these rights up for renewal in the coming years (starting with the NFL), no network is going to ask a league for a relatively small rebate and jeopardize their chances of acquiring the more lucrative long-term rights in the next cycle. These sports rights are imperative for networks to hold onto the audiences that are rapidly cutting the cord.

In Q1, over 2 million customers ditched their Pay-TV subscription (MVPD or vMVPD), a 5.5% increase from 2019 Q1. Some may point to the lack of sports causing this acceleration, but that is misguided because these figures are as of March 31st, just weeks after the suspension of sports. Most customers pay the bill in advance, so even immediate terminations would still be considered subscribers at the end of the month. That is not to say there won't be a further increase in cord cutting in Q2, (that is expected), but the correlation between the lack of sports and cord-cutting does not necessarily imply causation. Instead, to examine the subscriber trends in the quarter, it's best to take a closer look at the various distributors, from cable to satellite to virtual MVPDs.

The conversation of cord-cutting needs to start with AT&T (DirecTV), who has been aggressively rolling off promotional subscribers and focusing solely on the profitable ones over the past few years. In the past 4 quarters alone, they have lost over 3.5 million linear video customers, more than any other MVPD by far. Satellite companies are in a difficult situation because they lack the broadband offering that is vital for maintaining the overall customer relationship. As cable companies pivot to the higher margins around connectivity, they are no longer willing to chase unprofitable video subscribers. Instead, they are coming up with new ways (such as Comcast's Flex) to provide solutions for broadband customers that want video. Without those type of options, DirecTV and DISH Network were early pioneers of virtual MVPDs (DirecTV Now and SlingTV, respectively) as low-cost substitutes to the traditional bundle.

The rise of these skinny bundles offered an alternative to audiences who did not consume a lot of TV, and did not want to continue to pay high rates to only watch a few channels. At first, these products provided a safety net for cord-cutting customers, but that has changed quickly. Over the past year, these virtual MVPDs have been begun expanding their channel line-ups (as programmers became eager for more affiliate fees), and instituted numerous price hikes in 2019 to improve the unit economics. The business model is cratering, and in January, PS Vue shut down with only ~500k subscribers at the time. Many of these customers decided to cut the cord completely, rather than find an alternative TV provider. SlingTV lost subscribers for the 2nd consecutive quarter, and DirecTV Now has lost 50% of their customer base in the past year. Growth has stalled at other skinny bundles such as Hulu and YouTubeTV, and for the first time, the total subscriber base for vMVPDs decreased in a quarter. What seemed like a beacon of hope for the industry, has quickly disintegrated, paving the way for a rapid acceleration in the shift to OTT.

The Debate Around PVOD Has Resurfaced

As the Coronavirus swept across the world, theaters were forced to abruptly close, disrupting an industry that was already facing secular pressures. With such a sudden impact, studios moved quickly to adjust the distribution of films that were currently in theaters, as well those on the release schedule. Films on the tail end of their 90 day theatrical exclusivity were not impacted too much, as they quickly migrated to VOD services, slightly ahead of schedule. Films in the beginning or middle of their theatrical release followed course, as the majority of box office is usually achieved in the first few weeks anyway. The biggest decision studios had to make surrounded films slated for wide releases later in 2020, but especially from April to June. The result was a furious paced game of musical chairs as films were pushed back to Q3 and Q4, and in some cases 2021, with the amount of attractive release dates dwindling as the calendar became more congested. For Q2 releases, some studios (such as Paramount), chose to sell their films directly to streamers, with others (such as Disney) opting to release the film on their own newly launched OTT services. The most controversial decision was taken by Universal, when they announced a day and date release for *Trolls World Tour*. The studio was in a precarious position because the marketing campaigns for the April 10th release were well underway, and re-spending that P&A would have eliminated any potential profits. Bypassing the theaters completely (even if they were closed) sparked a fierce and very public debate and re-ignited speculation about PVOD and theatrical windows

Theatrical box office remains essential for tentpole franchises with high production costs and significant marketing expenses to become profitable, as well as to drive value to ancillary businesses, such as consumer products and theme parks. On the opposite end of the spectrum, low-budget films can achieve massive profitability from a box office hit, with limited risk. But it's getting much harder for anyone in between, with middle budget films continuing to get squeezed as attendance figures slowly decline. As a result, these films are increasingly being sold to directly to the likes of Netflix without any hope of seeing a theatrical release. Furthermore, studios are forming their own production banners to create these types of arthouse quality films specifically for their OTT platform. Independent studios are feeling it the most, as the business models has evolved away from deficit financing, where they can capture upside in the event of a hit, towards a cost-plus model where there is guaranteed profit, but at considerably lower levels.

