

The Economics of Basic Cable Networks

7/14/07

Operator

Ladies and gentlemen, your conference is about to begin. Here are your speakers, Derek Baine and Deana Myers.

Derek Baine

Hello, everyone. Thanks for joining the call. Every year for about the past 20 years we've done what we think is a ground-breaking study on economics of basic cable networks, and it's really a proprietary data set that's gathered on the financial metrics of virtually every cable network out there. So that was the topic of the call today, and since there's been so much controversy over potential a la carte pricing, we're also going to talk about that a bit as well.

Before we begin the conference, let me just talk a little bit about Kagan Research, for anybody who's not familiar with us. We track virtually all aspects of the media, and we concentrate on financial analysis and evaluations and anything which is going to impact the value of media companies, including traditional media, new media and ad-driven sectors.

We have a company called Kagan Media Appraisals. It does fair market valuations, fairness opinions, expert witness testimony, business plans and that sort of thing. And then we also have a publishing arm which puts out a number of newsletters which are very micro-focused. For instance, we have one on broadband advertising, broadband technology, *Cable TV Investor*, *Motion Picture Investor*, etc.

We also put out very detailed financial reports. Some of them are 200, 300, 400 pages. Very in-depth and, again, they're sector driven and they're finance driven. So for instance we have a book called *Cable Network Startup Strategies*, which goes over the economics of what it costs to launch a cable network, the ways that you can make it successful, how much it's going to cost to invest and that sort of thing.

We have more industry overview books, like we have *The Future of High-Definition Television*, covers that market. We also have another book called *The Economics of High-Definition Cable Networks*, and that covers the HDNet type of cable networks out there.

We believe that we carry a vast amount of knowledge in very niche sectors, that we're able to give out data that, really, you can't find anywhere else. That's how we try to differentiate ourselves from our competitors, is focusing on segments where there's a lot of uncertainty, people want to know where the values are going, and that sort of thing.

With that, I'm going to turn it over to Deana Myers, and she's going to go into a little bit about the methodology. Let me just first say what the structure of the call is going to be. We're going to go through, hopefully everybody's got the PowerPoint prescription. We're going to go through the first sector, or the first part of it, which is the economics of basic cable networks.

Then we're going to break for Q&A, then we're going to go into a section about a la carte, and then we're going to break for Q&A again. With that, Deana?

Deana Myers

Thank you for joining us today. Let me give you a little bit of background on the economics of basic cable networks. It's an annual survey of CFOs, in which we do profiles for each of the basic cable networks, which includes financials on advertising CPMs, license fees, programming costs and other variables. We build a financial projection model for all five networks and get CFO feedback on both historical and financial information. We believe it's the most comprehensive data source in the industry.

In the slides which follow, we will highlight trends of what we found from our EDCN survey. License fee gross is expected to soften, despite being strong over recent years. Ad revenue growth is robust in the aggregate, but some of the larger nets have shown pockets of weakness, especially that had been highlighted in the upfront this year. Both broadcast and cable networks have experienced a slower upfront this year.

CPMs show double-digit growth in 2005 at around 10% last year. This year we don't believe it will be that high. It will be more in the 3-4% range, is what we're expecting. Original programming is on the rise for many cable networks, but there have been as many failures as successes, if not more failures than successes. But original programming does offer additional revenue streams for hit shows, including DVD and syndication sales. And new channel launches are very difficult even for incumbents these days, and almost impossible for independents.

Looking at the advertising market, growth of the cable ad industry is expected to be more robust than the total ad market over the next decade. Cable advertising closed out 2005 at more than \$20 billion, and is projected to nearly double over the next 10 years versus the overall ad market, which will move from around the mid-\$200 billion to just under \$400 billion in the same timeframe.

Looking at historical growth, cable has outpaced that of the whole ad industry. Cable has also been more resistant to recessionary times than most other media. With the 2001 fallout, the overall ad industry lost about 6.5% versus a 0.6% loss for cable. Cable networks and local, that includes.

We expect cable to continue to grow at a quicker rate than total ad dollars. Cable should also increase at a faster pace than other TV categories, including broadcast nets, broadcast stations, and syndication. Derek?

Derek Baine

Thanks, Deana. I'm going to go over some of the top line numbers from the survey, and then you'll also find in the back of the deck there are some metrics on individual channels, top line numbers for the top 10 networks.

One of the interesting things about the market is that when you look at the top line numbers, it's a great market in aggregate. This continues to attract a lot of new entrants, channel launches, but I think it's a little bit misleading to look at the overall market and say "This is a great area for

growth.” Because what’s really happening is, the majority of the gains are being taken by the major media conglomerates that own a lot of networks and have a lot of leverage. So that’s kind of the trend.

To get into the numbers, show you how strong it is, 2005 ad revenue was up 14%, affiliate revenue up 11%, total revenue up 13%. A phenomenal showing, and what’s really attractive about this sector is the margins. The average cash flow margin is 35% in 2005. But consider that there are literally dozens of networks that have negative cash flow. So if you were to take those out, we’re looking more in the 40% range. Some of the networks are actually in the 50s and 60s.

What were the weak points? Well, affiliate revenue growth slid from 20% in 2000 to 14% in 2004, and down to 11% in 2005. Going forward, what we’re expecting is, some of the new networks will be able to generate maybe 5-10 cent type of license fee, where historically it’s been more 10-25. But affiliate revenue is slowing down, and the expectations are for CPI-like increases for most networks.

So particularly the large incumbent networks, where they were telling us about five years ago that they were expecting 5-6-7% annual increases on a per-subscriber basis, now those expectations have dropped to like the 2-4% range. So that’s the dynamic there, but luckily this industry remains very healthy, because unlike broadcast networks that are totally relying on ad revenue stream, cable networks get about half their revenue from license fees, and half from advertising. So there’s still quite a bit of growth left there.

