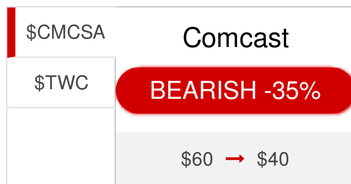
Cable Companies : Trouble Brewing



Cable's monopoly on broadband and content is dying. Consumers are switching to cheaper alternatives, and new competitors are gaining traction, on both content and internet access. Disney, Time Warner Cable, Comcast, Chartered will all suffer.

April 11, 2016

Executive Summary

Cable companies (CCs) tried to strengthen their monopoly in 2014, and to squeeze streaming services by making them pay for bandwidth. Their plan has failed, and started an exodus of subscribers, who started to bypass cable to access content.

To try and retain cord-cutting customers, CCs caved in and started offering "skinny" subscription plans. By doing so, they've further encouraged consumer exodus away from expensive bundles.

CCs are also facing new, powerful competitors on the broadband market, such as Google Fiber. They are losing the battle to slow down the deployment of LTE-U, a technology supported by Qualcomm and the big telecom companies.

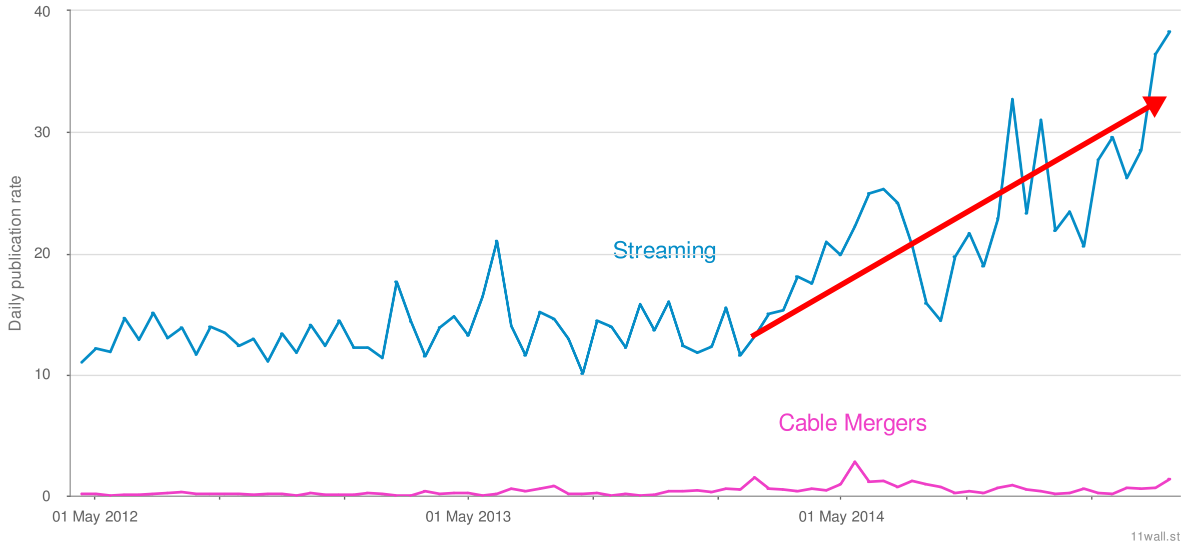
Just as CCs are losing ground on both content and broadband, the FCC has pushed for a revamp of the set-up box. This will provide customers with a catalyst to rethink their traditional relationship with cable en masse.

