CABLE INDUSTRY OUTLOOK:

HOW CHANGING CUSTOMER NEEDS IMPACT GROWTH OPPORTUNITIES

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part 01

Residential Cable Segment

MSOs Embrace Broadband to Drive Growth

Article Series: #1

This paper is the first in a series of three articles on the state of marketing in this volatile market; it captures:

- An overview of the recent state of the cable/MSO U.S. residential market
- Review of residential voice, video, and broadband offerings
- Analysis of weaknesses and opportunities for the near future
- Recommendations for a strategic approach to managing growth through change

Cable companies have experienced tremendous growth over the past 15 years, but several of the key drivers responsible for that growth are weakening, putting pressure on MSOs to identify and bring to market new revenue sources. This is part one of an article series that will take you through some of the most significant changes in the industry and recommend how MSOs can take a strategic approach to protecting customer sectors while creating new business areas for growth.

Setting the Stage

From 2003 to 2015, U.S. cable companies experienced a significant and sustained increase in revenue. During this period, cable revenue increased by about $62B* or 6.7% per year. The key factors to this growth were the growing market penetration of high-speed data (HSD) and voice services, increasing video rates due to price increases and adoption of the digital tier, and the launch and subsequent success of commercial services, especially in the small and medium business segment.

However, during the last five years, several of those growth drivers began to decline, most notably a significant slowing of subscriber growth in the voice business, and the acceleration of subscriber losses in the video business. As a result of these trends, MSO success factors for the next five to ten years will have to include:

1. The ability to capitalize on growing household demand for HSD
2. Moving upmarket in commercial services
3. Managing challenges to the residential voice and video businesses
4. Developing and deploying new product and service categories

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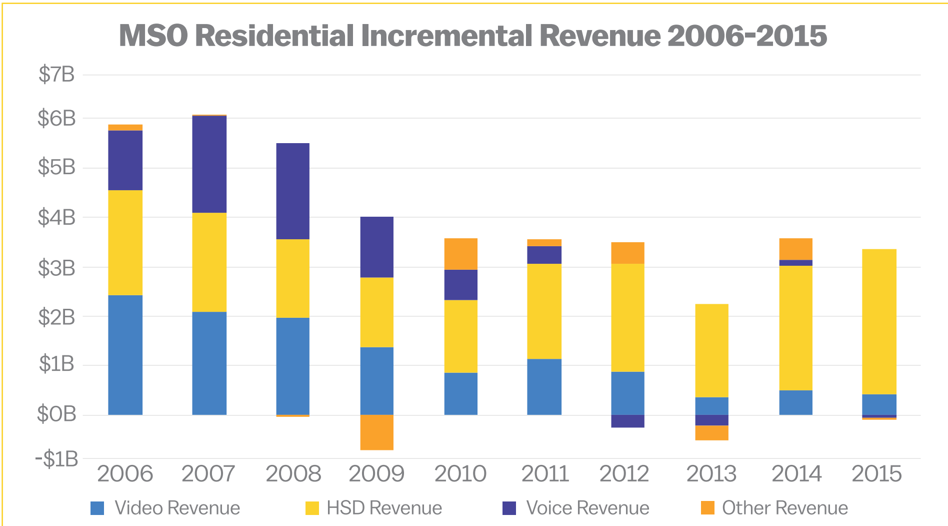
Within the residential segment, HSD and voice subscriber growth, along with higher video rates, fueled tremendous revenue growth. For the U.S. MSOs in our profile, revenue increased at a CAGR of 7.8% from 2003–2010. The sources of this revenue growth were increases in HSD and voice subscribers following the launch of these products in the early 2000s. In addition, MSOs transitioned their video customers from analog service to a new digital tier. The digital tier transition complemented annual price increases and offset declining video subscribers to ultimately grow video revenue. By 2010, however, residential growth was slowing. In fact, MSO revenue growth from 2010–2015 slowed to just 3.2% CAGR, due to slowing subscriber growth for Internet and voice services and the completion of the video digital tier transition by most MSOs.