One of the weak points that we noticed last year was that subscriber growth was slower than many had expected. Although some of the networks told us that they thought there may have been a Nielsen reporting problem. So we’re looking for, we’re not expecting that that’s going to be a trend. We still do believe there’s going to be some multi-channel growth happening.

But as I was talking about before, the market has really bifurcated. You’ve got some very, very successful start-up cable networks like TV1 and Fox Reality, but they’ve gotten backing from major multi-channel players, Fox Reality with DirectTV, and TV1 with DirectTV and Comcast. So, really, the successful networks that are launching now are signing big carriage deals with one of the top five multi-channel operators, and that’s what’s getting them going.

But kind of the slow-growth that many networks tried in the past, it just really doesn’t work anymore, because it can just be painfully slow to get subscribers on. So most of the new launches that we’re talking to are trying to launch with a commitment from a DirectTV or a Comcast or someone of similar size.

On page 14 in your deck, this is a snapshot of what the industry looks like now. Pretty amazing that we’ve gone from \$3 billion in 1990 to \$30 billion in 2005. The cash flow margin continues to ratchet up. There has been a shift from majority of revenue coming from ads, with 51% in 1990; now it’s 45%. But it’s still pretty similar to 50-50. We’ve got 51% from affiliate revenue, and four from other revenue. Other revenue would be like DVD sales, merchandise, that sort of thing. And 45% coming from the ad revenue line in 2005. It’s a very compelling story in this sector, and we think that the major media conglomerates are going to continue to benefit from these trends.

One thing I wanted to do is, since there's so much talk about sports programming costs, I wanted to take a look at ESPN for a moment. Affiliate revenues make up about half of industry revenues, but ESPN affiliate revenue is 75% of its total. That's grown from 54% in 2000. So they really kind of skew the overall numbers.

Pulling out ESPN and looking at all cable networks without ESPN, it's a more even split of revenue. And what has really been causing, I guess, a lot of press attention in this sector and in Congress and that sort of thing, is the whole issue of consumer pricing going up in excess of inflation. But a lot of this is having to do with Fox Sports Network and ESPN, which since they make up such a large share of affiliate revenues, any kind of an increase in license fees at ESPN or Fox Sports really kind of skews the industry because they're so large. I put in a couple of slides in there that you can take a look at what the industry would look like without ESPN.

Moving on, we're on page 18 now. What are the forecasts like going forward? Well, again, we are going to see some subscriber growth, simply because there's still a little bit of room in the market for multi-channel growth. And we are seeing new entrants come into the market, the telcos, namely. But on a per-sub basis, we still think that license fees are going to go up in a more normalized inflationary range, 2-5% for the very strong networks. But I would say those are going to be rare. You're probably talking 2-3% for the majority.

Double-digit ad revenue growth is expected to continue. We're still seeing viewing migrate from broadcast to cable. You're still seeing CPMs that are well below broadcast television, so even though they've been growing at a pretty nice clip, there is room for them to catch up. So we don't see any of those trends changing.

I think with the digital ad-insertion technology that's going on, local advertising has got a lot of growth as well. And in the future you're going to see, I think, some compelling interactivity added to ads that will help the market. But I think the main driver behind this trend is still leverage.

You've got some of these major media conglomerates that can sell a wide bundle of cable networks at a very attractive price. And if you look at what a CPM would be on a low-rated network show, I think advertisers are starting to scratch their head, because of course they're never going to have a problem selling the top 10 shows, but if you look at how low the ratings have gotten on the bottom 10 shows on any broadcast network, it's just not really compelling to buy those spots when you can get one much cheaper on cable and still get an audience that's in the demographic that you're looking for. That was our thinking behind that.

Total revenue we're expecting to grow 11-13% over the next five years. Revenue is going to grow faster than costs, and therefore we're expecting that margins will continue to increase. So by 2010, we're forecasting the average margin is going to be 41%, but I'll talk to you a little bit later about some of the individual networks. There are going to be more and more networks that are getting 50% type of a cash flow margin.

If you compare the economics of that type of a network to the economics of a broadcast network, it's very, very compelling. And I think that's what's driving a lot of capital into this segment of the market.

Looking at page 19, these are our industry forecasts now. We believe that by 2010 there's going to be total ad revenue of almost \$30 billion. And this does not include local. This is just on the national side. So that would be net to the cable networks about \$25 billion, and we're expecting license fees to be about \$27 billion. So in aggregate we're talking about going from \$34 billion in total revenue in 2006 to over \$53 billion by 2010. Pretty phenomenal growth.

On the cash flow side, we're expecting industry cash flow to double. We're projecting that 2006 is going to come in at about \$12 billion in aggregate, and we're expecting that to ramp up to \$22 billion by 2010. So we are expecting ad revenue growth to be a bit better than license fees, which is why we're showing ad revenue as a percentage of the total is about 46% in 2006. And that's going to grow to about 47% by 2010.

Again, I pulled out the ESPN numbers, so look at those separately. You can see the network right now, it's approaching \$5 billion in total revenue per year. And of that over \$3 billion is license fees. So, again, it kind of skews the overall industry numbers, because their license fees are quite high.

But everybody likes to pick on ESPN as the big problem for the cable operators, but really what's going on is sports rights fees just continue to escalate astronomically. And so if you look at the ESPN numbers, their margins are not that high compared to their peers. So what's really going on is, they're paying \$3.5 billion a year in programming which is pretty much equivalent to the license fees that they're getting from cable and satellite operators.