Analysis

Cable companies' plan to strengthen their monopoly, and force streaming services to pay for using their infrastructure, has backfired

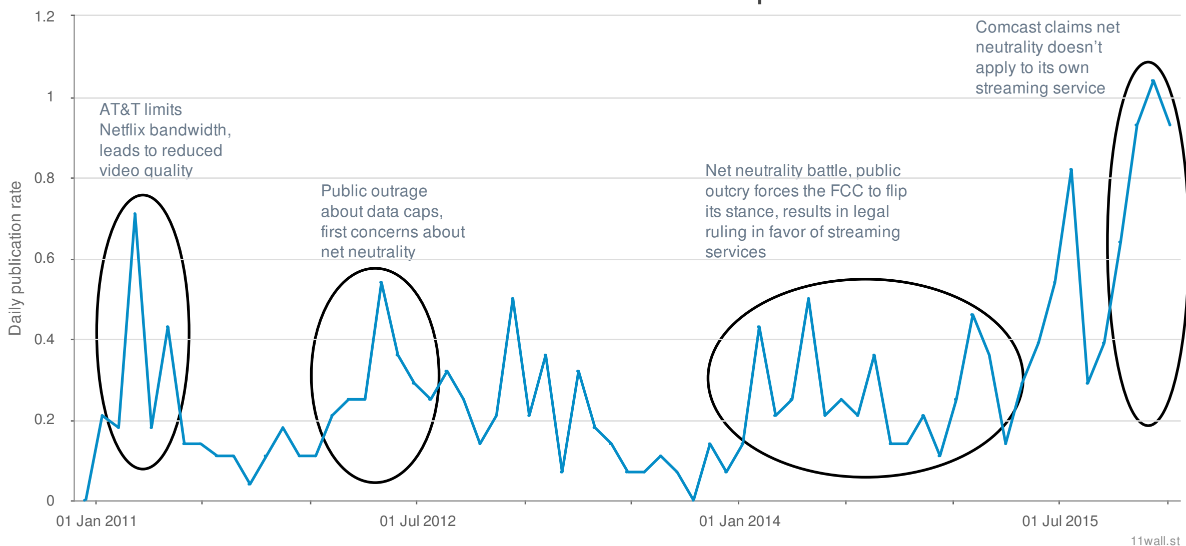
CCs benefit from a de facto monopoly in the U.S., due to high barriers to entry (internet access), high levels of regulation (content broadcasting), and consumer behavior inertia. “Triple-play” packages—cable, phone, and high-speed Internet access—that tens of millions of Americans buy from companies like Comcast and Time Warner Cable, are the norm.Their content provider privileges have been confirmed over the last years by court rulings, shutting down hopeful would-be competitors such as Aereo, ivi TV and FilmOn.

A wave of successful and aborted mergers started in 2014. We believe the CCs were trying to consolidate in anticipation of a new source of revenues: charging streaming content providers for bandwidth **(Chart 1)**.

