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Broadband Operators Well Positioned to Capitalize on Accelerated Connected TV Growth

Jeff Johnston

Lead Economist, Communications

Inside…

Key Points:

- With millions of bored consumers waiting out the pandemic at home this past year, 2020 was a tipping point for connected TV on-demand video streaming services, which drove an acceleration in cable cord cutting.
- Major media companies have started to prioritize their streaming services. Warner Bros. is now simultaneously releasing movies in theaters and on its streaming service HBO Max, and Disney has reorganized its business around producing and distributing streaming content.
- In 2020, streaming service providers added tens of millions of new customers, and more people now watch TV via a connected TV device versus the traditional linear programming model, according to some estimates.
- Despite the surge in cord cutting, some cable operators have been able to expand their margins with a broadband-first strategy.
- Several indicators suggest the connected TV phenomenon could accelerate in 2021, which should help improve margins for those cable operators who embrace this trend.

Introduction

The COVID-19 pandemic disrupted many industries and changed the way people live in ways that were once unimaginable. One of these changes is how people watch TV. Stuck at home with no sports to watch on cable channels, consumers turned to on-demand streaming video services via smart TVs and streaming devices, which fueled unprecedented demand for these services. This shift led to a spike in cord cutting, which forced cable operators to change how they think about their business. On the surface, cord cutting seems like a major headwind for cable operators – conventional wisdom suggests that as a service bundle begins to fracture, voluntary churn increases. But in reality this was not necessarily the case. One needs to look no further than Cable One, which saw this trend coming years ago. With its consumer brand Sparklight, Cable One has successfully implemented a broadband-first strategy that has paid dividends.

In this report we look back at the events of 2020 that accelerated the streaming video craze, and provide perspective on what to expect in 2021 for both media and broadband companies. We also look at some of the strategies broadband operators are employing to better align their businesses with streaming video.

Connect TV Overview

Traditionally, TV operators negotiate rights to distribute video content and then sell it in bundles over cable and satellite networks. Many consumers were frustrated by this model, as they were forced to pay for content they had no interest in watching. These frustrations, coupled with improved broadband networks, paved the way for new connected TV streaming services pioneered by Netflix. Streaming services enable consumers to build their own video subscriptions a-la-carte, giving them the option to only pay for content they want to watch. Each service is billed monthly and consumers can cancel at any time without penalty. Beyond that, all that is needed is a good broadband connection. This consumer-friendly model has led to an absolute boom in streaming content and has forced an unprecedented amount of cord cutting.

Tipping Point

Last year was transformational for the video industry thanks in large part to COVID-19. Live sports, a major reason why consumers stick with cable service, was unavailable, and as people were forced to stay home, they discovered the value of streaming services. This drove a massive increase in the number of streaming apps made available to consumers. According to digital advertising technology company The Trade Desk, at the end of 2020 more people were watching TV via a connected TV versus the traditional linear approach (in which viewers tune in to watch a program at a scheduled time).

Disney's streaming service, Disney Plus, has amassed over 100 million subscribers since its launch in November 2019 and expects that number to grow to 230 million-260 million by 2024. The growth in connected TV has forced Disney to completely reorganize its business around streaming – an unthinkable move 12 months earlier.

Apple TV Plus also saw tremendous growth as did AT&T's HBO Max and Comcast's Peacock service. And in a startling move, Warner Bros. announced that its entire slate of 2021 movies will premier simultaneously in movie theaters and on HBO Max. This decision in part was driven by the shrinking number of moviegoers due to COVID-19, but it also speaks to the extent to which streaming providers will go to acquire subscribers. The market places a high valuation on streaming customers, hence the incentive to grow this part of the business. For example, Disney saw its stock soar after the success of Disney Plus, despite the losses incurred from its closed theme parks during the pandemic.

On the broadband side, Comcast announced that it experienced two years' worth of network traffic growth in just four months. And despite the increase in video conferencing applications like Zoom, video streaming drove the lion's share of the increase in traffic. Video streaming accounted for over 70% of the downlink traffic, representing a 70% increase over 2019, whereas video conferencing represented less than 5% of network usage.

Broadband Opportunities

All of these trends represent opportunities for broadband providers. Video margins are thin at best for small rural operators, which means they should embrace a broadband-first model. Broadband margins are healthy, and many operators have been able to thread the needle between cord cutting and growing margins.