The trend at ESPN is not one of gouging the cable operators. It's just a fact that they do continue to bid on these very expensive games, and they've had a lot of bidders in the market, both broadcast and other cable networks. And so it's kind of a tough situation, but that's really what's happening, is these sports costs are being passed on down the line.

And then on page 21 now, we have the industry without ESPN. So without it it would be about a \$45 billion industry, and it would have a margin of 44.1%. So if you look back at the slide on 19 and compare that with the slide on page 21, the overall industry average cash flow margin is 41%, but taking out ESPN, it actually pops up to 44% by 2010. In 2006 it was 35. And without ESPN it's 37.8. So over two points on the industry margin from ESPN.

That concludes the first part of the presentation. At this point, Cathy, can you open it up for Q&A?

Operator

Certainly. [GIVES INSTRUCTIONS FOR QUESTIONS] We'll go to our first question now. This one is from Larry at Drexel University. Go ahead when you're ready, please.

Larry

I have a question about the graph on page 12, which is the graph that shows that cable advertising continues to grow faster than advertising in general. That still continues to be true, but the lines do appear to be converging, and I'm just wondering what you believe is driving that, and if you think that at some point the difference will disappear.

Derek Baine

I think that the reason that cable TV advertising has been much stronger than the overall market, well, there are several reasons for it. The biggest one is that CPM has traditionally been much lower than broadcast. It is starting to close a little bit. But it's still a very compelling buy on cable versus broadcast, and you can see this year and last year there has been an impact on other traditional media. So it's cannibalizing things like broadcast television.

But another thing that I think is causing that trend is just that there are more viewers. It's a combination of people migrating from broadcast television, but it's also an increase in the number of multi-channel households. So the overall number of people viewing is increasing for those two reasons.

Over time, yeah, you can see that we're bringing the forecast down to the 8% range in 2015. I can see, over time I can see it being closer to the overall market growth rate. Because once the CPM gap is closed and multi-channel growth is slowing or comes to a halt, then that's what's going to cause that trend to disappear, and you're going to see more like inflationary CPM increases.

Larry

Thank you.

Derek Baine

Sure.

Operator

Our next question comes from Anita at Opportunity Capital Partners. [COLLOQUY] We'll go to our next caller then. This one from Carl at Independent in Chicago. Go ahead when you're ready, please.

Carl

Derek and Deana, you mentioned that TV1 as one of the examples of a successful start-up over the past year or two. My understanding is, I believe that TV1 received an equity investment by at least one of the DBS and one of the MSO providers. Given that, can we expect similar arrangements going forward? And, two, are MSO or DBS providers more likely than the other to go down this path?

Derek Baine

You're right as far as, I would call them more "equity partners" than "equity investors." One big trend has been cable networks wanting to launch realize that it's extremely important to get on a DirectTV or a Comcast, and so a lot of them are now approaching those companies saying, Hey, would you be willing to put us on the air if we would give you an equity stake in the network?

It can be equity or it can be cash. Most of the carriage deals that are going on right now, there is some form of payment that goes from the cable network to the operator. But it's just a way to save on capital costs, if you could get them to take equity rather than cash. Obviously depending on what percent you're giving, that could be much more advantageous.

Carl

And, again, you do believe that that's going to take place increasingly over the near term and midterm?

Derek Baine

Yeah, I do. I would expect particularly Comcast has really said they want to have a big presence in the programming arena. But I would also expect DirectTV and EchoStar to continue to do that.

Operator

Thank you. We'll go to our next question now. This one's from Jeff at Sprint/Nextel. Go ahead when you hear the three beeps, please.

Jeff

Yeah, thank you. I was interested in your comments on ESPN, what you said about the margins made sense. Apparently the viewer demand for major sports is so high that they can ask for a lot of money from the networks, and ESPN can pass that cost on to the stations and then to the viewers.

Wouldn't it seem like, from an economics point of view, that eventually other networks might want to get in this business by maybe covering other sports and getting in the van for them. Kind of like in the 1960s, ABC Wide World of Sports, when they wanted to compete with the other networks, they started covering things that nobody thought of watching before, all around like skiing competition. So my question is, do you see any movement? New stations trying to enter and compete with ESPN by maybe getting attention on other sports?

Derek Baine

Yeah, absolutely. We go through cycles in time, and you do have the broadcast networks that during certain periods of time have been very aggressive on some rights. And now you've got Comcast with outdoor, bidding on the hockey. So I definitely see that.

But, again, that's what's driving up the prices for the consumer. Any time you have multiple bidders in there aggressively bidding on these, prices rise. So I don't know that what you're talking about would help the overall market or not. It could obviously hurt ESPN if they lose some major games.

Jeff

Just making more competition, creating more competition on the content side by having alternatives to just Major League Baseball and NFL and NHL.

Derek Baine

What kind of alternatives?

Jeff

Well, like NBC in the 60s in broadcast TV kind of created the AFL, because they didn't have a sport to cover, a league to cover. It seems like it comes down to viewer interest. People think they have to have Major League Baseball or football or the World Cup. But if people could be, demand could be created for other kinds of content that are competitive to that.

Derek Baine

There is a market for alternative sports programming, although I can't see anything over the horizon that would draw a huge amount of viewers from NFL or something like that. They're really the marquee games.

Deana Myers

It's really expensive to get into that type of programming, to launch your own football, AFL these days. And the broadcast networks are really moving away from the sports rights, anyway, with mainly battling for NFL rights is the only one they're pretty much focused on anymore, other than the finals of baseball or such. That's pretty much the only rights they're interested in anymore, because it just doesn't draw the ratings. It doesn't have a cost/benefit. It doesn't make good sense for the broadcast networks anymore. So they're kind of out of the picture on that.