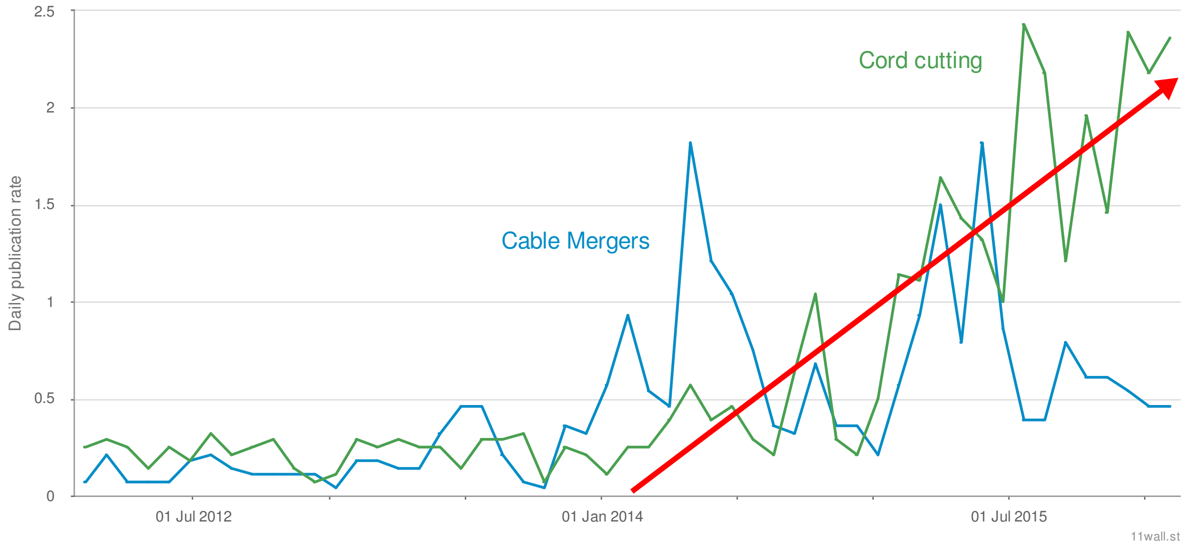


Although Netflix and Hulu have been around for years, video streaming only started permeating the consumer mindset at the beginning of 2014, around the same time CC mega-mergers started. CCs had hit Netflix in the past, forcing the company to pay them in order to keep its data flowing and safeguard video quality. Had they managed to establish this practice as standard and recurring, they would have benefited from the new consumer trend, without doing much.

Alas, an unprecedented public outcry raised the Net Neutrality issue, and the FCC was forced to flip-flop and to rule against CCs in March 2015 **(Chart 2)**. Charges on streaming content providers, as an additional source of revenue, were out.



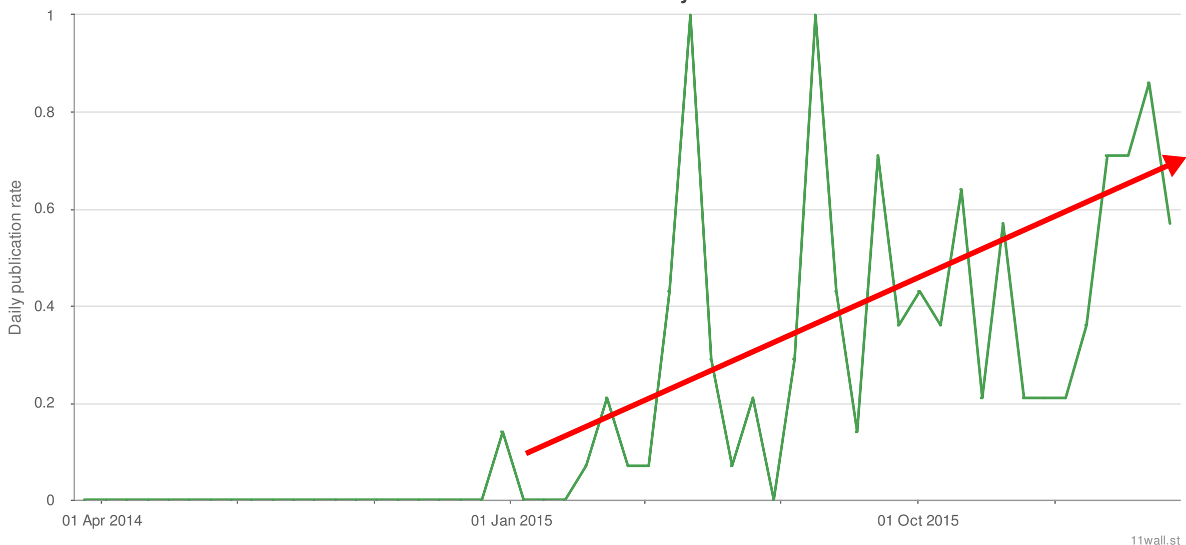
Worse, consumers realized that the cable monopoly on content was fading out, and cord cutting started to gain traction **(Chart 3)**. Cord cutting is the phenomenon where viewers cancel their subscriptions to subscription TV services (Wikipedia has an excellent article on it for more details).



Consumers are becoming aware that they have a choice. They can go directly to Netflix or Hulu, or even access the content illegally without paying anything, on any of the online streaming websites you can easily find on Google. The FBI might have shutdown Kim Dotcom's Rapidshare.com back in 2012, but hundreds of copycats are alive and well.