One of the most forward-thinking broadband providers, and the poster child for how to pivot to a connected TV world, is Cable One. Smaller rural operators should pay close attention to how Cable One deemphasized its video service and adopted a broadband-first strategy. Years ago, the company adopted a cost-plus model for its video business, which means it simply passed on content cost increases to its customers. They didn't try to save video customers with promotions based on a fear that a lost video customer could lead to a lost broadband customer. Instead, Cable One educated cord cutters that in order to watch streaming video, a reliable high-speed data connection is needed. And by doing so it was able to leverage the strength of its network and retain a high percentage of broadband customers. Predictably, residential video revenues have been in decline but residential broadband revenues have increased a whopping 17% per year since 2015 *(Exhibits 1a and 1b).* These strategic moves have had a disproportionate impact on margins. The company's EBITDA margins have gone from 40% in 2015 to 51% in 2020 *(Exhibit 2),* and the company has seen its stock surge over 280% in the last five years *(Exhibit 3).*

Since Cable One's initial strategic shift, it has been working on a new IP-based TV service that will replace its traditional linear video service (which frees up spectrum for its broadband network). Repurposing spectrum helps Cable One to expand the capabilities and speeds of its broadband network.

EXHIBIT 1a: Cable One Revenues for Residential Subscribers

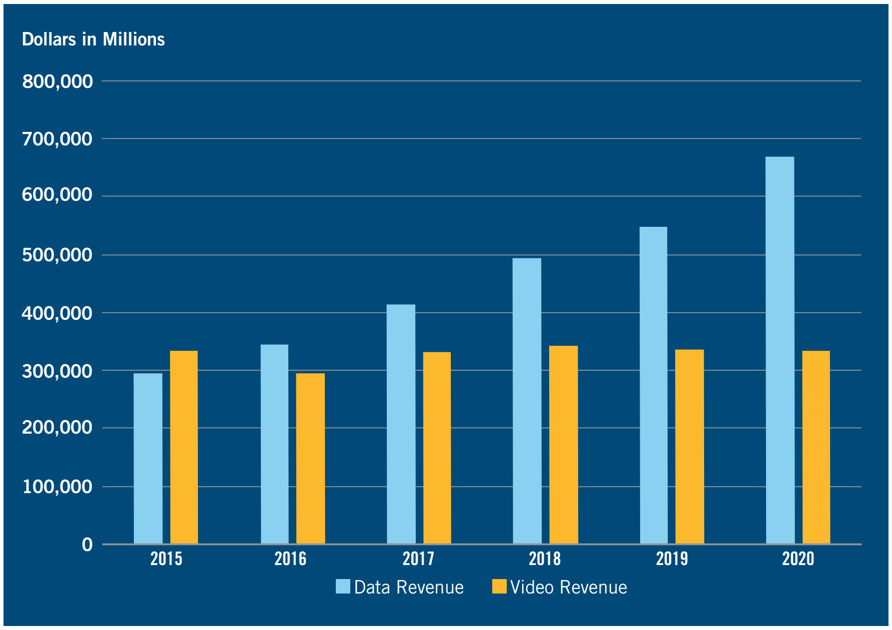
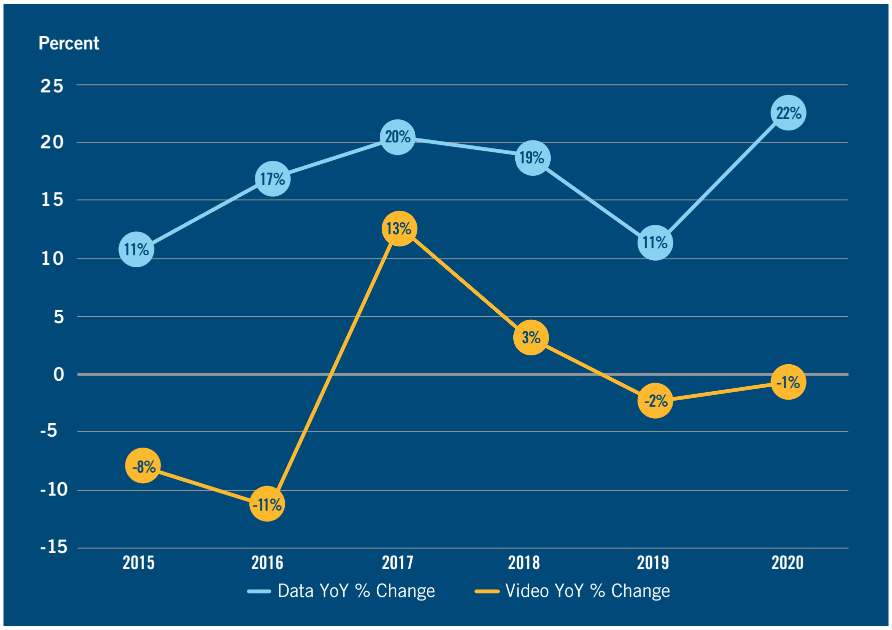


EXHIBIT 1b: Year-over-Year Percent Change in Cable One Revenues for Residential Subscribers



Source: Cable One company filings

Cable operator WOW! has also executed well in this new environment. Over the last 12 months WOW! increased its EBITDA margins while shedding video customers and growing data subscribers *(Exhibit 4)*. WOW! is marketing virtual multichannel video programming distributors (vMVPD) as an alternative to its linear TV service, and on the last earnings call, the CFO said he expects the company to lose more than 60% of its video subscribers by 2024.