Theaters are starting to re-open across the world, more so in Asia and Europe, and in some states in the U.S., but moviegoing is not expected to just snap back to pre-COVID levels. There is a bit of a chicken-and-egg game being played between the studios and exhibitors as neither want to take on the risk of opening too soon. Studios want exhibitors to open to get a better sense of audience demand and formulate the release schedules for their biggest properties. Box office remains the biggest driver of revenue, and dictates licensing fees in windows further downstream, so there is a lot of focus on maximizing value. Exhibitors, on the other hand, and are reluctant to increase their level of expenses in order to open without any notable films on the calendar that can attract sizable attendance. In the interim, some studios are licensing library films to theaters to slowly bring back audiences at low pricing levels. There are also social distancing measures being put in place, limiting capacity to ~25%, but with very few new movies, that should not impact the potential success of a film. Exhibitors can utilize all their screens to show 1 or 2 films to accommodate the demand, but weekend nights will be more difficult. All eyes are on Christopher Nolan's *Tenet*, which is currently scheduled for a July 17 release, and Disney's *Mulan* shortly after on July 27. But so far, there has been limited marketing spend by these studios. China is much further along on the path to recovery, and is a vital market for the success of *Mulan*, but it's not apparent that Disney is doing any advertising there either. *Tenet* premiered a new trailer in *Fortnite* (where else), but notably omitted the release date at the end, giving themselves some flexibility. Flying a little under the radar is the July 1st release of *Unhinged*, a mystery thriller starring Russell Crowe from Solstice Studios. It's already less than 30 days out, and awareness for the film is non-existent. While its performance can serve as a barometer for success (or failure), at that point it might be too late to make adjustments for *Tenet*, or even *Mulan* for that matter.

The Growing Importance Of Direct Response Advertising

The advertising industry saw a drastic pullback in spending in late March and into April, as people were confined to their homes. As expected, brands spending on travel, automotive and retail sectors dissipated, while CPG and telecom remained fairly steady. Additionally, small businesses were the hurt worst as many were forced to close (at least temporarily), eliminating all ad spending that was primarily directed towards Facebook and Google. As Q1 results came in, the impact of the worldwide pandemic could start to be quantified.

- **Google:** In March, revenues began to decline and ended the month at a mid-teens percentage decline in year-on-year revenues.
- **Twitter:** Ad revenue from March 11 to March 31 declined approximately 27% year-over-year.
- **Snapchat:** Year-over-year growth in January and February was approximately 58% before declining to approximately 25% in March.
- **New York Times:** First quarter advertising revenue declined 15% overall, with the economic slowdown beginning to play a role in March where the declines were much steeper

These numbers are staggering, but there are some indications that advertising is slowly starting to recover, although in some places more than other. Facebook and Google, with their massive scale and strength in targeting, will most likely be the first place that brands return to. But across all digital platforms, the overwhelming theme from management was the importance of direct response advertising, and the need to make this a bigger part of the business.

With demand absence, and supply increasing due to higher levels of engagement, prices have fallen off a cliff, creating unique value opportunities for brands that are less impacted. Performance marketing, tied specifically to customer action makes it easier to assess ROI, compared to brand advertising. This type of advertising has been heavily utilized by mobile apps (i.e. click to install), especially games, to increase their user base. Mobile game publishers, who primarily serve as an ad network through their free-to-play games, have been able to take advantage of lower customer acquisition costs to promote their own games, as well as increase their spending with other mobile game publishers. Direct responding advertising has even extended into audio, where Spotify touted the success of their sponsored recommendations that push new song/album notifications to listeners. The best place to advertise music should be on a music streaming platform where users can seamlessly interact, and labels should be taking advantage of low prices to do more of this.