Jeff

OK, thank you.

Operator

Our next question comes from Tony at the Italian American Network. Go ahead when you hear the three beeps, please.

Tony

With ESPN skewing the economics of basic cable, wouldn't they be the most likely target to become an a la carte pay service?

Derek Baine

There's certainly been a lot of talk about it. But most of the contract agreements with operators run 10 years, and there have been disputes with Cox and others where the MSO has threatened to just completely drop them, or has dropped them for a period of time.

And the problem is, it couldn't be done overnight, because like I said, these programming agreements are for 10 years' duration for the most part, some of them five. And a lot of them have certain restrictions where you have to be penetrated x-percent or on the most basic level.

So I think it's something that a lot of the operators have thought about. Obviously ESPN, which I believe is on the line, they can chirp in if they like. I think they would fight pretty vehemently against that. And it's a big media company, and they have other networks that they can leverage as well.

So, yeah, it's been talked about. I can't see it happening anytime soon. One possibility would be maybe at some point the network gets broken in two, and you have an ESPN Basic and an ESPN Plus. That might work, although some of the leagues are probably not going to want to license games that are only shown to an a la carte tiered network.

So I think there's kind of two dynamics here. One, it seems logical, but it could just destroy the economics of the network, because if the leagues don't want to license games to a network that's only shown to a subset of the population, then they don't have any programming. So that part of the equation, I don't think has been thought through by some of the regulators who proposed a la carte. Because that's the big appeal to NFL or any other sports licensing to an ESPN, is pretty much everybody can watch it. It drives brand recognition and ad dollars, etc. Not that compelling of a story if they were on a 10% tier or something like that.

Tony

Thank you.

Operator

Our next question comes from Carl at Independent in Chicago. Go ahead when you hear the three beeps, please.

Carl

What about doing your survey of the CFOs of the operators? You mentioned Black-Belt TV as an example, the Anime Network an example, TV1 again. I believe Water Channel's another relatively new network that's on the airways now. Just generally speaking, what are some of the reasons why these types of networks are picking up subscribers and are being put on increasingly some of these operator platforms? They seem like very, very niche players, even down to the Water Channel.

Derek Baine

Networks like Anime started out on a video-on-demand service, and what the operators founds was that demand was actually pretty robust, perhaps unexpectedly. And so they've been able to line up some linear carriage.

I would say there are a number of things that are going to impact whether or not a network gets launched. One of them is just simply money. If you have a network that has a decent idea, and you're offering an operator two bucks a sub, and another guy comes with another niche channel, and they're paying a dollar a sub, who do you think they're going to put on?

So a lot of these programming decisions, they're not made in a vacuum, but the financial analysis of what the operator is going to pay and get paid is a pretty critical part of the equation when they decide what they're going to put in their channel lineup.

Carl

OK, thank you.

Operator

Our next call comes from Jeff at BeeLink [sp.]. Go ahead when you hear the three beeps.

Jeff

Hi, thanks. You had mentioned previously that there were some substantial cost differentials in CPM on broadcast versus cable.

Derek Baine

Yes.

Jeff

Will you be willing to go a little bit more specific on what kind of average CPMs we're seeing in those two entities?

Derek Baine

Sure. Typically cable networks would get CPMs that could be anywhere from \$2-6, let's say. There are higher CPMs. ESPN, I think, has the highest CPM. I'm just pulling up a spreadsheet here to give you some real numbers here. So, yeah. ESPN is generating an average CPM that's about 1053 last year. Now, keep in mind that's across all day parts, so it'd be much higher during key games, that sort of thing.

The industry average last year was 509. So I'll just kind of give you a range here so you can see. Like an A&E generates about \$4. BET is in the \$4 range. Bravo, a little more upscale audience, is in the \$8 range. CNBC is also in the \$8 range. Comedy Central \$7. Discovery about \$7. There's a wide range. You can have anywhere, like a game show network which has been on the air for years, they're only generating a CPM of \$2.75. Hallmark is only generating a CPM of \$2.50. That's kind of the range, can be like \$2-10.

Jeff

What about for broadcast?

Deana Myers

Broadcast, it really varies by network, but in the Big Three you get primetime CPMs in the \$12-15 range. And it's hard to compare all day on a broadcast network. That's the most significant area, though, is definitely in primetime.

Jeff

OK, thank you.

Operator

Thank you. Our next question comes from Larry at Drexel University. Go ahead when you hear the three beeps.

Larry

My question's been answered, thank you.

Operator

Thank you. There are no further people in the queue at the moment.

Derek Baine

OK, great. We do have a few questions that have been emailed in, so I'll just pull one and then we can come back to these later. Jeff Gilbert, you sent in a question: "When looking at the economics from an operator perspective, you include only basic and digital tier sub-revenue, and then compare this to affiliate fees. Basically wanted to know the rationale for that, because there are so many other revenue streams flowing to the operators."

The thinking behind that, Jeff, was that we just really wanted an apples-to-apples comparison to see what the gross margin was on programming costs. And so the other revenue streams that you're talking about, there are direct costs that go with that, and we didn't want to mix in high-speed data and premium programming and that sort of thing. We were just really kind of looking at what the cost per channel is to the consumer.

That leads us into the next couple of slides. I'm going to go ahead and start in on the a la carte part of our presentation, and then we'll take Q&A again at the end. If anybody has any thoughts on either part of the presentation at the end, feel free to email them in or we'll have the live Q&A.

Why is there this push towards a la carte that keeps rearing its head again in Congress over and over and over again? Really it kind of started out with consumer advocacy groups looking at the cost to the consumer and kind of making the assumption that the consumer is being gouged.