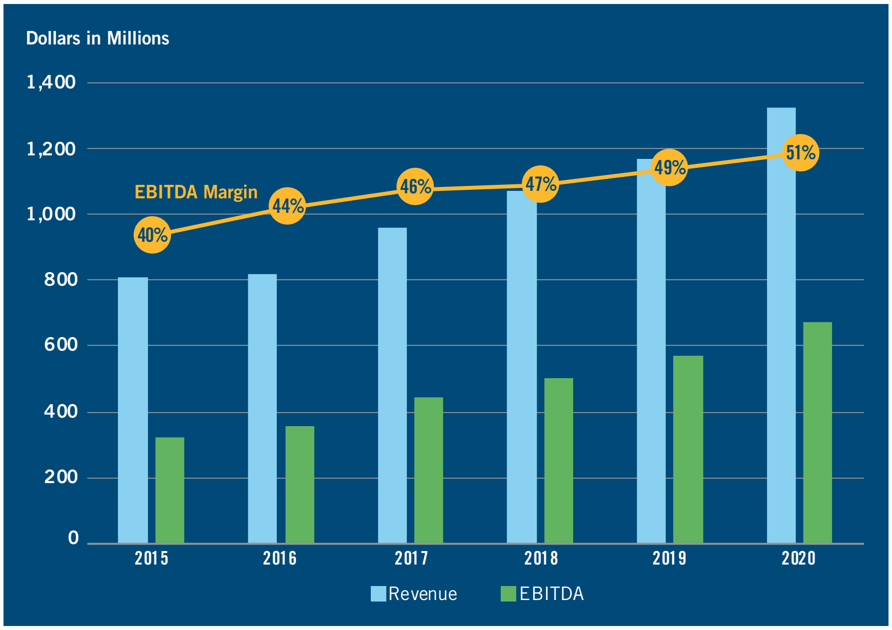
As people cut the cord, they tend to upgrade their broadband plans. And as we know, margins on faster data speed plans are higher than lower speed plans, given the operating leverage of the business model.

Continued Momentum

Numerous signs point to an increase in connected TV adoption over the next several years, which should help broadband operators improve their margins. According to The Trade Desk, which helps advertisers buy ad inventory programmatically, 27% of U.S. cable TV subscribers plan to cut the cord in 2021, up from the 15% who did so in 2020. Trends in the digital advertising industry also indicate where things are headed.

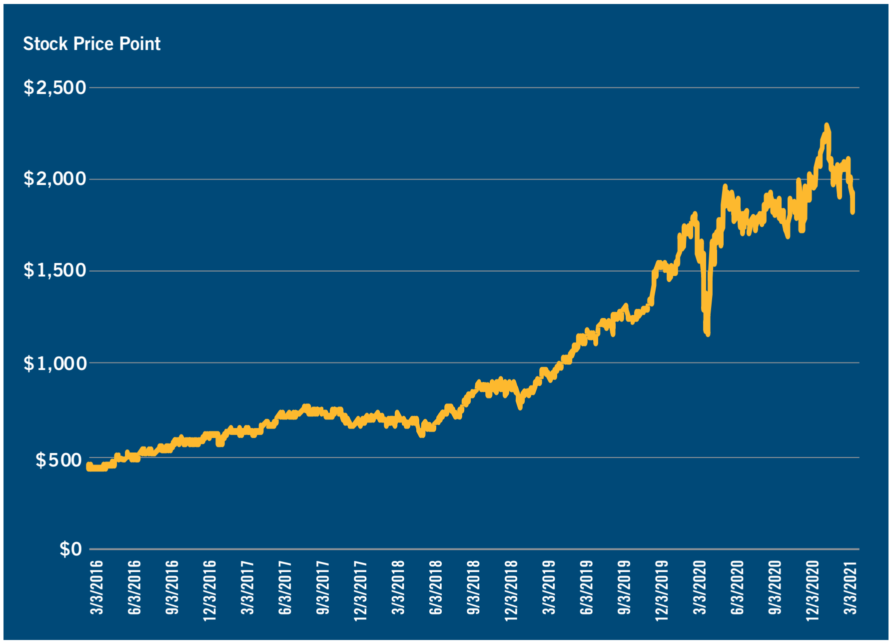
The U.S. TV advertising market is valued at $70 billion, but advertisers spent only $8.11 billion on connected TV in 2020, according to eMarketer.