Conversely, TV has always been a brand advertising platform, where companies use the reach of the medium to build awareness of their products. But similar to digital, demand has evaporated, and the loss of sports, especially playoffs has hurt scatter pricing and led to the renegotiation of contracts. Upfronts have been cancelled, and many commitments for Q3 and Q4 have been pulled back with so much uncertainty around TV production. On top of all this, consumers continue to move away from linear television and watch more content on OTT platforms. Networks that have launched DTC platforms can retain this audience engagement, but the problem is that many of these services are ad-free, meaning there is limited inventory to shift. This partly explains why there has been a recent spending spree on AVOD products (Pluto, Tubi, Xumo), which allow media networks to grow their inventory, but more importantly add new features, such as targeting, that they can't provide on linear channels. These large conglomerates are re-organizing their ad sales team to combine TV and digital under one roof in order to provide a holistic solution to clients, rather than a fragmented approach across platforms. NBCUniversal seems to be slightly ahead of others in their efforts to improve the TV ad experience and incorporate digital features. Through their new AVOD service, Peacock, they will be rolling out transactional ads that are the first step towards direct response. While it's somewhat of a clunky process, with consumers interacting with on-screen ads just to have it pushed to their mobile device, rather than directly engaging through Peacock. But technological

advancements should see that improve over the next few years, and the recent acquisition of Vudu, gives them an existing TVOD product to build upon.

E-commerce is the next frontier for performance advertising, and while it will take to fully develop, the lines are starting to blur a little bit. Facebook has just begun to roll out Shops across all of their apps (Facebook, Instagram, WhatsApp, Messenger), allowing business to sell directly on the platform. This is especially beneficial for small businesses who no longer need to build their own website or their own digital storefront to transact with their advertising base. This elimination of friction adds value to customers, as well as businesses, and has enormous potential in emerging markets with limited tech infrastructure. This is one of the main reasons for Facebook's recent $5.7B investment in Reliance Jio, as they seek to control the mobile marketplace offering in India. Another $4B in investments from PE giants Silver Lake, Vista Equity, General Atlantic, and KKR highlights the size of the potential opportunity around mobile commerce.

Musicians Are Going Direct To Consumers, While Podcasters Seek Platforms

The sudden cancellation of concerts has severely disrupted the music industry, as it removed the primary revenue stream for artists. As Live Nation works on rescheduling tours for later in the year, or even 2021, refunds have been offered for 80% of shows, but customers are not taking them. These are rare moments for fans to see their favorite artists in person, and they want to ensure they have a ticket when the show returns, especially due to inefficiencies in the buying process caused by the secondary market. While many fans will be content with waiting for shows to be rescheduled, there is still no time table for that to happen. Live concerts, with thousands of people in close proximity, will be one of the last type of events to resume to any sense of normalcy. Taylor Swift has already cancelled her tours for the rest of the year, and promoters, agents, managers and artists will need to work together to reconfigure guarantees to expedite the path to resuming tours. In the interim, there will be experiments around drive-in concerts and fanless broadcasts, but none of these will replicate the experience fans get from live events.

Artists have not been idle, instead they have been using their creativity to experiment with new ways to connect with fans through live streams. Most notably, two of hip-hop's super producers, Timbaland and Swizz Beatz, have teamed up to create *Verzuz*, which produces "battles" on Instagram Live between notable hip-hop artists such as DJ Premier vs. RZA, Erykah Badu vs. Jill Scott, and Nelly vs. Ludacris. While there have been tech issues, these weekly events have still seen concurrent viewership exceed 500k, with marquee names in the industry joining the fun in the comment section. This type of interactivity is most commonly seen in video gaming, where the chat feature is a critical component to the live streaming success of Twitch. This sort of direct-to-consumer experience would make even more sense on Spotify, but labels have been vehemently opposed to empowering streaming services with tools to helps artists monetize themselves (and thus diminishing the role of labels). Spotify has rolled out donation buttons in support of COVID-19 (either for artists themselves or for charity), but there has been little promotion around them, and they have not really made much traction, with artists or fans.

To combat the power of labels, Spotify has taken bigger steps into podcasting over the past few years to help diversify their content and reduce the reliance on licensing recorded music. In February, they acquired The Ringer (including digital media assets) for $250M as their 4th notable acquisition following Gimlet, Parcast and Anchor. But their biggest podcasting move came just weeks ago, when they signed an exclusive licensing deal for *The Joe Rogan Experience*, that includes audio and video. The similarities to Howard Stern signing with SiriusXM are evident, but with Spotify, there is no need for additional hardware purchase (most people have a smartphone), and no need for subscription (content will be on free, ad-supported tiers). It will be much easier (and cheaper) for Joe Rogan fans to move over to Spotify, although it's difficult to discern how many actually will. Many consume the podcasts via YouTube, where it is home to full episodes, as well many of its viral clips, which no doubt boost

the show's popularity. While some clips will remain on YouTube, it's unclear what they will look like, but the primary objective will surely be to shift audiences to the music platform.