To try and retain cord cutters, cable companies started offering "skinny bundles", but by giving the option to their clients, they've further exacerbated the mass exodus

The cord cutting exodus from traditional, expensive cable bundles has created a new market for stripped-down, "skinny" bundles, where the user only enjoys minimal mandatory content **(Chart 4)**.



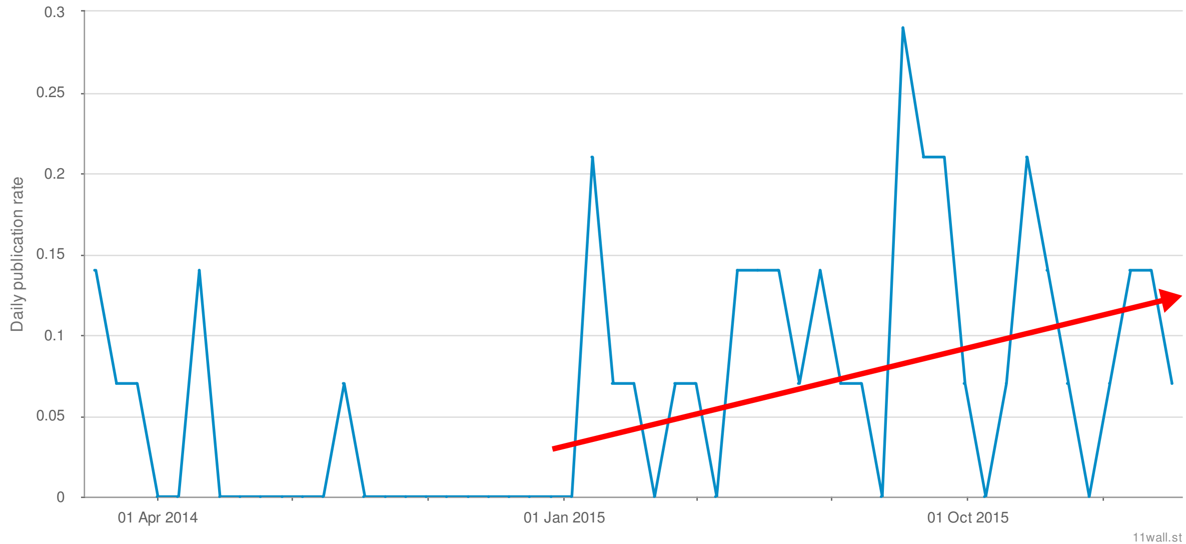
Faced with the choice of losing customers to Google Fiber or Verizon Wireless, or retaining cable cutters at much lower subscription costs, CCs went with the second option. This shift didn't happen smoothly, as some legacy third-party content providers, such as Disney and ESPN, fought the transition tooth and nails. The reason? ESPN belongs to Disney, and is the most expensive channel, costing over $6 per month. Consumers are not aware of it, as they pay a lump sum for all the channels, even if they don't watch them.

The system has been a gold mine for Disney (who owns the most expensive, but far from the most watched channels), based on long-running agreements between CCs and content providers. Almost half of Disney's revenues, and over half of its income, came from its media networks in 2015.

New competitors emerge in the broadband access market

A new threat to traditional Internet providers is emerging: LTE-U (unlicensed 4G) **(Chart 5)**.

