

Media & Entertainment: Flow of Funds

Trends and developments in the UK



Content

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Executive summary

After contracting during the global financial crisis from 2007 to 2009, the UK Media and Entertainment sector has exhibited solid growth to reach Euro 46.1 bn (equivalent to GBP 39.1 bn) by end 2013. This growth has been driven by multiple factors – rising population, increasing spend per capita on media services, a robust resumption in spend by advertisers and also moderate rise in total public funding.

Consumer spending on media and entertainment accounted for more than half the total industry in flow of funds over the period, though the proportion coming from advertising is now growing strongly. Both segments exhibit a shift towards online services. Within product genres, and when combining online and offline spend, TV/Video and Gaming exhibit overall revenue growth, whereas Music/Radio and Newspapers/Magazines remain in decline.

Amongst the payment flows analyzed by Arthur D. Little, the clear recent beneficiaries have been the contents and rights owners, whereas retailers of physical media have been the hardest hit since the downturn and are forced to radically adapt their footprints and business models. Nevertheless, the solid growth performance of the Media and Entertainment sector overall has outstripped both European peers and also the adjacent telecoms sector.

Several trends and developments help to distinguish the UK market:

- Consumers relentless adoption of new device formats and new services, coupled with multi-tasking and media stacking, means UK citizens now spend more than 11 hours of 'effective' time every day using communication and media services (compressed into under 9 hours of 'linear' time).
- Content distributors, including the BBC, are gearing up to respond to these trends, and the generational shifts that underlie them.
- The continued cross-sector battle between Telecoms and Media giants BT and Sky is exacerbating contents rights inflation, and other actors – notably ITV – are investing heavily in content production.
- Dynamic new segments like videogaming – where UK-based studios truly create world class content – are growing resiliently and are significant developers of talent, as well as major exporters.

Looking forward, we expect continued growth, propelled by further increases in population, advertising spending and online services. This, coupled with foreign currency effects, will place the UK media and entertainment market well ahead of aggregated European peers in Euro terms for the foreseeable future.

1. Recent evolution of the Flow of Funds in the UK

Arthur D. Little has carried out a structured study of the recent evolution of the media & entertainment sector in the United Kingdom. The analysis comprises the period between 2007 and 2013, distinguishes the sources of funds and their destinations, and separates online and offline consumption. As Figure 1 shows, we have studied the existing flow of funds between the different players in the sector, from its sources to its retailers, aggregators and producers, identifying received, retained and transferred values for each participant. The conceptual framework of the analysis can be observed in Figure 2. The results of the study have allowed us to develop quantitative arguments in order to understand what has happened in the sector during the past years, who the winners and losers are, what the current trends are, what important opportunities might arise in the near future, and what the keys are for each player in the market to seize them.

After a year of economic recession in 2008, the United Kingdom has returned to growth faster than Europe, witnessing an average annual growth rate of the country's GDP of +3.8% since 2009.

The media & entertainment industry has followed a similar trend over the same period, decreasing in size between 2007 and 2009, and growing since then (CAGR +3% between 2010 and 2013) to reach a size larger than the 2007 level, as shown in Figure 3. In 2013, the industry represented €46.1 billion (equivalent to GBP 39.1 billion), funded by the consumers, advertisers and the government. This growth can largely be attributed to four factors:

- Increasing population.
- Increase in public funding.
- Renewed expenditure by advertisers.
- Rise in consumer spending per capita on media services.

Figure 1: Flow of funds in the UK media industry (2013 vs. 2007)

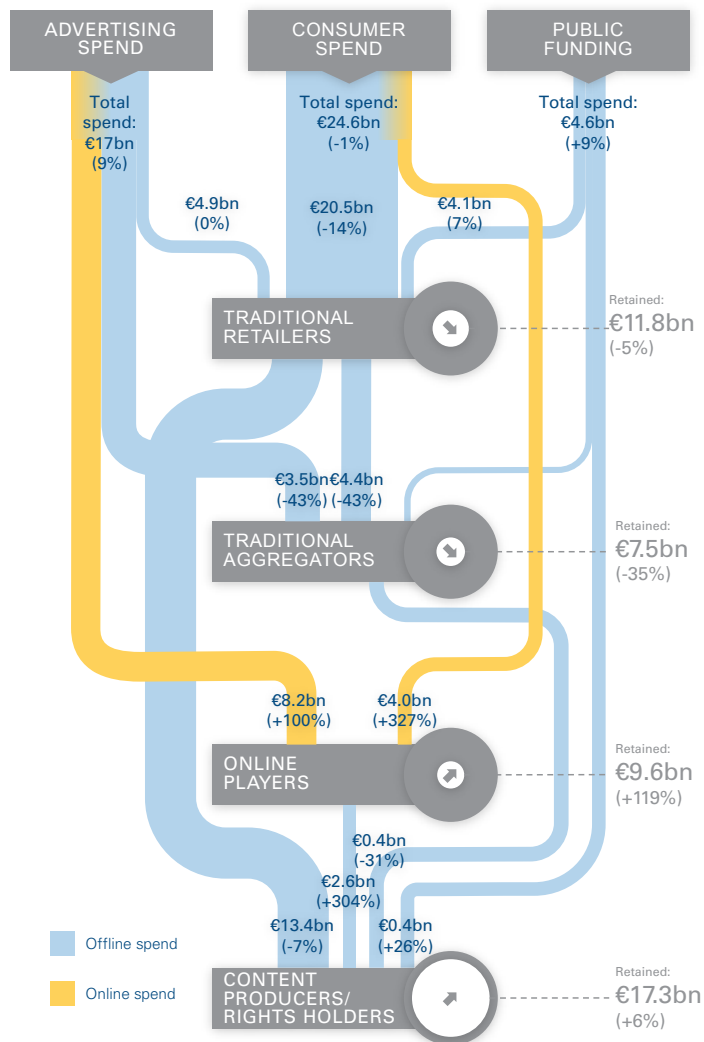
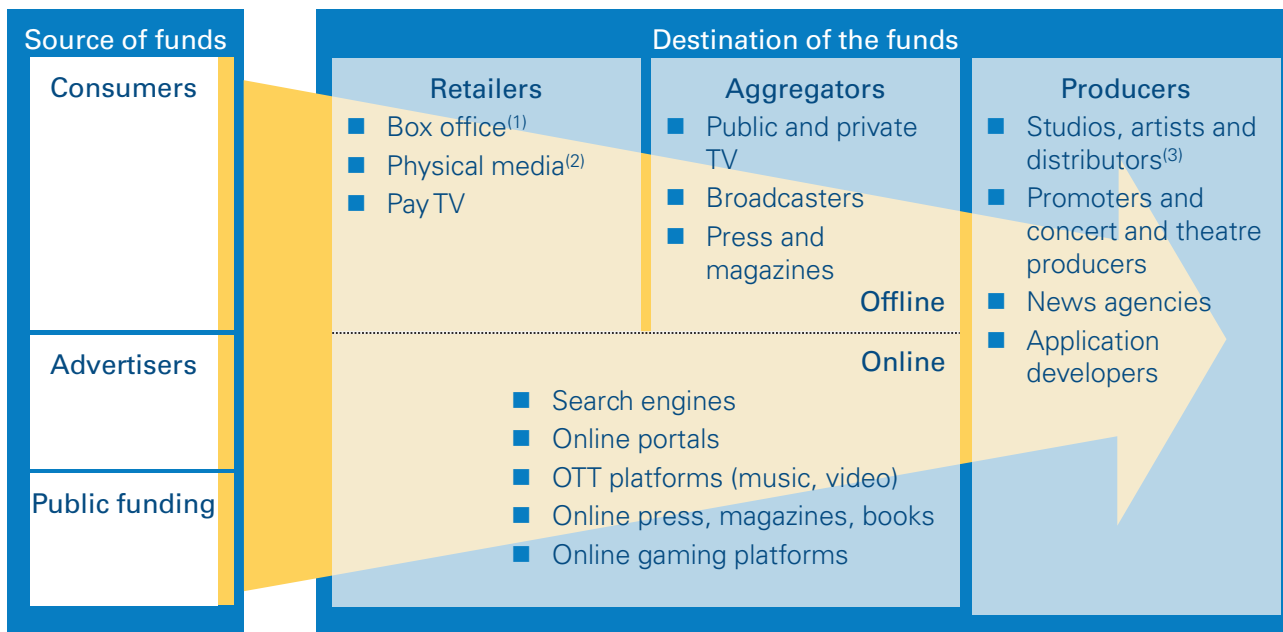


