EDITOR'S NOTE BY JARED FRANK

Don't Be Left Holding the Severed Cord

ESPN is paid $6.04 per month per subscriber by cable providers (whether or not that subscriber watched one second of ESPN). Keeping the math simple, $6 multiplied by the 100 million households with a bundled cable package equates to $600 million of revenue per month for ESPN. So even if a modest 15% of subscribers end up cutting the cord, ESPN will lose $100 million of revenue per month.

According to *Forbes*, the world's 50 most valuable sports teams are worth an average of $1.75 billion in 2015, which is a whopping 31% increase from just last year. In North America, the Dallas Cowboys and New York Yankees are both currently valued at $3.2 billion, ranking second globally behind Real Madrid, the world's most valuable team at $3.26 billion. Exact valuations can vary slightly from source to source and can depend on when the information is published, but for the sake of this discussion, let's just agree that valuations are high. And what's feeding these eye-catching valuations is without question their lucrative cords that are plugged into multi-billion-dollar media rights contracts.

Television is the golden goose for all sports leagues. In the NFL, its current TV deals, including both network and DirecTV contracts, are worth $6.5 billion annually to the league. Divide that figure by 32 teams, and each team receives approximately $200 million from television before it sells one ticket, one suite, one sponsorship, one tee shirt, or one hot dog.

The NBA will soon begin its new deal with ESPN and TNT, worth $2.5 billion per year, which fueled a free agent frenzy this summer and will continue to do so in the coming years, as the money pool fills higher. Meanwhile, franchise valuations are reaching new highs with each new sale. The Atlanta Hawks, for example, sold for $850 million earlier this year, which was double the *Forbes*' valuation from just one year earlier.

In the midst of this unprecedented prosperity and bullish view on sports business, it's important to understand a potential landmine, which is the fact that the lucrative cord of cash flow fueling the prosperity is being shaved, or cut altogether.

CUTTING THE CORD

A little over 100 million U.S. households still pay for traditional bundled cable TV services. But there is no doubt that a shift from the bundle package to over-the-top services is in motion that is altering the business model for the television industry. And as the shift escalates, the sports industry will experience downstream impact.

Cable television continues to observe subscription losses at a record pace. According to media research firm SNL Kagan, the largest-ever quarterly drop, 625,000 subscribers, occurred this year, and acceleration for the trend doesn't seem like it will reverse direction.

ESPN, the Worldwide Leader in Sports, isn't immune from these declines. According to Nielsen, the most watched cable TV station in America has seen subscriptions drop from 100 million to 94 million, with half of the decline occurring just in the past year, according to *Business Insider*. In the wake of these declines, and increases in rights fees, ESPN was forced to lay off 300 employees, nearly 4% of its payroll, in October.

Even if the bundle continues at some level (and many television executives are desperately trying to convince investors that it will), enough consumers are fleeing cable subscriptions to affect profit margins. So while I'm not suggesting television is about to crater, a critical mass is developing that is bringing inevitable change to the existing model, creating significant revenue gaps.

Take ESPN again as an example. Most cable TV providers offer ESPN on their most basic cable packages nowadays. The channel is paid $6.04 per month per subscriber by these cable providers (regardless of whether or not the subscriber watched one second of ESPN). Keeping the math simple, $6 multiplied by 100 million cable-subscribing households equates to $600 million of revenue per month for ESPN. So even if a modest 15% of subscribers end up cutting the cord, ESPN will lose $100 million of revenue per month, unless the current model changes. The profitability of the entire ecosystem, including advertising, can be traced back to subscriptions, and subscriptions are shaving, if not cancelling altogether.

WORD ON THE STREET

Traditional media companies have seen their stock prices sell off into bear market territory. At the time this editorial draft is being writ-

EDITOR'S NOTE BY JARED FRANK

ten, many leading traditional content producers and suppliers have seen their stock prices drop substantially in 2015. Year-to-date, Time Warner is down 17%, CBS 25%, and Viacom 38%. While the traditional media sector struggles, over-the-top is booming. Netflix, the S&P's best performing stock of 2015, is up a staggering 125%.

