Streaming wars—A new hope

Last year was a big one for cord-cutting streaming services as mega-corporations Apple and Disney, among others, entered the previously oligopolistic marketplace. Can these new players thrive and what impact will it have on Netflix and traditional cable companies? Jonathan McMullan, global equity research analyst at Newton, shares his take.

It started in 2006 when Amazon, now part of the trillion dollar club1—but less of a powerhouse back then, decided to launch Amazon Video, which allowed users to rent and purchase thousands of movies. Not long after, Hulu joined the party—officially going live in 2007. That same year, DVD-by-mail service Netflix started to leave its traditional business behind and, well... we all know how the story goes: media was never the same.

Today streaming services have begun to displace traditional cable subscriptions across the globe as consumers cut the cord and, unsurprisingly, many companies want a share of the pie.

“Increased competition is rarely a positive thing for any company or stock and I don’t see this being an exception,” McMullan says. “The key question is: To what degree does this increase competition, and how will this impact each player’s growth prospects?”

Investors have been watching this evolution play out for quite some time and increasingly, the consensus view is that scale and the ability to produce high-quality content matters more than ever. In 2019 alone, Netflix spent $15bn of cash on content, with roughly 85% of expenditure geared towards original films and series.2

According to McMullan, these kinds of costs are increasing: “There’s more competition for the top talent, whether it be scriptwriters, actors, directors or producers—and that’s going to put some pressure on margins,” McMullan says.

Band of brothers

New entrants in the space might not necessarily spell doom for existing streaming services, he says. This is because, as far as a streaming war goes, rather than take market share away from each other, the new services may grow at the expense of traditional cable companies. One only has to look at the evolution of cable TV to understand how this could play out.

When cable TV first came out and a host of new channels launched (think MTV, USA, Nickelodeon), McMullan says, rather than take viewers from each other—cable TV channels grew together at the expense of broadcast channels. He believes the same could be true for

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1 CBS News: Amazon becomes second trillion-dollar company in US, September 4, 2018
2 The Motley Fool: How much are the streaming giants spending on content, September 8, 2019
video-streaming services, which can grow together at the expense of higher-cost traditional pay-tv plans.

“Even for those who pay for multiple streaming subscriptions—I think the value proposition is pretty good, particularly when you compare it to the average monthly cost of $107 for a traditional TV bundle,” McMullan says. “Increasingly, my expectation over the next few years is that over-the-top services will be a substitute for, rather than complementary to, the cable bundle.

While the effect on consumer consumption is clear, what’s not so clear is how this translates to attractive opportunities for investors, according to McMullan.

“This is certainly a fantastic time for consumers, with the scale and ambition of television beginning to rival that of feature films. However, the future returns for investors are less certain,” McMullan says. “Projections on the future size of the market, how intense the competition will be, and how valuations look, all have to be factored in.”

The Mickey Mouse club

Many investors have their eye on Disney with its Disney+ streaming service, which debuted in November 2019. Part of the reason is because it is already a multi-faceted corporation and, as such,—no stranger to video entertainment content.

Disney was among the first to admit it was not immune to changes in consumer behavior and how video content is viewed, according to McMullan. It is now addressing the threat head-on with its own direct-to-consumer offerings (Disney+, Hulu, ESPN+) and pulling content previously licensed to Netflix.

“Disney has invested heavily in its content through its prior acquisitions, whether it be Fox, Pixar, Star Wars, or Marvel—and over the long term, that will serve Disney well, because ‘quality content is king’,” McMullan says.

“Because of this, we believe Disney is in a stronger position than most, and that is reflected in its stock price, which is on a mid-20s price to earnings multiple, compared to other content companies that haven’t made that pivot as successfully, and are maybe trading at eight or nine times earnings.”

However, he highlights that the near-term profitability of Disney+ will probably not be as lucrative as its legacy pay-tv business for many years.

“In the short to medium term, what will matter most for Disney is subscriber numbers. So far, the investment community is showing patience, knowing that it will be several years before the Disney+ streaming service is profitable. The key risk is that the new service could eat into

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3 *The Balance: The average cost of cable fees keeps rising*, January 29, 2020
Disney’s own higher margin legacy pay-tv business by driving an acceleration of cord cutting,” he says.

**How did we get here?**

Despite the tough comparison, investors and new entrants have been looking to past successes as a guide to whether new endeavors will prosper in the future.

“Part of what has been painful for large media businesses is Netflix, which is a monster they helped create,” McMullan says. “They initially didn’t see Netflix as a threat, and that’s why they licensed some of their content to it. While it may have given them a nice short-term revenue boost, it came at the cost of helping Netflix grow to scale.”

Netflix’s success has been built upon the clarity of its vision of how content should be delivered, and the aggressive way it is moving towards that, years ahead of the competition, says McMullan. Arguably, it has merged together technology and video content in a way that we believe is better than anyone else has ever done before.

“The impressive consumer experience, investments in original content, and international expansion, have allowed Netflix to grow its subscriber base, which drives higher revenues, which in turn funds even larger content investments. That virtuous cycle has been in place for many years now,” he says. “At the moment, there are a lot of chess pieces on the board so it will be interesting to see how they fare over the next few years.”

**Newton’s view**

“Recent developments highlight how the barriers to entry for new players have come down dramatically. Historically, to be a pay-tv provider you either had to lay cable past homes or put satellites up in the sky, but now, all you need is a server and access to content,” McMullan says.

Newton’s investment approach of using bottom-up fundamental research, combined with a top-down thematic overlay, has helped it navigate the profound changes ongoing within the media and technology sectors, according to McMullan. “This has helped us to avoid companies that are being disrupted, while tailoring our exposure to the beneficiaries of that disruption.”
Risks:

All investments involve risk, including the possible loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing.

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