Figure 2: ADL media flow of funds framework



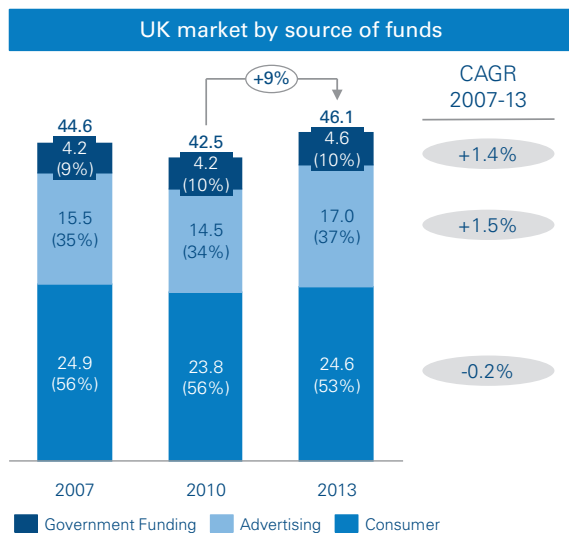
Notes: (1) includes cinema, theatre and concerts; (2) Includes retail chains, kiosks, etc.; (3) Includes record labels (music), editorials (books) and studios (video and videogames)

Advertising spending is the source of funds that has recovered the fastest after the 2008 global downturn

Consumer spending remains the main source of funds with 53% of the total. This share has been decreasing between 2007 and 2013 due to the relative stagnation of the consumer revenues, and the increase of advertising revenues and public funding (as Figure 3 shows).

In 2013 consumers contributed €24.6 billion to the media & entertainment industry, a decrease of €300 million (-1%) compared to 2007. Along the value chain, it is the distributors that are the first and most affected by this decrease, as observed in Figure 1.

Figure 3: Historical evolution of the size of the UK media sector



Source: Arthur D. Little analysis

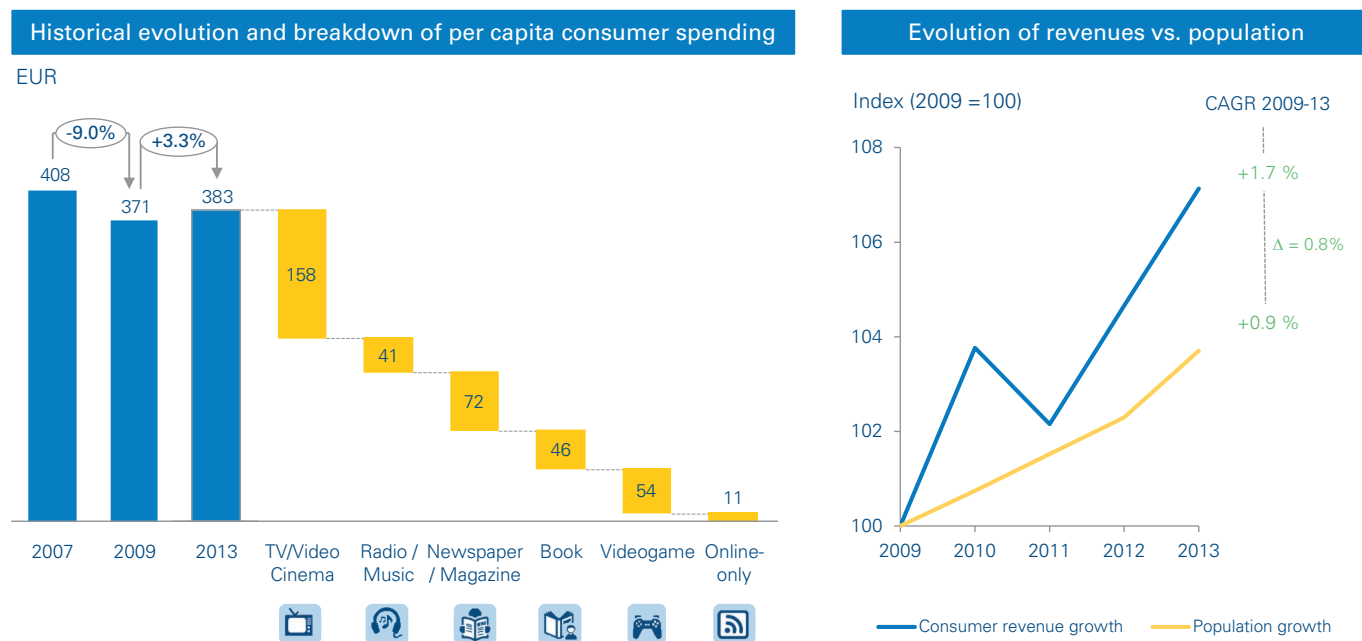
The decline in consumer revenues stems from the shrinkage in spending per capita between 2007 and 2013 (see Figure 4) that can be largely attributed to a precipitous decline of discretionary spending. However, a year-by-year analysis shows that this trend has reversed since 2009, where the consumers spending (+1.7%) has outpaced population growth (+0.9%). This additional 0.8% growth can be attributed to higher expenditure by consumers, including higher prices, larger bundles of media services consumers, etc.