Looking more closely at residential revenue, incremental revenue peaked at $6B in 2007; since 2010, incremental revenue has not exceeded $3.5B. Moreover, HSD has driven the overwhelming share of incremental revenue since 2010. The voice revenue change is neutral to negative, while the change in video revenue has been $500M per year or less since 2013.

Peeling back the onion in the residential segment provides insight to the changes impacting the Internet, voice and video businesses as well as the prospect for the future of each product.



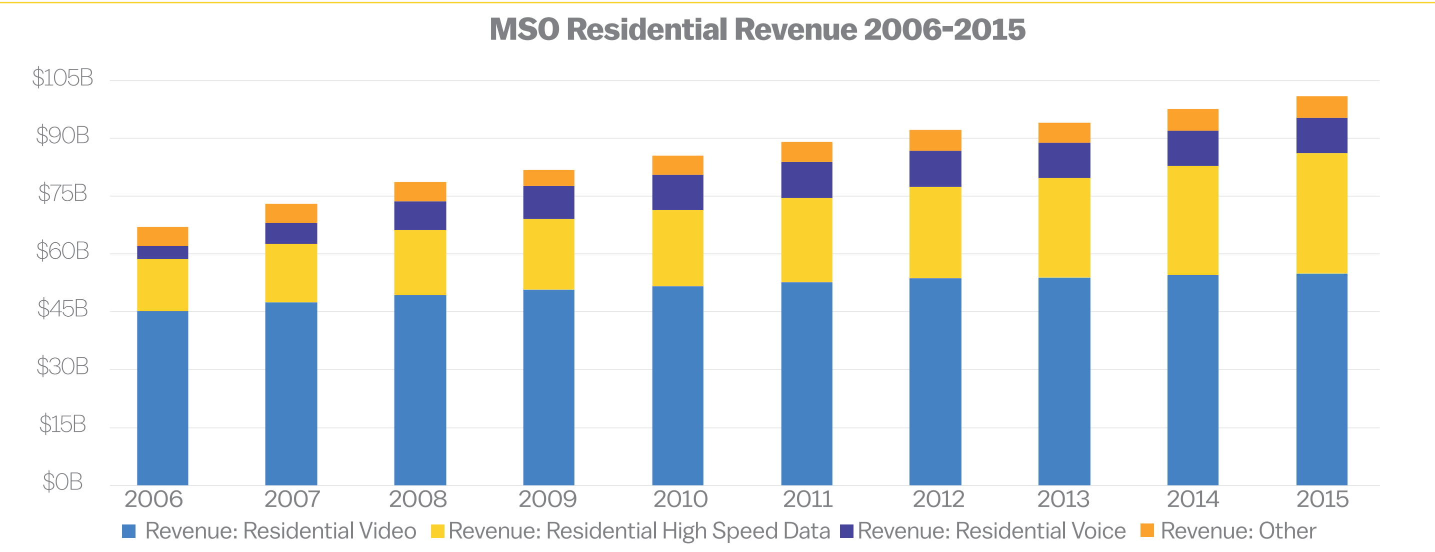


Chart Sources: SNL Kagan

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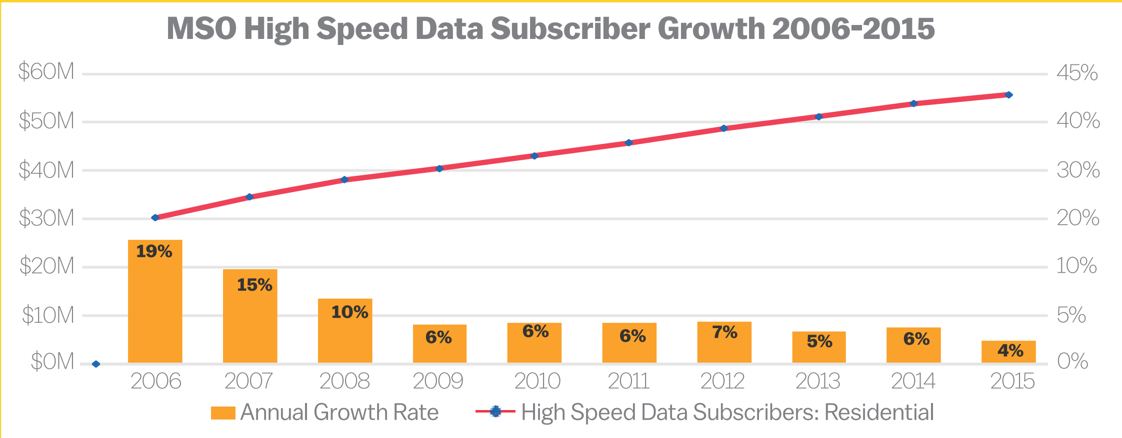
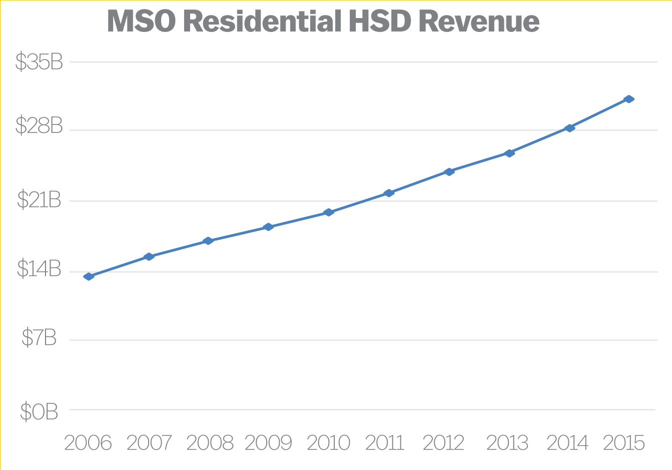
HSD Service

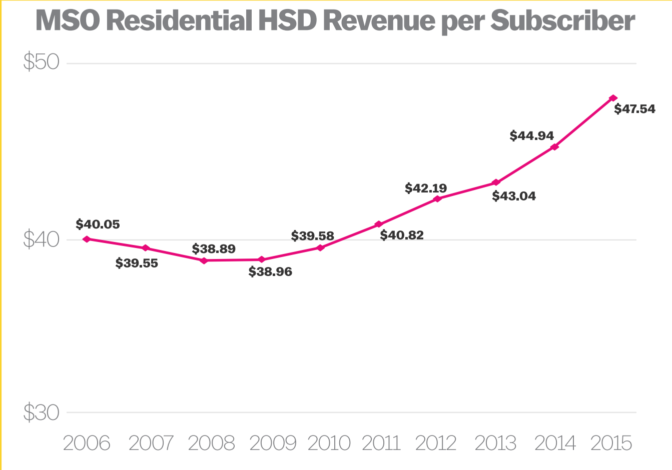
Internet has driven the majority of MSO revenue growth since 2010 as shown here:



From 2003–2008, double digit subscriber growth fueled revenue growth. However, since 2008, subscriber growth has fallen to 4–7% per year.



Residential HSD revenue has continued to grow at an impressive pace, hitting $38B in 2015.



A steady increase in HSD rates beginning in 2010 has offset slowing subscriber growth to drive continued revenue growth.

Chart Sources: SNL Kagan

Within the MSO industry, HSD subscribers surpassed video subscribers in 2014. With the category beginning to approach saturation levels, HSD success going forward requires a further increase in customer rates. Unlike video rate increases, the HSD rate increase is not based on price increases. Rather, HSD rates are increasing due to the subscriber base "buying up" or upgrading their service level. As demand for residential data continues to grow due to streaming video and the number of screens per household, MSOs have successfully rolled out and sold higher tiers of HSD service to households with increasing demand.