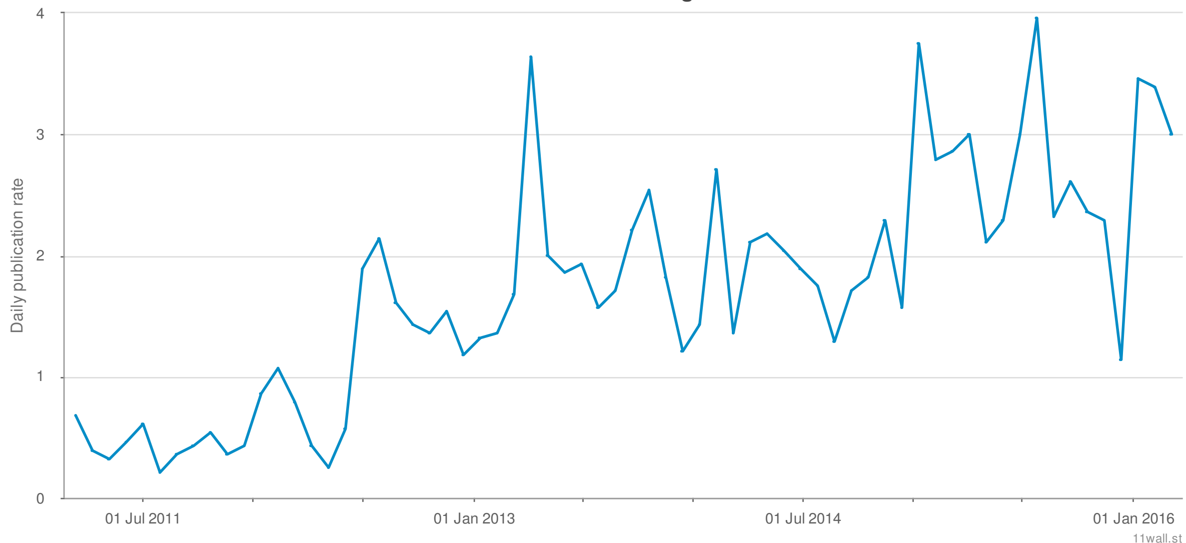
Chart 5: News flow for cable & "unlicensed spectrum"



Existing wireless technologies use exclusive radio frequencies, regulated by the government, for which they pay licensing fees. This is a huge barrier to entry, and dampens competition. LTE-U, originally promoted and heavily supported by Qualcomm, targets frequencies used by Wi-Fi, and offers a much more flexible system. CCs are trying to fight it, appealing to FFC with claims that LTE-U interferes with existing systems (Wi-Fi et al.), but Qualcomm seems to have its stuff together, and is pushing hard for the transition. Verizon and T-Mobile have already announced their plans to adopt the new technology. Should they succeed, expect a new wave of competition in the broadband market, putting another strain on CC revenues.

And by the way, have you heard about Google Fiber **(Chart 6)**?

Chart 6: News flow for "Google Fiber"

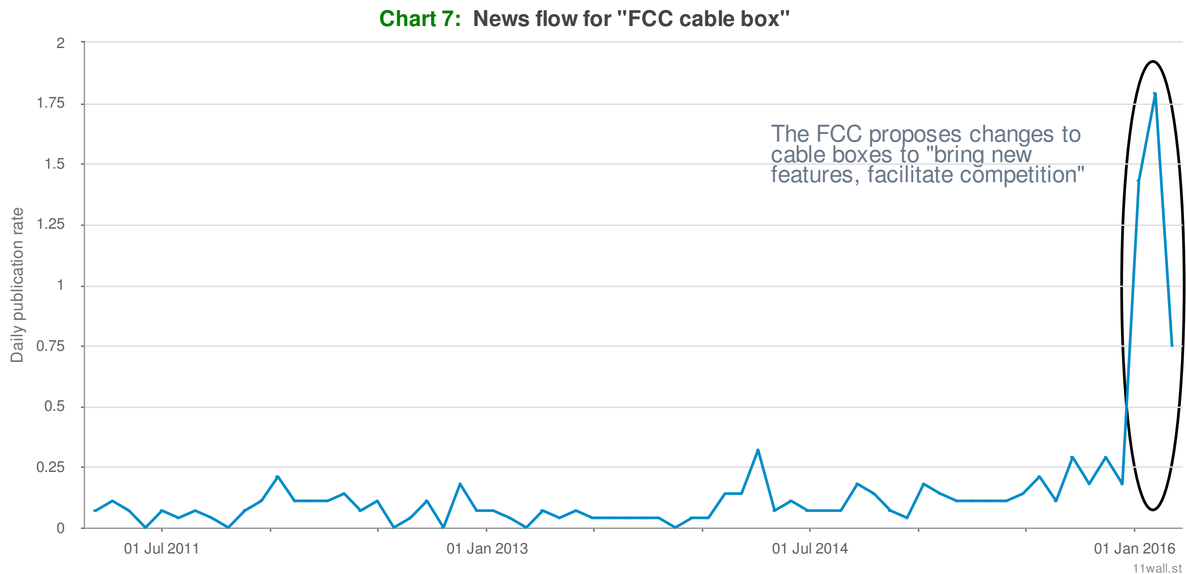


FCC's push to revamp set-up boxes will force consumers to rethink the way they see their cable company