On average UK consumers spend most of their media & entertainment budget on television, video and cinema, which represent €158 out of the total spending per capita of €383 in 2013. This is followed by newspaper & magazines (€72), and videogames (€54).

In 2013, advertising spending represented €17 billion in revenues. Unlike consumer spending, advertising has surpassed its pre-crisis level of funding. Over the 2007–2013 period of time, advertising as the source of funds has experienced the largest growth rate, increasing by +1.5% on average per annum. As a result, the share of advertising in the source of revenues has increased, from 35% in 2007 to 37% in 2013 (see Figure 3).

This overall favorable development hides widely varying performance depending on the advertising format. Indeed, as shown in Figure 1, the flow of **online funds** towards distributors and aggregators has doubled between 2007 and 2013. Over the same period, flows of offline funds towards the same actors have either stagnated or sharply decreased.

Figure 4: Evolution of spending per capita



Source: Arthur D. Little analysis

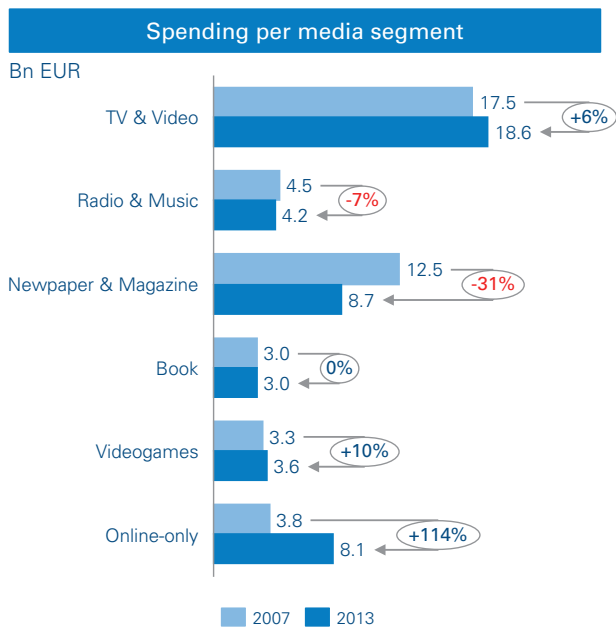
Public funds have followed a similar trend as the other source of funds between 2007 and 2013, although more nuanced. Overall they have increased by +9% over the period. Traditional retailers received more than 90% of the government procurement funds in 2013, with rights owners receiving the remainder.

Online-only, TV & Video, and Videogames are the three segments that grew during the 2007-2013 period, whereas Radio & Music and Newspaper & Magazine have both witnessed significant decline over the same period.

The TV & Video sector is the largest media segment, representing by itself 40% of the overall UK media & entertainment industry. It has been driven by the Pay-TV subscription revenues, which has increased on average by 2% per annum since 2007 to reach €6.3 billion in 2013. Although online revenues represent only 5% of the sector, online streaming services have become very mature in the UK. Providers of different types are now offering these services: Pay-TV players, such as Sky and Virgin, OTT players like Netflix, YouTube or Amazon Prime, Fixed telecoms players as BT and Talk Talk, mobile-only players such as EE or Vodafone, and (at least until recently) also retailers such as Tesco.

The Radio & Music sector has suffered from the rise of online consumption of content, and its weak monetization rate. Overall the size of the sector decreased by 7% between 2007 and 2013. The increasing penetration of streaming music services, like Spotify, Deezer and Xbox music, have greatly contributed to slash sales of physical recorded music with sales declining from €1.5 billion in 2007 to just under €0.7 billion in 2013. Nonetheless, revenues from live events like concerts and festivals remain stable at €1.3 billion during the time period, as the industry tries to better monetize the live experience.

Figure 5: Historical evolution of spending per media sector



Source: Arthur D. Little analysis

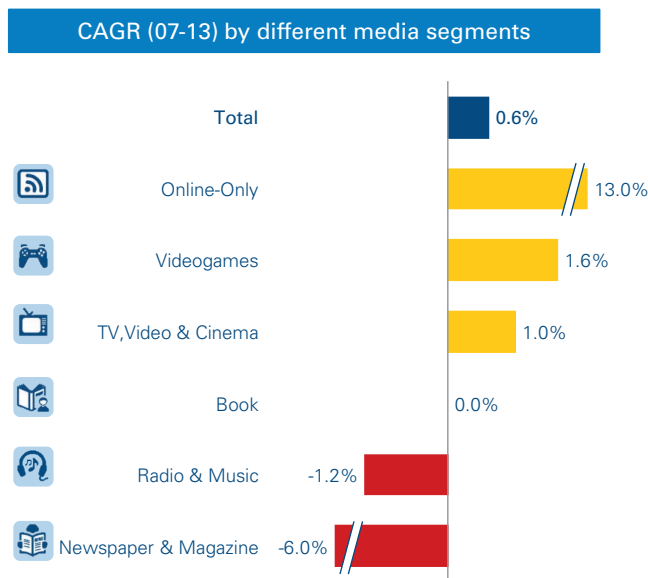
The Newspaper & Magazine sector is the one that has been the most affected during the 2007 – 2013 period. Indeed revenues for this sector decreased by 31% over the period. We can expect the online-only segment to surpass the Newspaper & Magazine in term of funding in the near future. The proliferation of “free news” via internet and mobile websites is the main reason of the sector declining revenues. Several papers abandoned print edition fees (i.e. The Evening Standard), and others instituted online pay-walls (i.e. the Times). Moreover, the drop in the number of subscriptions coupled with continuing falls in the print classified advertising value has also been a key reason behind the deterioration of the sub-sector revenues.