We don't really believe that, because if you look at—it's hard to look at averages. Yeah, averages are going up. However, there are still pretty compelling programming packages that are being offered to consumers at a low price. EchoStar, for instance. They've got some great packages that are not really, really expensive.

And so it's not like the consumer has a monopoly like they used to, where you only have the choice of cable and you're going to kind of take whatever they give you. That's not true anymore. We've got DirectTV, we've got EchoStar, we've got over billers moving into a lot of markets. So there is a lot of choice from a consumer standpoint.

What we did, just to kind of take a step back and go: Wait a minute. Is this really a phenomenon where consumers are just paying much more than they should be? And it's not, on a per-channel basis. So multi-channel costs are rising faster than inflation, but they are not on a per-channel basis. The average retail cost per channel has actually gone down from 75 cents in 2000 to 71 cents in 2005.

During that same time period, the average number of channels per multi-channel subscriber has grown from 42 in 2000 to 64 in 2005. Now, these are only basic and digital cable channels, so this does not include broadcast television station feeds, it doesn't include pay-per-view, it doesn't include PBS, things like that. So what we were really looking at is, on a per-channel basis, what is this costing?

Now, there are also some other issues which keep bringing this up to the forefront, and they are family values and censorship issues. Some of these advocacy groups have been family oriented and they said, Oh, we shouldn't have to pay for this channel because it's got things on there that we think are too risqué or foul language or something like that.

There is blocking technology available. However, that's a valid point. You don't want to pay for a channel if it's not something you don't want your kids watching. But I think it's kind of gone overboard, in my mind, because we've gone through, for several years we've gone through kind of hot and cold periods in the media where it's front-page news, and then it dies down. And it really gained a lot of momentum after the Janet Jackson wardrobe malfunction, and everybody was up in arms about that.

And so these family values groups starting saying, Oh, you know, if we had a la carte, that never would have happened. Which I think is ridiculous, because it was CBS, the SuperBowl. Who would not be subscribing to that if it was a la carte? So I thought that was kind of a silly argument. But it does come up periodically.

Page 24 is a table that kind of outlines what I was talking about. On average there's about 64 channels per multi-channel subscriber. That's been growing about 2-3-4% per year. The channel on page 25, what we did is, we took cable operator revenue only from the digital and the basic, and then we looked at, divided, basically all the affiliate fees into that to see what was going on with their margin.

As you can see, in 1990 the programming costs as a percentage of that basic and—well, it wasn't digital back then; it would have been just basic revenue—was pretty small. It's like 13%, 87% margin. That's gone down to, in 2005, it's 70%. It's still a nice margin, but you can see how over time it's been eating into the operator's margin.

So even though cable operators are being targeted by these consumer groups about the rate of increase in their basic and digital packages, in fact they're not passing all the programming costs on to the consumer.

I'm going to pass this on to Deana.

Deana Myers

Are there too many channels out there? is the next question. With the average viewer watching between 10 and 14 channels, probably there are too many channels for most people. But what 10-14 channels people watch varies in every household. And some people like to still sample. I don't believe that they entirely don't only watch those 10-14 channels, but sample other channels as well, and maybe move what 10-14 channels they watch.

So cable networks have migrated towards offering original programming to attract viewers. Getting viewers to notice the network has definitely helped with original programming. Shows like *The Sopranos* and *The Shield*, which I know is a pay-network show, but it really helps show that viewers

would turn to cable for original programming. So shows like *The Sopranos* and *The Shield* have helped create buzz for basic cable networks, and ad advertising revenues on top of that.

But the successes are rare, and originals are very expensive to produce. If you do get a hit, the good side of it is that you can distribute the show internationally, be it DVD, syndication, etc. But you have a lot of costs in order to get original programming on the air in the first place.

There's a trend towards digital spin-off. Lifetime, Lifetime Movie Network, Lifetime Real Women, MTV, MTV2, MTV Hit, MTV Jams. It's the channels tend to be all bundled by media conglomerate, and offer little chance for some of the indies to get carriage. Thanks to Comcast's push for free on-demand, many new programmers are forced to get into the market by offering VOD content instead of linear networks at this time.

The trends in cable network channels, the average channel per multi-channel sub, this year we expect it to be about 67.5. And that will likely move up to 79.3 over the next five years. Although we don't necessarily think that that's going to come from offering many new networks. It will be offering networks that are currently available, more so than a lot of new networks. Other video offerings, including VOD, mean less room for linear network. Average channel growth per sub has slowed in recent years, and we expect that downward slope to continue.

On the programming cost side, operators want to protect their margins, but programming costs are rising at a faster rate than video revenues are expected to increase. Their margins are expected to be about 69% on video versus 63% in 2010, and that has a lot to do with rising affiliate fees, and not as quick of an increase in what the consumer is paying. So we expect retail costs per channel at 71 cents this year versus just 72% in 2010.

I'm going to turn it back over to Derek at this time.

Derek Baine

Thank you, Deana. Deana was asking the rhetorical question "Are there too many channels?" Another one is, "Are they all owned by the same companies?" That's really the big trend that we've seen in recent years with the consolidation and the launch of digital cable. A lot of the media conglomerates have come out with myriad new networks which are not really original ideas; they are more kind of taking a programming library that they have and sorting it by genre or what have you.

Discovery has been very successful at this, launching digital spin-offs. Deana mentioned VH1 and MTV are always two that have several different kind of spin-offs which are just basically music by different genre.

The media giants have a sustained competitive advantage. They've got leverage. Some of them also have leverage by owning TV stations and using retransmission consent leverage. We believe that companies with significant market share are in a better position to come up with new products and leverage them on the air.