The coming deployment of DOCSIS 3.1 will further increase MSOs' data throughput and provide speeds of 1GB and potentially much higher to customers. Competition for super-fast residential service is heating up, however, with AT&T and Google deploying Gig services in a growing number of U.S. communities. The MSO advantage is that their DOCSIS 3.1 upgrade can utilize their current hybrid fiber coaxial (HFC) infrastructure, while AT&T and Google must continue to expand their fiber and plant at considerably higher cost. A successful DOCSIS 3.1 deployment is crucial to winning share of residential Gig services and subsequent MSO revenue growth over the next five years.

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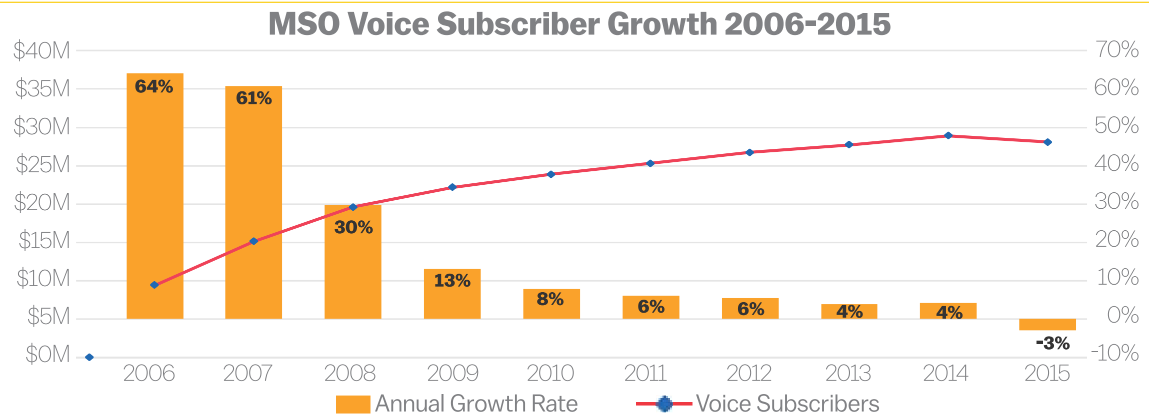
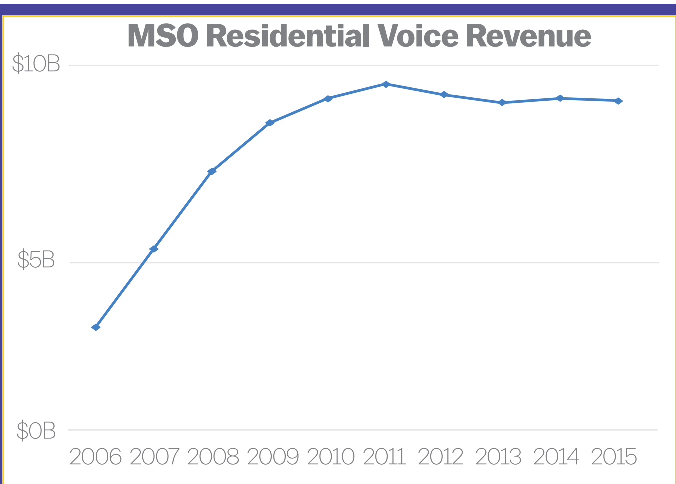
Voice Service