The book sector witnessed stable revenues between 2007 and 2013, remaining at €3.0 billion, as shown in Figure 5.

The gaming sector has proliferated much beyond the confines of hardware/console games to cloud-based, as well as mobile and tablet gaming. This has also influenced the changing demographic composition of the traditional gaming population; with 52% of game players now women, as a whole new set of game genres become wildly popular.

Online funds have been a clear growth driver for the UK media industry

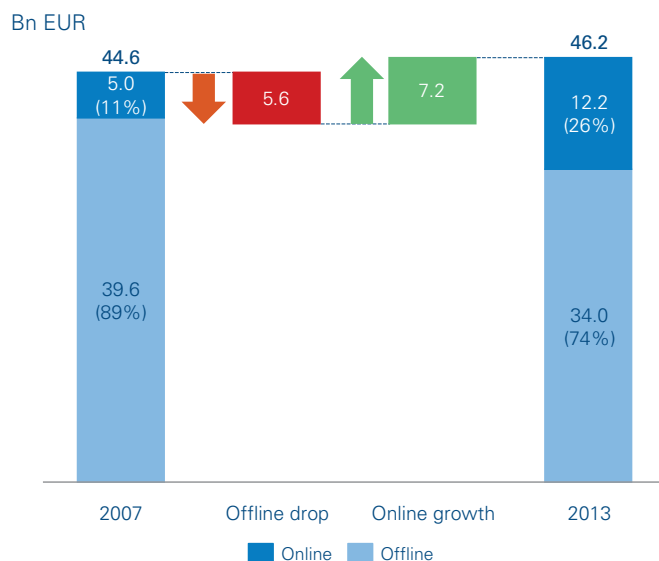
In the UK, online growth (€7.2 billion) has more than offset the drop in offline segments (€5.6 billion), thus increasing the overall market by €1.6 billion (see Figure 6). In 2013, the online segment represented €12.2 billion (26%) of the overall media market by revenues. This is more than a twofold increase in comparison



to 2007, when the online segment generated €5.0 billion of the market revenues. Nonetheless, not all media segments have experienced similar growth.

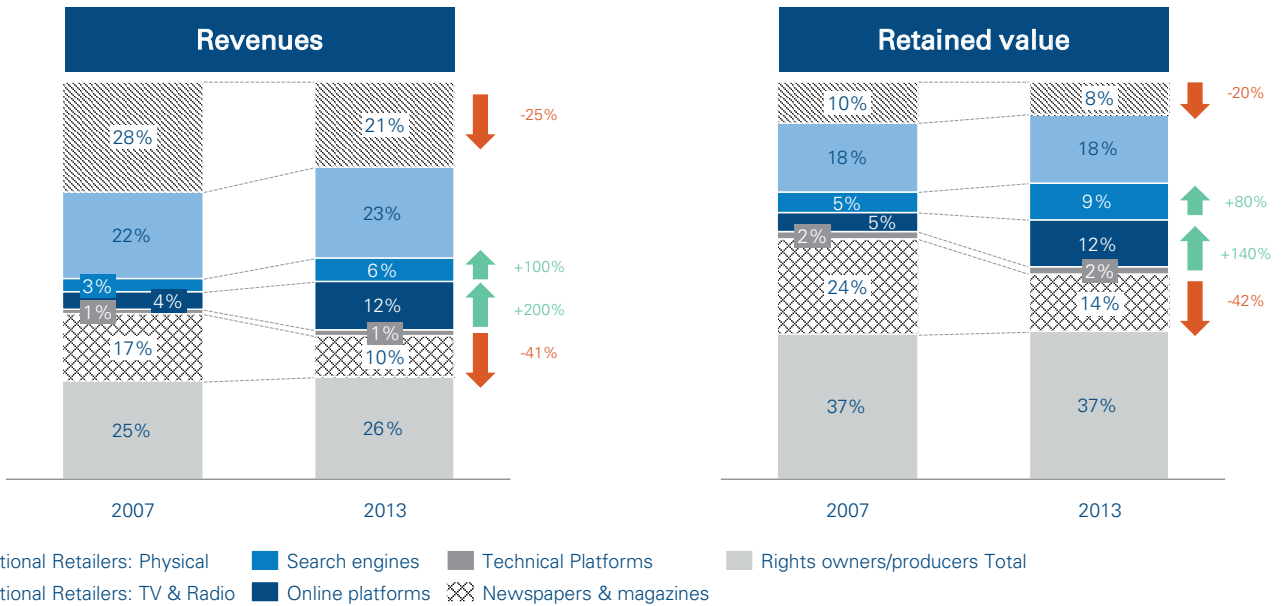
The Newspapers & Magazine is one of the sectors that have suffered from this shift towards online format for content consumption. Indeed offline revenues have declined by €4.5 billion, when at the same time online revenues have only increased by €0.6 billion, which is equivalent to 15% of the offline decline. The difficulty faced by traditional media houses, such as News Corporation, Press Holdings and Trinity Mirror,

Figure 6: Revenue composition offline vs. online



Source: Arthur D. Little analysis

Figure 7: Historical evolution of revenues and retained value by type of actor



Source: Arthur D. Little analysis

in monetizing their readership can be attributed to a number of factors:

- Availability of free news from several sources, such as newspaper websites (guardian.co.uk, metro.co.uk), TV broadcasting websites (bbc.co.uk, news.sky.com).
- Aggregator news sources (Google news, Yahoo News).
- Specialist websites that cater to different user needs, such as sports news (espn.co.uk, goal.com), technology (techradar.com, cnet.com, The Register).

- Rights owners and content producers generate 26% of revenues, but retain 37% of value (a retention ratio of 145%).

Note: (*) Includes incoming funds from consumers, advertisers and government, as well as funds flowing within the industry (e.g. from distributors to rights owners).