There are big barriers to entry for independents. The biggest one is cash. Cable operators want to get some sort of an incentive for launching the channel. They call it marketing support, but it's just basically cash that the network has to come up with upfront and pay the operator as an enticement to put them on the air.

This bundling that's done by the major media companies really is a powerful disincentive for the independents, because one of the problems that we've seen is, if somebody comes up with a really good idea, it's quickly replicated by one of the major media companies. So unless you can get in there with a major commitment from a DirectTV or an EchoStar or a Comcast, you also face the problem that it's possible your idea could get stolen.

The key question should be, for the cable operator or the satellite operator, what is the supply and demand curve? The problem is, by channel, no one really knows, particularly on the new channels that are launching, because you won't get a Nielsen rating for four, five, six years, until at that point it's pretty well entrenched in a 10-year contract.

What's happened is, a lot of these digital networks have been launched under 10-year agreements, and we're just now starting to get Nielsen ratings and find out that hardly anybody is watching them. Obviously from a cable operator's point of view, that's got to be really irritating, but if you're in a 10-year contract, there's really nothing you can do until the contract comes up for renewal.

But we think, at the end of the renewal, you're going to see more channels being given the heave-ho than you've seen in the past. If they can't come up with a decent Nielsen rating to support the level of license fee that they're getting, the cable operator's not going to renew them.

Somebody was talking about will people buy ESPN a la carte? This is an interesting question, obviously, and because of the bundling phenomenon that we have in the U.S., people don't realize how much they're paying per channel. But if you look at the operator margin and the license fee at ESPN, and gross it up to a retail level, people are paying almost \$10 a month now for ESPN as part of a bundle.

However, one interesting thing is, when this whole a la carte was in the forefront in 2004, Deutsche Bank did a survey which showed only 6% of customers would pay \$10-15 per month for ESPN a la carte. So that study tells you that there's not going to be the demand at the retail price that ESPN would have to charge, which would be probably somewhere over \$10 a month.

One other interesting thing was that satellite subscribers were much more inclined to buy ESPN a la carte. And I think that's because DirectTV in particular has a lot of sports programming. You've got the NFL Sunday Ticket and a lot of regional sports networks, so it probably skews more towards sports fans than cable.

What are the problems from the consumer point of view? Well, obviously, prices are rising too quickly. As new products are rolled out, this trend is being exacerbated. A lot of the operators are charging for DVR rental, HDTV box, kind of adding on little charges here and there, which is making the whole bill go much higher.

Consumers are often forced to take products they don't want, as channels are currently sold in bundles. But there's a Catch-22 here. If they don't take bundled channels, they'll never be able to sample most of the new networks, and new channel launches could probably just come to a complete halt if we went to a completely a la carte system.

From the distributors' point of view, obviously they don't like seeing their margin being compressed, like we showed on the previous slides. Outdoor Life Network was booted from EchoStar after it tried to push through a rate hike. Dish refused to pay it. And this has happened in several instances. It's happened with Lifetime. So some pretty major networks here that are being given the boot over license fee increases that the operator doesn't feel are fair. TimeWarner just recently was having kind of a spat with some independently-owned networks as well.

Some of the other issues are, the NCTA argues that both a la carte and theme tier requirements would violate the First Amendment. And even the Consumers Union's Gene Kimmelman, who's been a big name in the media in favor of a la carte, I had a quote in here from him where he said "A la carte emerged in the consumer agenda only after efforts to prevent concentration of ownership and price gouging all failed. It was kind of a fallback position; it was never viewed as the totally optimal approach." So even Gene Kimmelman is admitting this is not the ideal solution.

One option which was suggested to the GAO in 2004 was that, similar to common pricing schemes for electricity and natural gas, subscribers might pay a flat charge just to get connected to the cable operator system, and then you would pay additional charges for each network. That's an interesting idea. The way that would work would be you pay \$50 or something like that, and then every channel that you ordered would be a very nominal fee. So you would pay, but it would problem be a nickel or a dime or something not outrageous.

And then the other possibility that I mentioned is ESPN could be bifurcated into a cheaper basic fee without all of the games, and then developing an ESPN Plus. Although, as I said before, there's problems with that, because it's not clear that the teams would want to license to the ESPN Plus one.

So that kind of concludes the a la carte. I think before we go into the Q&A, I'm just going to wrap up the presentation here and tell you some of the top line numbers. As some of you may have figured out, this is kind of a commercial for this product that's coming out, that we're hoping you're all going to call immediately after this call and order the book, which is actually an Excel electronic edition, so it's great for building financial models.

What I did was, I put together some slides. Who were the big winners and who were the big losers last year. Some of the key trends that we found are—and my apologies if any of you are on the call from the networks that we have as the losers. Networks like CNN, Discovery and VH1 we think have lost some of their luster. CNN has grown from \$192 million in ad revenue in 1990 to \$376 million in 2005.

By comparison, Nickelodeon grew from \$60 million to \$1 billion during this timeframe. Lifetime has gone from \$100 million to \$575 million. So that's really been a function of more competition in

that genre from Fox News and, I think, now MSNBC might even give them a run, now that that venture has been restructured.

So who were the biggest in ad revenue growth? Ones which were just kind of up and coming were like National Geographic, Oxygen, SpikeTV, Hallmark—although I think I mentioned earlier that Hallmark's CPM is well below the industry average, and so they're just kind of catching up. Fox News is similar. They've had phenomenal success at Fox News.

So what are the bottom 10 channels in ad revenue growth 2005? The Learning Channel was a big problem child last year, and MSNBC as well. What's interesting, though, from this chart on page 40, I think, is that there's only two that had negative ad revenue growth. That's pretty amazing when you think about it. I think there's something like 140 networks or something in this database that we tracked, and out of all of those there's only two that are negative. Quite a positive trend.