Disney, who owns ESPN, is up 10% YTD, but it is well off its highs after investors were spooked by a recent earnings report and comments by CEO Bob Iger about the possibility that ESPN could one day be sold direct to consumers as an a la carte service, similar to what HBO has started to do with its standalone, over-the-top offering. If that happens according to the *Wall Street Journal*, ESPN would need to charge $30 per month for its own over-the-top offering to generate the same revenue that the current cable bundle does. Will enough people be willing to pay $30 a month? By comparison, current over-the-top services, such as Netflix, Hulu, and Amazon Prime, cost around $10 a month.

Any revenue gap could, in theory, be closed if a la carte services are priced at levels that make up for the shaved or lost bundle. But I just don't see how that happens. Personally, I do not pay even an additional $9 per month for NFL Redzone, and I love the NFL. So if the league can no longer gain revenue from people who are not watching NFL games even though they are paying for them (through bundled services), and it experiences churn from some avid, but cost-conscious, NFL fans, then it's not difficult to see the potential problems on the horizon.

Its seems like a fait accompli that 500-channel TV packages are headed the way of the dodo bird, and cord cutting will only accelerate moving forward. And if that happens, there are significant downstream impacts on the valuations of sports franchises.

REGIONAL SPORTS CHANNELS

In the case of ESPN, the network is still able to milk profit, despite reductions in subscription revenue, because viewership is still high relative to everything else on TV. And whether through a bundle or a la carte, I predict ESPN will figure out a profitable model. But what about all of the regional sports stations that have emerged in recent years? Are they going to be just fine?

In the country's largest markets, New York and Los Angeles, local TV money is largely credited with increasing the value of MLB's Yankees and Dodgers. The Dodgers have a 25-year, $8.35 billion contract with Time Warner Cable, while the Yankees continue to reap the benefits of their YES Network.

Many MLB and NHL teams across their respective leagues now have similar equity interests in local sports networks or similar lucrative local TV rights contracts. And many of these channels are almost entirely dependent on cable subscription fees to keep their lights on. One sports executive familiar with the local TV deal of a small market team told me that 85% of the local sports network's revenues come from subscriptions.

When XYZ Network isn't broadcasting a hometown game, they're showing a replay of a high school JV basketball game or fishing lessons with Uncle Ed. There are a couple of reasons for this strategy. The first is the fact that low-budget, basic programming is dirt cheap to produce. Now couple that with the fact that many of these networks don't care whether anyone's watching or not during these times because their revenue models aren't based on advertising. And as illustrated earlier, these channels are paid subscription fees by the cable providers whether anyone is watching or not.

Again, let's use overly-simple math just to illustrate the point. Let's say 90% of the citizenry of a typical small market has a cable package that includes that market's local sports network, but only 15% of those consumers are actually watching the games on that network. Does that mean if given the opportunity to unbundle or go completely over-the-top, 75% will shave the local sports network? That scenario has drastic implications on a model that is primarily funded by subscriptions.

ADAPTING TO THE NEW WORLD

The future of television consumption in general is not with cable, which we've established is the anchor revenue source for the sports industry as we know it today. The future is with digital media and Internet streaming. In the next ten years, it's possible that there will be no cable TV bundle, and all content will be purchased a la carte and consumed through streaming services.

Think about it. How many TV channels do you pay for each month? How many of those channels do you actually watch? Its seems like a fait accompli that 500-channel TV packages are headed the way of the dodo bird.

The sports industry does have a couple of silver bullets in its chamber. Firstly, live sporting events are DVR-proof, something few programs can offer. And an enormous slice of consumers obsesses over these events. So we are not facing a popularity barrier, nor is the barrier a limitation in technology. Most networks offer access to their content through streaming sticks and set-top boxes, including Apple TV, Roku, Google Chromecast, or Amazon Fire, as well as on mobile devices through applications. So the custom experiences that consumers are now expecting are available on the market.

The barrier for the sports industry is how to capture the same content-related revenue without the traditional cable bundle. To illustrate, consider that for the week of October 19th – 25th, Sunday Night Football claimed the number-one ranking for TV viewers with 20.61 million. The 20% of Americans watching the NFL on Sundays isn't the issue. That's an astounding number. It's the 80% of households who do not watch, yet are still profited off of, that is the issue to keep in mind. I know I keep reiterating the same point, but that's because it's so important to realize.

[continued on page 134]