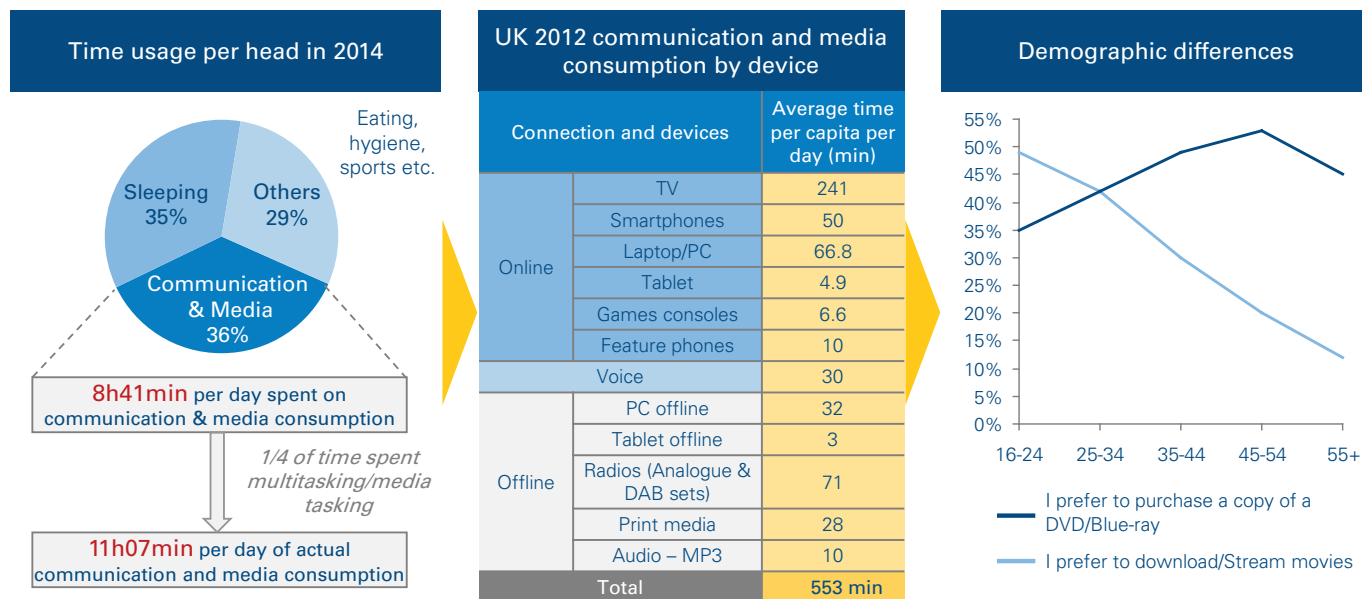
Rights owners and content producers are among the actors that are the most able to retain value

As well as quantifying the funds injected in the media and entertainment sector, this study shows how funds are flowing between actors of the industry. In particular, it is able to quantify the revenues that are received, transferred, and therefore retained by each type of industry participant. The retention ratio (retained value over total revenues) gives an indication on the ability of the actor to retain the funds that it receives. The analysis of retained value and retention ratio clearly indicates that some sectors are performing much better than others:

- Traditional physical retailer segment has been one of the hardest hit. Even though they receive 21% of overall sector revenues*, they are able to retain just 8% of value (a retention ratio of 38%).

2. Key developments in the UK industry

Figure 8: Evolution of audio visual content consumption



Source: Ofcom 2014 CMR, Arthur D. Little analysis

The UK Media & Entertainment media landscape is being reshaped on account of several key developments:

- Rapid changes in the way end users consume audio visual content.
- The continuous rise in the prices for the rights to FA Premier League.
- UK's strong presence in the videogames and mobile app development sector.
- New challenges faced by the BBC as technology evolution remodels the audience behaviors.

The Media & Entertainment market is witnessing rapid changes in the way end users consume audio visual content

Compared to 2010, UK adults spent 26% more time consuming media and communications in 2014, as shown in Figure 8. In 2014, adults (16+) spent on average more than 11 hours per day engaging in media and communications activities, more than 36% of our activities across the day. This strong increase has been driven by the fact that people increasingly tend to carry out these activities simultaneously. Indeed, the 11 hours and 7 mins of daily media activities are actually squeezed into just 8 hours and 41 mins of 'chronological time' because of this trend.

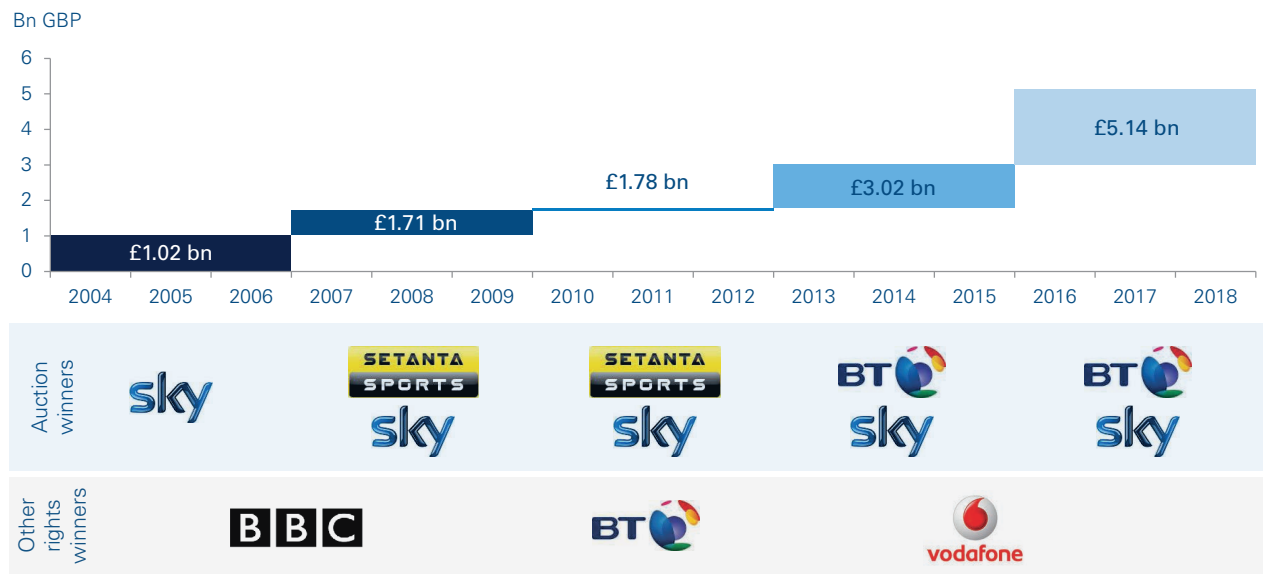
Moreover, communication and media consumption is now predominantly done online. Even a couple of years ago, more than two thirds of this consumption was already online, across multiple devices.