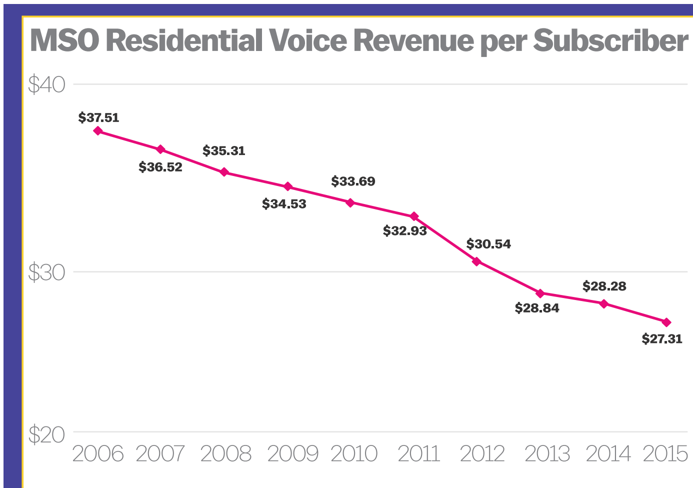
Residential revenues are falling due to a combination of declining subscribers and lower rates.



Subscriber growth rates of over 60% drove revenue growth through 2007, and subscriber growth continued at double-digit levels through 2009. However, starting in 2010, subscriber growth fell below 10% and continued to decline, resulting in a loss of subscribers for the first time in 2015.



Residential voice revenue has contracted since peaking in 2011. In 2015, revenue was $9.2B, off its 2011 high of $9.5B.



Compounding the subscriber decline, voice rates have steadily fallen. In 2015, the voice rate stood at just over $27 per subscriber per month.

Chart Sources: SNL Kagan

Perhaps unsurprisingly, the MSO voice segment is declining both in subscribers and revenue. High substitution of voice service from both wireless and VoIP services is having a significant impact on the MSOs' voice business. Initial success in converting subscribers from higher priced telco service drove a significant voice business for MSOs in the early 2000s, but today MSOs are experiencing the same set of dynamics that eroded telco voice revenue a decade ago.

Voice has become a cash cow for MSOs and will continue to provide significant profit. Gross subscriber additions will continue to come through Triple Play bundles, but rates will continue to fall given lower bundled revenue allocation. Long term, as voice continues to become more an app versus a monetized product, MSOs must consider replacing voice revenues with new lines of business.

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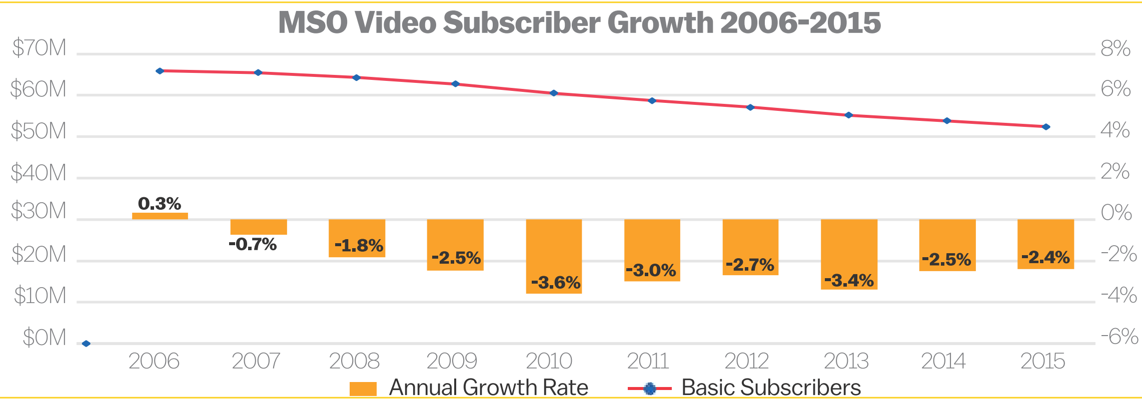
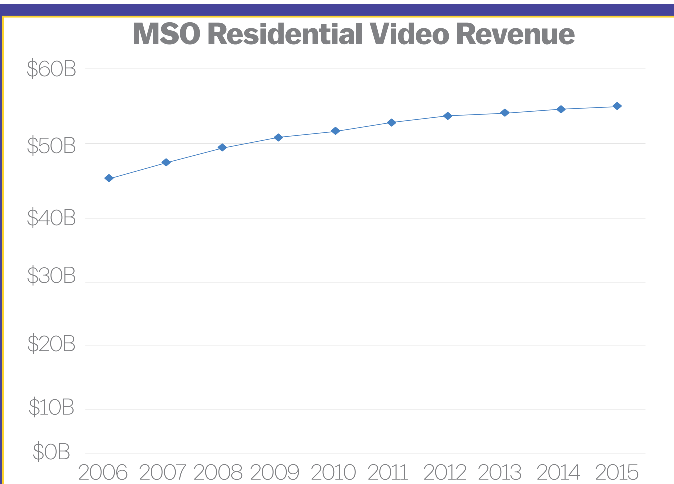
Video Service