Page 41 has got the top 10 channels in cash flow. There's only four networks that generate over \$500 million in operating cash flow. Nickelodeon's the biggest, over \$1 billion. ESPN number two, followed by MTV and TNT.

SpikeTV, Court TV, National Geographic, Comedy Central and Golf were the biggest in cash flow growth. And looking at margins, as you can see from this chart on page 43, there's quite a few which have 50% cash flow margins. The highest is 78, one in here at 66, and quite a few at 50. And then if you look at the trend I was speaking about before with the cash flow negative, if you actually do a straight average of all of the cable networks, it's a negative margin. But when you do the weighted average, it's about 35%.

Let's look at license fees for a minute. ESPN is approaching \$3 a sub. It's \$2.60 right now. Fox Sports is \$1.45. Those are the only two networks that are over \$1. And you can see there's actually only a handful that are over 40 cents. Affiliate revenue, again, ESPN and Fox Sports Network are the only networks over \$1 billion in affiliate revenue. And then there's a handful that are over \$400 million.

Who are the winners and losers going forward? Thanks to recent rights deals, ESPN ad revenue is expected to grow at a compound annual growth rate of 12% through 2010. We're expecting some ratings growth there driving that as these new games appear. Fox News is expected to displace CNN in the top 10 networks as early as this year. Forecasts are for ad revenue to grow at a compound annual growth rate of almost 20% over the next five years at Fox News.

Comedy Central and Food are also growing in the double digits. Niche networks like TV1 and Fuel [sp.] are expected to be growing rather rapidly. And networks like SciFi, BET, Discovery and Weather are expected to grow ad revenue well below their peers.

On page 47 and page 48, we have our projections for the top 10 networks in ad revenue and cash flow going from 2006 to 2010, and you can see the growth rates in there are pretty high, most of them close to the double digits. Top 10 in margins, we're expecting by 2010 that, again, you're

going to have quite a few networks up here in the 50-60-70% range. Some of these are digital spin-offs like Nick2, but other ones are established players like Nickelodeon.

The bottom line analysis, of the 140 networks we tracked, 15 have margins over 15%; 36 are on track to get there by 2010. More than one-third of the nation's cable networks are currently cash flow negative. Of the established networks, Nick has the highest margin. Music networks and some niche networks like HGTV and BET have 50%+ margins. None of the general entertainment networks have 50%+ margins because of their higher original programming costs. And then on page 51, I just did kind of a distribution to show you how many networks are in each category by margin.

On that note, we're going to open it up to Q&A. And I also wanted to mention that you're all going to get a survey after this call, and we would appreciate it if you would give us your feedback. If you do, as soon as you send in the survey, we're going to give you a free transcript of this call. With that, Cathy, you want to open it up to Q&A?

Operator

Sure. [GIVES INSTRUCTIONS FOR QUESTIONS] OK, we do have some questions. The first one comes from Jeff at BeeLink. Go ahead when you hear the three beeps.

Jeff

Hi, I understand the analysis or the statistics that you've demonstrated with regards to price increase of cable television to the consumer. The question I have is with regards to the conclusion. The assumption that because people get more channels and the dollars per channel hasn't increased, that somehow the consumer is feeling the benefits of competition sounds odd to me.

The consumers are clearly recognizing that at the end of the month it's cost more to watch television than it did the month before. It seems to me that that's what's driving the a la carte argument on the consumer side, is they've just recognized, Look, I'm paying more money every month, and I may be getting more channels, but the point is I don't want those more channels, because I'm still watching 10 or 12 channels a month, yet my bill's gone up. I now have 80 to choose from, which is fine, but I haven't really gotten all that much of a benefit. Maybe I've changed one or two of my 12.

But I just don't understand how that conclusion can be that prices haven't gone up substantially in the marketplace when the consumers are clearly seeing this at the bottom of their bill.

Derek Baine

Yeah, but, see, again I think you're looking at the top line numbers, and I would go back and the counter argument to that would be you can get basic, you can get expanded basic, you can get fairly reasonable, I think, packages from companies like EchoStar. So you don't have to subscribe to the \$80 package or the \$100 package. And a lot of people aren't.

That's the only, I'm not saying that it's a good thing. I think at some point you just do reach total saturation on the number of channels. But I'm saying that from a price value standpoint, it's not as bad as it looks in a lot of these trade press articles.

Jeff

Is there, can I follow on?

Derek Baine

Sure.

Jeff

Just browsing the 'net, Comcast last year increased their prices 10% in the San Francisco marketplace. They did something consistent with that in Chicago. DirectTV raised their prices, I think, 8% last year. And these are for the expanded basic packages, the most basic package you can get on these services, aside from an off-airs only package. This is just the expanded basic package that they all offer.

So if you want to actually subscribe to cable television, at least in the major markets, and this is inconsistent with the data you're showing, at least in the major markets, the increase in consumer price was exactly the same kind of lowest-end package of services, is dramatically outpacing the increase in costs that your statistics show these operators are paying in affiliate fees. There's a big disconnect for me. I guess I don't understand how that fits together.

Derek Baine

I don't agree with that. I think, I don't know that particular market, but I would be surprised if Comcast was raising prices 10% a year in a market like that for the basic package. I think probably what happened is they put in a price increase in various markets and it probably covered two or three years. DirectTV also, they don't raise their rates every year. So they do increase it, but I don't agree with that conclusion.

Jeff

OK, thank you.

Operator

Thank you. Our next question comes from Clayton at Amber Media. Go ahead when you hear the three beeps.