Finally, this increasing online consumption is especially observed within the 16-24 age group, this specific age group is more inclined to consume online content, rather than physical media material and also places greater reliance on non-linear formats.

FA Premier League rights have continuously been rising since 2004, increasing at the same time the incoming funds in the media industry, and pushing the retained value towards football clubs

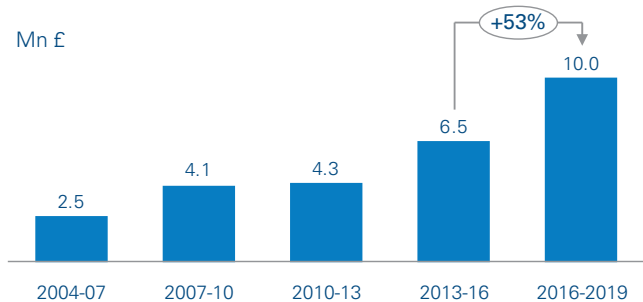
The FA Premier League (FAPL) sells broadcast rights in three season bundles. In February 2015, the most recent auction for the 2016, 2017 and 2018 seasons saw Sky spend £4.18 bn for five out of seven of the live game packages; BT won the remaining two packages of games for almost £1 bn (Figure 9). This represents an 80% increase in Sky's expenditure compared to the last auction. Overall, the live rights prices have increased by 70% compared to the 2012 auction.

Figure 9: Evolution of FA Premier League rights prices



Source: Arthur D. Little analysis

Figure 10: Cost per FA Premier League game



Source: Arthur D. Little analysis

Clearly this battle for exclusive prime content is being driven by the adjacent fight for broadband or ‘convergent’ service market share. However, the rights costs will need to be recouped.

Following the record sale of FA PL rights, Sky announced in March 2015 that it will increase the price of its Sports and Family channel bundles this summer by £1 per month, to £25.5 from June 1st.

Alongside the traditional media sectors, the UK also has a very strong videogames industry and leading mobile app development companies

The UK videogames industry is the second fastest growing segment (behind online-only services) (cf Figure 5). In 2013 it represented €3.6 bn (Figure 11), at least a +10% increase compared to 2007 (CAGR +1.6%). The growth of the industry has been fuelled by online revenues growth, and the broadening of both game genres and the demographics of the gamer base. Indeed online revenues have been increasing by +14% on average p.a. between 2007 and 2013, compared to -3% for offline revenues.

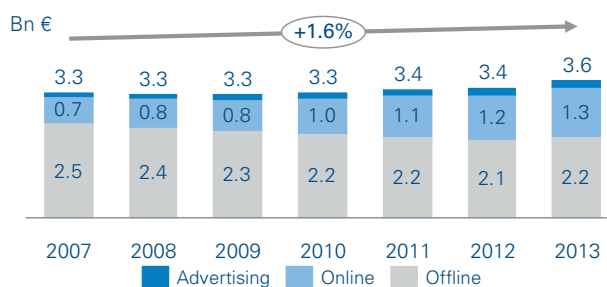
There are over 1,900 video game companies in the UK. The number of such companies has been growing at over 20% between 2011 and 2013. The UK videogames sector employs over 12,000 employees, however 95% of UK video games companies are micro or small businesses. The mean number of employees is 120 and the median 49.

The UK government too has been committed to supporting the creative industries, which make a valuable cultural and economic contribution to the UK. In this respect, the government has introduced a tax relief - video games companies across the UK can claim tax relief up to 25% on their production costs from 2014.

Some of the world’s most successful games developers are based in the UK, either as headquarters or with some of their most significant development teams. For example, Rockstar North, the studio behind the Grand Theft Auto franchise – the ‘fastest selling entertainment product of all time’ - is one example.

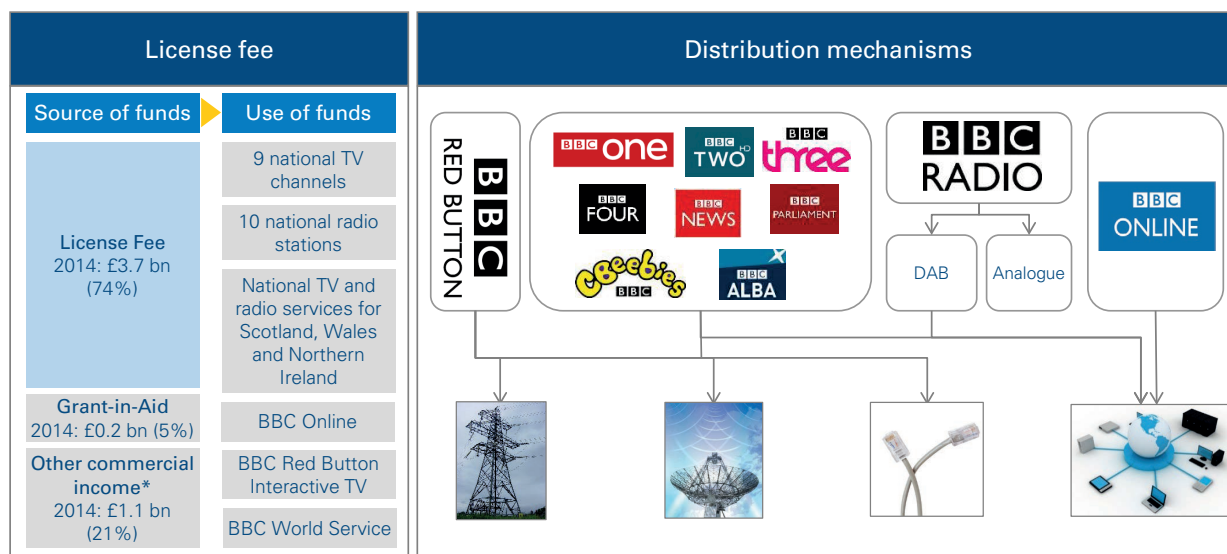
Moreover, the UK hosts some of the major mobile app companies such as Monitise Create, Nodes and SomoGlobal amongst others.