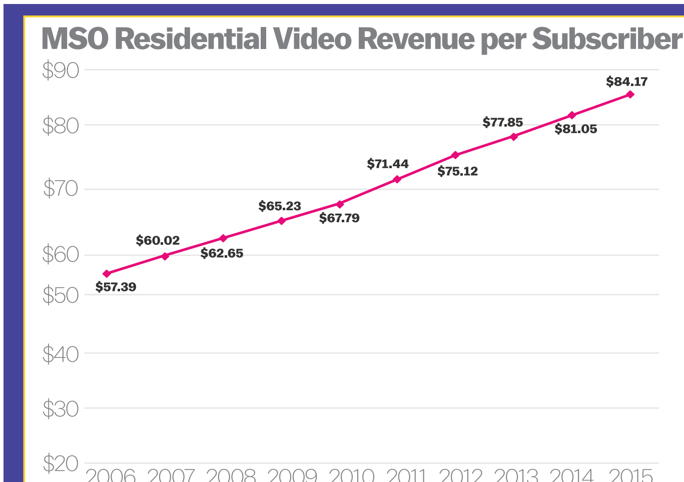
Video remains MSOs' largest revenue driver and faces unique challenges from the other businesses.



A decline in subscribers began to accelerate in 2009, eroding the video subscriber base from 64M in 2008 to 52M in 2015. The decline of the video base slowed slightly in 2014–2015.



Residential video revenue has begun to plateau following steady growth through 2009. Despite slowing growth, video revenues were nearly $55B in 2015.



Video rates have increased steadily over the past 10 years, driven by digital tier conversions, consumer adoption of HD and DVR services, and annual rate increases.

Chart Sources: SNL Kagan

The cable video business is the original revenue source for MSOs and the most mature of their businesses by far. Today, the MSO video business faces two key challenges.

First, displacement by substitute services, mainly over-the-top (OTT) streaming video services, but also displacement by telco video services, is putting pressure on MSOs' subscriber bases. OTT continues to grow, sometimes as a complement to traditional pay TV services, but increasingly as a substitute by customer segments, especially Millennials. Netflix and direct-to-consumer programmer products like HBO's streaming service will continue to put pressure on pay TV services. Telco video competition from Verizon FiOS and AT&T U-Verse have a less dramatic but steady impact.

Second, customer rates for video service are increasing, but not at levels sufficient to offset programming cost increases. Operating margins on MSO video service continues to fall as programmer costs take a significant toll on profitable video operations. Using the example of Time Warner Cable, the charts below illustrate how the growth of programming cost is outpacing the rates customers pay for video service.