Despite all the claims of collusion, monopoly, gatekeeping (an on-purpose under qualified consumer service department that makes it hard to process claims), people still use cable. Habits don't change overnight. It's cumbersome to change your subscription plan. A growing part of the consumer base was just born with a set-up box in the living room. It's just part of the culture.

The problem is, the FCC pushed for a revamp of the set-up box at the start to 2016 **(Chart 7)**.

Chart 7: News flow for "FCC cable box"

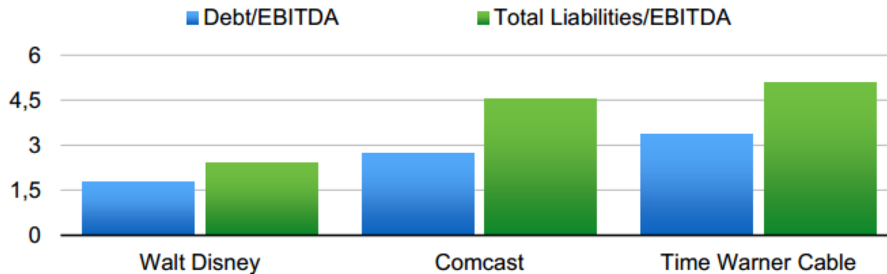


Despite nice-sounding headlines such as "U.S. proposes TV set-up box competition to let in new players", "These New Government Rules Could Slash Your Cable Bill", given the FCC's track record, we don't believe the move is intended to hurt the CCs in any way. However, CCs have established a system that fights change by all means (except for price increases, obviously). The repairman ringing at the door to set up a new system, would be the catalyst for consumers to realize that things aren't what they used to be, and look for alternatives.

Roadmap & Playbook

As a rule of thumb, we would avoid cable companies' stocks. Walt Disney Co stock is bound to come under pressure as well, but the valuation levels (P/E around 18) don't seem stretched enough as to warrant a real crash. Walt Disney Co's balance sheet isn't leveraged, and even a sharp decline in EBITDA would preserve its bonds from trouble **(Chart 8)**.

Chart 8: Balance sheet leverage (source: SEC 10-K filings for FY2015)



Time Warner Cable stands out as the most leveraged of the big players, with a high valuation for its stock (P/E over 30). We would avoid its bonds, and initiate a position in January 2018, $160 strike puts (trading around $5). Should the company's revenues decline, and its stock's valuation be stripped of its "growth" premium, we would expect its stock to trade below $100, fueled by leverage concerns, for a 10x-return on the put options.

On the upside, the most promising LTE-U company seems to be SpiderCloud, but it's still private, with plans of an IPO in the 12-18 months to come. We will have time to see how the transition to a new business model unfolds for cable companies and ISPs in general, before anything happens on that front.

Probability	Event	Early signs
50 %	Consumers shift away from Cable TV and to online streaming en masse, turn to other providers for Internet access. CCs revenues crumble, leverage shoots up	• Growing awareness for the cord-cutting phenomenon • Growing « skinny bundle » market share • New Internet providers using LTE-U emerge
20 %	CCs retain control of content and grow revenues from streaming	• More rulings against competing startups • Successful prosecutions against illegal streaming • Wireless technology fails to live up to hype, bad service quality
20 %	CCs transition to a more flexible model, with reduced market share and revenues	• Successful renegotiation of contracts with Disney, other third-party content providers
10 %	Nothing changes, CCs retain their monopoly status	• Qualcomm loses battle over LTE-U • Cord cutting phenomenon dies out

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