Clayton

Hi, my question is really twofold. One is, the projections that you have, are they taken in the consideration for a lot of the networks and certainly on fees, the telcom impact? Just curious if you factored in the growth in that area, and how that may impact both license fees, ad revenues as well as the potential for a la carte.

The second question had to do with your bullet about the domino effect. And I was curious if you could elaborate on that. Is this a positive thing, a negative thing? Is it a doorway for diversity, where we can get more voices out there? I'm just curious what you meant by that.

Derek Baine

The domino effect as it relates to a la carte?

Clayton

Yes.

Derek Baine

OK. What I was thinking is, if we went, I'm not a proponent of a la carte, because I think if we went to a la carte, there are a lot of great networks out there that would never get sampled, and would just go belly up. And so it would dramatically reduce the diversity, and you would end up with people would just go in and select brand names that they knew.

As a matter of fact, when DirectTV first launched, that was their business plan. They had, it would going to be called Personal Choice, and you could go in and pick your entire channel lineup, whatever you wanted. And they tested that, and they found that consumers were just completely paralyzed. They could not make a decision.

Because when you confront a consumer with a list of 200 networks, that's a lot of decisions to make. So I just don't think the whole thing would work, and I think a lot of networks, both established networks and new networks would suffer.

From the telco point of view, yes, we did. We did take that into consideration. Basically what we do is, we do forecasts on every single network, and then we talk to somebody at that network and we get their guidance, and so that is baked into the numbers that you're seeing.

Clayton

OK.

Operator

OK, thank you. [GIVES INSTRUCTIONS FOR QUESTIONS] Our next question comes from Darryl at Alcate. When you hear the three beeps, you're live. Go ahead with your question.

Darryl

Could you elaborate a little bit more on the telco impact? Do you see with the growth of telco TV an impact on consumer bundles that would increase as a result of additional competition for the same content, or possibly decrease because of lower margins because of the distributor competition?

Derek Baine

I see, anytime you get new competitors in the market there's going to be competition on pricing. From what I've seen, the packages that have been put together for Verizon, for instance, are not dramatically different than what you would get on a cable package or on a satellite package.

I think that if you're not competing on differentiation, then you're going to be competing on price. So I think that's going to be good for the consumer. It's probably not going to be great for the operator that's in that market where they launch.

Operator

OK, did that answer your question?

Darryl

Yes, it did.

Operator

Thank you. We do have another question now. This one, again, from Clayton at Amber Media. Go ahead when you're ready, please.

Clayton

Hi, another question on the growth of broadband and video via the broadband network. In looking at your projections, could you see a la carte working more effectively on, let's say, a broadband network level, versus traditional cable or satellite?

Derek Baine

When you say a "broadband network," are you talking about IPTV or are you talking about another—?

Clayton

I'm actually talking about both, IPTV and just a general growth of the networks now migrating much of their programming to the computer, ranging from first-run product is being migrated to the computer.

Derek Baine

Yeah, well, I think it could work, but I think that there's kind of, let me just talk about Akimbo for a second. Akimbo is a service that delivers TV content over the Internet to a dedicated box which plugs right into the TV. And it basically dribbles the content down over the 'net and then stores it on a hard drive.

And I think they're having some success with that, and I think that type of a service is excellent for many very narrow niches. So, for instance, they have a lot of Korean programming on there. If you're a Korean American, you're going to be lucky to get a few channels in Korean on cable or satellite. So this kind of opens up a whole new world. There's many different target, I guess different niches that a service like that could serve.

Delivering it to the PC causes the different setup problems, how you get the content to your television. Most people aren't savvy enough to set up the whole network. That will change over time. But, yeah, so I think there are different opportunities there, but I think as far as the home networking is going to be a big issue making IPTV coming in over the Internet happen.

Clayton

OK.

Operator

Thank you. We'll take our next question now from Anita at Opportunity Capital Partners. Go ahead when you're ready, please.

Louis

It's actually Louis Byrd at Opportunity Capital.

Operator

I'm sorry.

Louis

The question is, can you suggest what are appropriate metrics for valuing networks that may be per subscriber? Or do you simply need to look at cash flow multiples?

Derek Baine

Over time, historically cable networks have been valued kind of in their early stages, pre-cash flow positive, in maybe the \$5-10 range, until they start hitting maturity, and then it goes up into the 20s and higher depending on what their cash flow is. I think the average cash flow multiple, historically, has been around 14 times, but it's kind of varied between 12 all the way up to the 20s, depending on how marquee the network is.

I would be kind of cautious about using a per-sub valuation, because we just had Hallmark come on the market, for instance, and they didn't get any buyers, and they were trying to look at on a per-sub basis, because they're just breaking cash flow positive. So that's kind of the context, but it really depends on the cash flow of the network or the perceived ability to value it.

Louis

You mentioned the maturity of the networks. Is there a number in terms of subs where you think networks goes from that 10 times to 20 times? And, in terms of cash flow, what multiples of cash flow do you think are appropriate today?

Derek Baine

I would say once a network starts getting over 20 million subscribers, 20-30 million, that's when advertisers kind of think it's for real. It becomes viewed as it's going to be around for the long term. Because there are a lot of networks who just kind of struggle around 5-6-7-8-9-10 million subs and don't really go anywhere.

So that's I think where you hit kind of an inflection point. But I would say just a run of the mill cable network would be like 12-14 times. I would be surprised if Disney would part with an ESPN for under 20 times. So it depends on both the cash flow and the brand name recognition of the channel.

Operator

OK, thank you. If there are any more questions, we have time for one or two more. [GIVES INSTRUCTIONS FOR QUESTIONS] It does not look like we have any further questions at this time.

Derek Baine

Great, well, thank you all for joining us.

Operator

Thank you very much. This concludes today's program.