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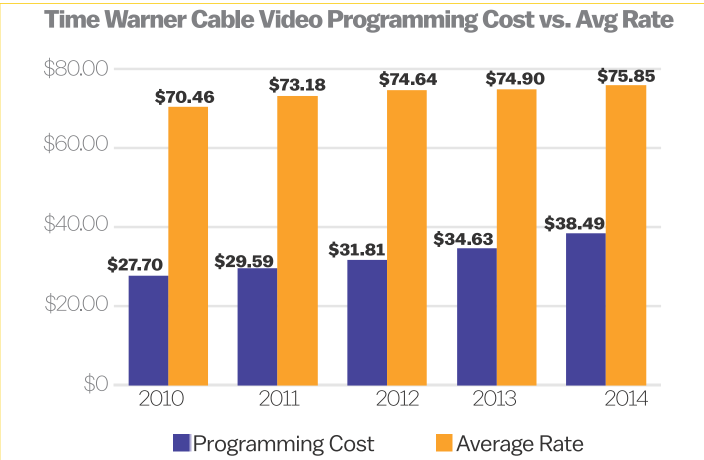

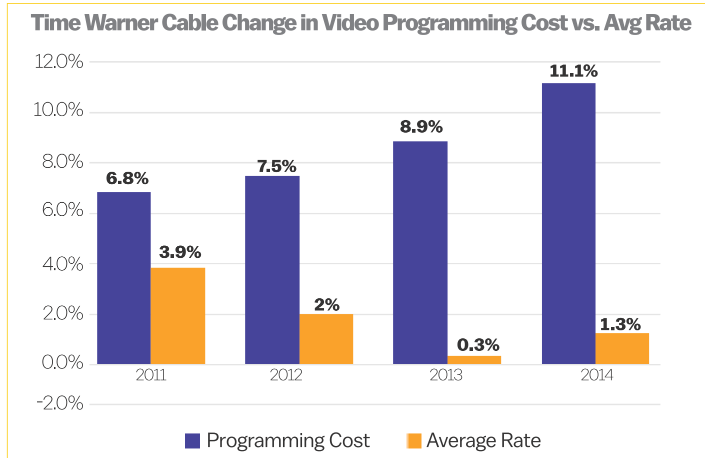

Chart Sources: : Time Warner Cable 10Q

To offset these challenges, MSOs are responding in a number of ways. Many are introducing new packages to Millennials and other OTT-likely customer segments that provide a base TV package plus HSD designed to accommodate streaming video. Comcast participates more directly in OTT through its investment in Hulu. MSOs are also attempting to enhance the TV viewing experience; as one example, Comcast introduced its X1 IP set-top platform several years ago, and Cox launched X1 (licensed from Comcast) in 2015. Finally, MSOs are focused on improving customer service across their business, making investments to increase customer satisfaction and improve loyalty and retention.

Despite these opportunity areas, the challenges to the MSO video business illustrate the importance of new revenue streams to MSOs. In the short-term, video services will continue to generate significant cash for providers, but as video revenue growth slows and costs continue to increase, MSOs must find more profitable businesses to drive future growth.

Residential Wrap-Up

In conclusion, MSOs must deliver a successful DOCSIS 3.1 deployment for HSD; the DOCSIS upgrade with associated speed enhancements is crucial to winning a share of residential Gig services and subsequent MSO revenue growth over the next five years. For video, MSOs should evolve their approach to enhance the TV viewing experience (through IP set-top and other new technologies), as well as develop and evolve offerings to OTT-likely segments like Millennials. With regard to residential voice, since this business is unlikely to rebound, MSOs must consider replacing voice revenues with new lines of business (the subject of our third article). And finally, MSOs must continue to focus on, and invest in, the customer experience. Driving improvements in customer satisfaction is paramount to long-term customer retention and incremental revenue opportunities.

Winning Growth Strategies

Want to learn more? In a future article, we outline the success drivers for MSOs to develop new products and services:

- Identify and develop product ideas that have high business potential and fit their business and operating models
- Address the challenges of providing training, systems, and organizational support
- Identify the right business and technology partner(s)
- Allocate marketing investment to drive awareness and consideration of new offerings

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For More Information
To learn more about how CMG can help you face up to the competition and win, please visit our website at cmgpartners.com or contact us today at cable@cmgpartners.com.

The second article in this three-part series, will provide an overview and analysis of commercial business in the MSO space.