Figure 11: UK videogames and mobile app market



Source: Arthur D. Little analysis

Figure 12: Future of the BBC



Note: (*) Includes other commercial income from BBC Worldwide, royalties, rental income and others
 Source: Culture, Media and Sport Committee of the House of Commons, Arthur D. Little analysis

The BBC is facing new challenges as communication and media technologies are rapidly remodeling the audience needs and behaviors

The current Royal Charter will be reviewed in 2017

The current Charter expires at the end of 2016, so the House of Commons Committee for Culture, Media and Sports has started a review process with the objective of examining the role and position of the BBC in the recent past, and exploring what it could become in the future. The Committee published a report in February 2015 on the "Future of the BBC." Among the topics highlighted, the corporation's governance and spectrum management are of particular interest.

The current governance structure of the corporation has been subject to criticism, and the Committee "consider that the BBC Trust has not lived up to its expectation." It suggests instead a board of non-executive directors to oversee the BBC, who would eventually be accountable for the BBC's performance and services. This contrasts with the current situation where the Trust is separate from the Executive Board; the proposed BBC Board would have complete responsibility for the BBC's corporate governance and operations.

During the current Charter period, the BBC gained control of additional terrestrial spectrum at 600MHz that was freed by completion of the digital switchover. The management of this spectrum is constrained by the fact it is a public asset, and therefore the BBC cannot avail or profit from its sale. The Committee comments in his report that "if the BBC no longer requires the scarce spectrum it was granted [...] it should be obliged to give this valuable public resource up for alternative, public value use."The BBC continues to experiment with

alternative distribution mechanisms, for example, moving the BBC Three channel entirely online.

The license fee is not seen as a long term viable funding mechanism for the BBC

The funding of the BBC can be categorized into two sources (see Figure 12): license fee income – i.e. a consumer tax/levy - (75%) and other commercial income (25%); mainly from BBC Worldwide and grant-in-aid for the World Service.

The license fee is required from each household within the UK where television programmes are watched as a live broadcast (irrespective of the signal method or receiving device). In 2010, it was fixed at a yearly fee of £145.5 for six years until the end of March 2017; in 2013/2014 the fee raised £3.7 billion.

The House of Commons Committee for Culture, Media and Sports in its February 2015 report concluded that "there currently appears to be no better alternative [...] in the near term other than a hypothecated tax or the license fee"

However, the Committee does not see a long term future for the license fee, given the ongoing changes in the way fee payers consume media content. An indicative timeline has been set for the possibility of a change in funding in the 2020s.

In particular, the Committee concluded that a degree of subscription based funding could be possible as the BBC moves towards a more personalized service, as long as some content remains universally available and free-to-air. It was also noted that a broadcasting levy on all households would be the preferred alternative to the license fee.

New distribution channels and innovative connected services: some changes in BBC's strategy

To adapt and thrive in this digital revolution, the BBC has launched a series of new services that will help the corporation in negotiating the shift toward more connected, versatile, and individualized media consumption:

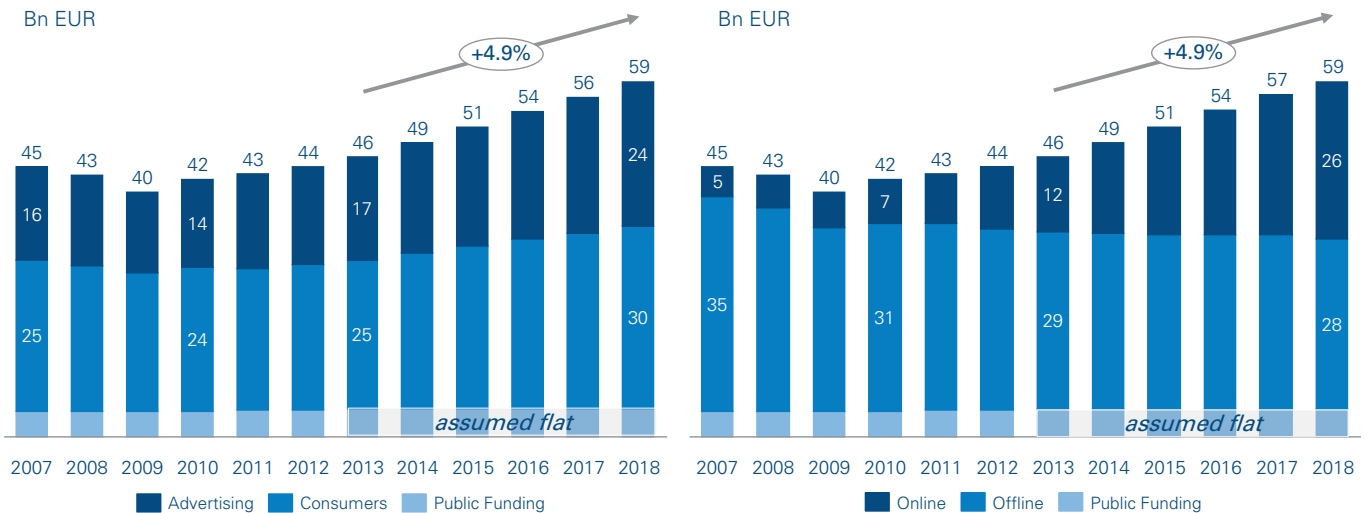
- In January 2015, BBC Taster was launched; an online interactive service that allows the sharing of experimental ideas for digital content and technologies across TV, radio and online. This platform allows the user to try, rate and share new content.
- The BBC weather service is a good example of how the corporation has managed to transform traditional content, a linear scheduled slot, into connected and personalized content using the BBC Weather app. The smartphone app is providing the user with real-time localized information.
- The potential move of BBC Three to online only with online programmes, new formats, and new content is another element showing the engagement of the BBC in online initiatives.

Another trend is an increase in the number of distribution formats available. The BBC intends to take advantage of new formats, for example with iWonder in the field of factual and educational content. Phones and tablets allow users to access existing formats, as well as bonus information on TV shows.

Finally, the personalization of the content is also an element that the BBC will use to improve its service offering. Based on individual data "myBBC revolution" will try to "reinvent public service broadcasting through data", as outlined by Tony Hall, Director General of the BBC. The revamping of the BBC News app is one step that the BBC has already taken towards the personalization of content delivery, though the potential entry of the public service broadcaster into the big-data consumer services has not been without criticism from free-market libertarians.