Spotify has unsuccessfully experimented with video before, but has taken another recent step towards that space with introduction of video podcasts for a few of their creators. This speaks to how they think about podcasting as a multi-dimensional strategy. On a straight-forward basis, podcast listeners are a highly engaged and rapidly growing segment that they can bring into their platform, even if on a free basis. Once in the funnel, Spotify has demonstrated proven success with the freemium model by converting users into the premium subscribers (over 60% conversion rate). The amount of time spent listening to podcasts vs. music doesn't impact their margins, as payouts to labels are based on a percentage of all subscriber revenue. But the growing engagement around spoken word content gives them more ability to isolate that content in future negotiations. The bigger play for podcasts is around advertising, and owning the audio ad network, in a similar way that Google and Facebook dominate the digital ad market. Rather than relying on host-read spots, dynamic ad insertion can target different demographics of listeners, as well as enable smaller podcast creators to monetize their work. Terrestrial radio revenues have remained surprisingly stable over the past decade, and Spotify has made it clear they want to take some of that market share. As with all mediums, advertisers will gravitate to eyeballs, or in this case eardrums, and it could be poised for further growth, which wouldn't need to be shared with labels.

5 IMPORTANT DATA POINTS

- **Take Two** first released Grand Theft Auto V in 2013, but the franchise is still experiencing record breaking engagement with **over 130 million units sold, and Grand Theft Auto Online has had recurrent spending growth of 87% in the quarter and 40% in the last 12 months.**

- In late March, as customers were confined to their home, **Spotify** saw an evolution in listening habits, with usage in Car, Wearable, and Web platforms dropping (double digits in some instances), but the audience through TV and Game Consoles grew in excess of 50%. **For ad-supported MAU in the US, game consoles have been a top 2 or 3 platform in terms of consumption for the better part of the month, and connected device usage generally is up more than 40% among ad-supported users globally**

- **Disney** has opened Shanghai Disneyland with extra precautionary measures, but the financial impact on Theme Parks has already been felt in March, **with the disruption impacting quarterly operating income by approximately $1 billion, with a little over half of that reflecting 2 weeks of closures on the domestic side.**

- After a prolonged carriage dispute with Comcast, **Starz** is now only sold as a premium add-on channel, resulting in **6.2 million bundled subscribers disconnecting in December, but they have been able to capture back about 1 million of those subscribers (at higher ARPU) in the first 6 weeks.**

- As the Coronavirus spread around the world, **Live Nation** saw an abrupt stop to touring and even though they had promoted 5,500 shows (up 17%) for nearly 8 million fans (up 2%) through February**, they finished the quarter with only with 7,100 shows for 10.4 million fans, down 14% and 30%, respectively, from last year.**

5 RESONATING QUOTES

“And when you look at Warzone, it was definitely built to provide endless fun on its own and to stand on its own as a great game, but Warzone and Modern Warfare are also obviously connected in many ways, including through shared progression systems, game systems and content offerings. And what we're seeing right now in Warzone is a large number of players choosing to upgrade to the premium Modern Warfare game and experience everything that the Modern Warfare universe has offered.”

Rob Kostich, Activision Blizzard President of Publishing

“Frankly, we, long term, are still bullish about Hulu International. Right now, though, given the cash situation and the sort of uncertainty around our overall business, we've got no plans immediately to make any investment in that business internationally.”

Bob Chapek, Disney CEO

“One of the things we've been really investing a lot in is this transition from augmented reality being something entertainment-based to something that provides increasing utility. And we believe that, that transition has been accelerated by this crisis.”

Evan Spiegel, Snapchat Co-Founder & CEO

“So TV has become an app without commercials. And if there are commercials, it's a lighter load. And you can put that linear TV where you might have 16, 17 minutes of commercial time during an hour's show, it might be a really good show, but you just -- it's painful, right, once you've seen something without commercials.”

Charles Ergen, DISH Network Co-Founder & Chairman of the Board

“We're evaluating our product distribution strategy, relooking at volumes and the required support levels we need in a down economy. We're rethinking our theatrical model and looking for ways to accelerate efforts that are consistent with the rapid changes in consumer behavior from the pandemic.”

John Stankey, AT&T President & COO