EXHIBIT 2: Cable One Revenue and EBITDA



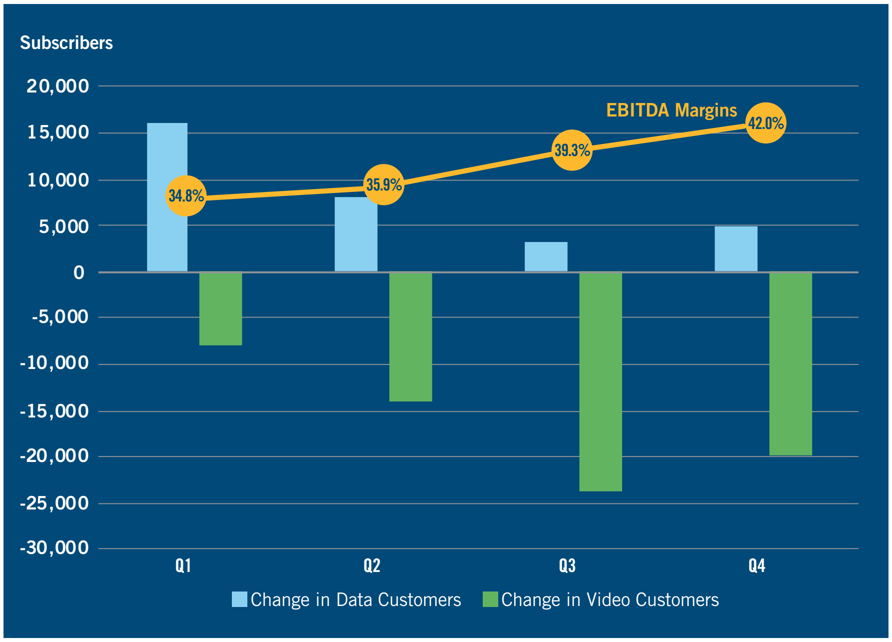
Source: Cable One company filings

EXHIBIT 3: Cable One 5-Year Stock Chart



Source: Yahoo Finance

EXHIBIT 4: WOW! Margin and Subscriber Trends in 2020



Source: wowway.com

This disconnect between consumer viewing habits and advertising spend should narrow as marketers start making bigger bets on streaming. eMarketer estimates that connected TV advertising spend will increase 40% in 2021, and by 2024 it will reach $18.29 billion.

It's not just the TV ad spending trends that portend a bright future for connected TV – and for that matter, broadband operators. Technology companies that enable connected TV advertising also paint a bright future; they've reported solid earnings and been rewarded with high stock valuations as investors anticipate robust growth.

The aforementioned The Trade Desk grew its 2020 revenues by 25%. That alone is impressive, but given that it was able to achieve this during the pandemic, when large swaths of the economy stopped advertising, speaks to the resiliency of connected TV. Investors have become bullish on The Trade Desk's prospects, and as a result its stock price is up 177% over the last 12 months as of this writing. And even more impressive, the stock now trades at 35 times its 2021 consensus revenue estimate. It's important to note that the higher the valuation, the more optimistic investors are about the future of the company. To put this valuation into perspective, Facebook currently trades at 7.4 times its 2021 consensus revenue estimate.

And it's not just The Trade Desk that is benefiting from this trend. Streaming platform provider Roku is growing like a weed with 2020 year-over-year revenue growth of 58%. Streaming hours on its platform grew by 20.9 billion in 2020 to a record 58.7 billion. It too has enjoyed a surging stock price and high valuation as investors see Roku as a great way to play the connected TV trend.

Conclusion

Despite the acceleration in cord cutting, cable operators who've been able to embrace this trend have improved revenue and margins. The shift to connected TV will only increase over the next few years and there could come a day that all TV is watched via a connected TV. Major media companies are investing heavily in their streaming content and in the case of Disney, reorganizing entire businesses around streaming. Companies like Disney don't make these kinds of bets unless they believe their industry is going through a long-term structural change. It's important for cable operators to align their business with these trends, such as offering an IP-TV service like Cable One is doing. This allows operators to repurpose spectrum for broadband use, which helps them meet speed and capacity demands. It also reduces the network costs associated with distributing traditional linear TV.

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