3. Future opportunities and forecasts

Figure 13: Forecasted evolution of UK media market revenue by type of funds



Source: Arthur D. Little analysis

Overall the UK Media and Entertainment market is expected to experience steady growth, supported by rising population, improving macro-economic fundamentals and the transition to online for both consumer spend and advertisers

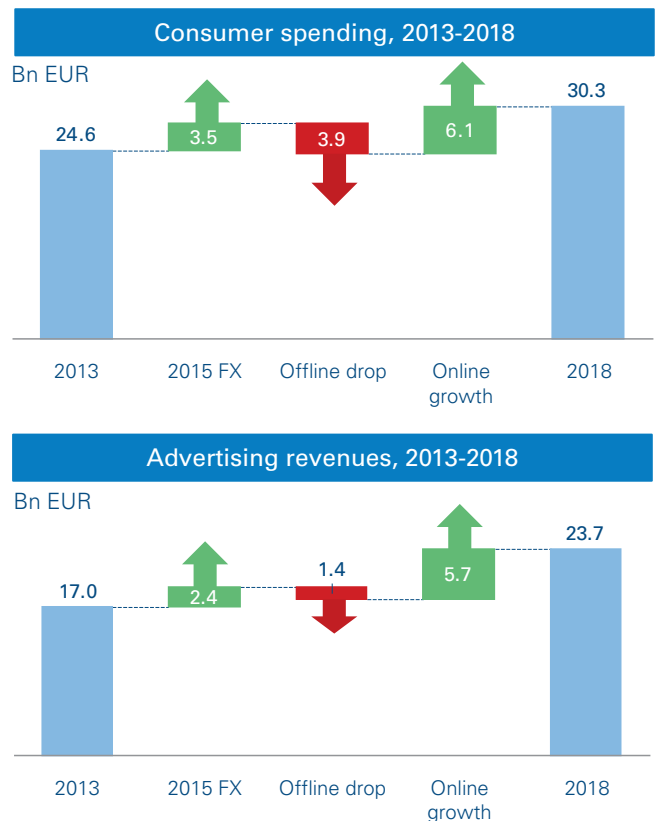
The UK media and entertainment market is expected to experience steady growth until 2018, with an average growth rate of +4.9% per annum (+2.4% in sterling terms, before recent currency movements, i.e. FX).

Consumers' spending is expected to continue to rise. The consumer spend will grow at a rate of 1.5% (+4.3% after FX) between 2013 and 2018. We also foresee growth in the advertising segment, growing by an estimated +4.1% p.a. (+6.9% after FX) between 2013 and 2018.

The share of each sector in the total of funds is forecasted to vary slightly (see Figure 13) over the 2013-2018 period, from 59% to 56% for consumer spending, and from 41% to 44% for advertising spending.

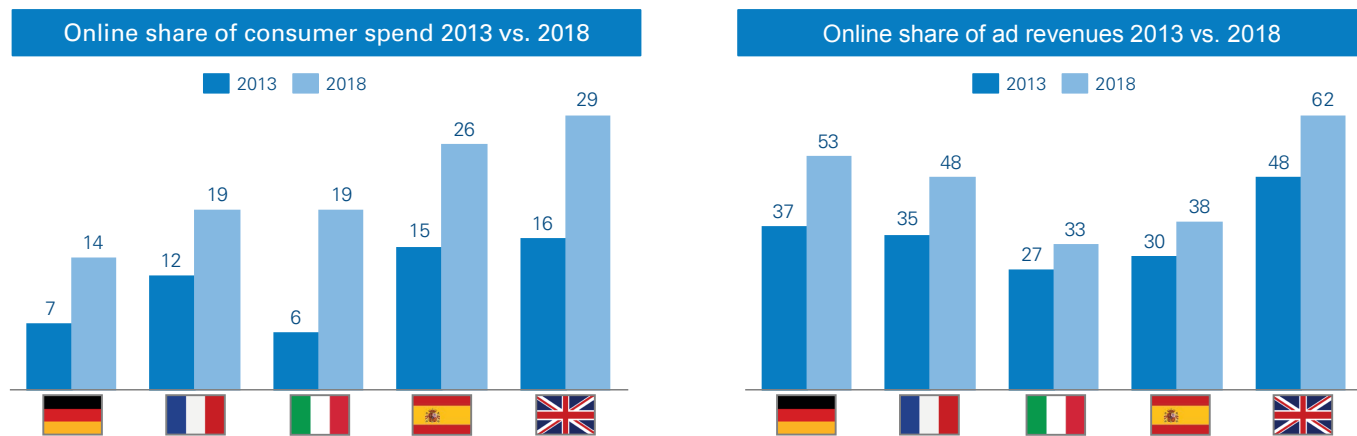
In the case of consumer spending, the growth of online revenues will continue to propel the sector. This and the weakened Euro since 2013 lead to an increase in consumer spending from €24.6 billion in 2013 to €30 billion in 2018.

Figure 14: Forecast of consumer and advertising spend



Source: Arthur D. Little analysis

Figure 15: Forecast of online expenditure



For advertising spending the online revenues growth is forecasted to more than offset the drop in offline, with an increase of €6.9 billion (€5 bn organic) until 2018 (see Figure 14). Advertising revenues are expected to grow, from €17.0 billion in 2013 to €23.7 billion in 2018.

However, the analysis by online/offline segment shows that the online segment is forecasted to grow steadily by 13% on average per annum (+16% after FX), from €12.2 billion in 2013 to €25.8 billion in 2018.

This growth will be at the expense of the offline segment, which is expected to further decrease in size. The offline segment represented €29.3 bn in 2013, and it is forecasted to decline, to reach €28 billion in 2018 (equivalent to €25 bn pre-FX).

As shown in Figure 14, the United Kingdom is one of the most advanced EU countries in term of use of online formats, both for consumers and advertisers.

The relevance of the online format can be gauged from the fact that the BBC is to be remodeled as an “internet-centric” broadcaster, as the web becomes the main way it reaches British viewers. BBC is putting in place production foundations which will allow it to compete successfully with established digital players.

Moreover, we can see that advertising has embraced online channels faster than consumers. Indeed, in 2013 48% of advertising revenues were online, to be compared with 16% for consumers spending. These shares are expected to increase respectively to 63% and 36% by 2018 fuelled by the explosion of broadband connections, devices, and digital offerings combined with changing consumer habits.

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The digitization of the media industry has created a complex and volatile environment for media companies. The emergence of new online competitors and business models has allowed consumers to gain access to endless opportunities to consume media across multiple devices. Media corporations need to identify opportunities areas where maximum value is being created and prepare for vertical or horizontal integration, as well as to guide portfolio optimizations and go to market strategy.

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