

MEDIA &
ENTERTAINMENT

 **ERNST & YOUNG**

Quality In Everything We Do

Fast Forward

**Technology Propels Media and Entertainment
CEOs into the Future**



“Without a doubt, the digital revolution is the fundamental technology shift affecting everybody.”

“There is no solution to DVRs skipping over advertising.”

“Planning in this business is like target-shooting from a Ferrari going 200 miles per hour.”

Foreword

Historians tell us that the velocity of change has always increased throughout human history. But the force of change on the media and entertainment industry has grown dramatically in recent years, as anticipated by Sir Isaac Newton's famous second law, force equals mass times acceleration ($F=ma$). Media and entertainment is a massive industry: it is changing fast, and that change is accelerating—hence the force of change exerted on industry players has become enormous.

In endeavoring to understand that force of change and to help the industry guide and shape it, Ernst & Young sought insights from the top executives of some of the largest, most influential media and entertainment companies, and their financial stakeholders. The list of participating CEOs, CFOs, and financial stakeholders on the following page is indeed impressive, as is the \$214 billion¹ (FY03) in combined annual revenues of just the media and entertainment companies that participated in this global study.

We gratefully thank these executives for their time and their insights. In keeping with past study policy, the participants' quotes have not been attributed so that their candor can be protected—and candid they certainly were. So although the executives won't be named with their quoted insights, it is, of course, their contributions that make this report so powerful.

Enjoy the report.

¹See *Narrative Sources*, page 31

Study Participants

Ernst & Young thanks the CEOs and senior executives whose contributions made our report possible.

Ernst & Young interviewed 23 of the top global media and entertainment chief executive officers (CEOs), chief financial officers (CFOs), and financial stakeholders for insights into their thinking on the issues facing the industry at this critical time of change.

We combined these insights with factual research and our own analysis to yield a report that is designed to help you gauge your perspective against the viewpoints of colleagues within the media and entertainment industry around the world. Ultimately, the study is meant to help you *fast forward* your own company into the future.

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Aegis Group plc

Martin Stewart
CFO
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Gordon Crawford
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Lorna Tilbian
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Quotes are from the study participants and are not attributed because we promised participants anonymity in exchange for their candor. Moreover, the views in this document represent those of the participants and do not necessarily reflect the views of Ernst & Young. Information was current at the time of the interviews.

The Future Is Fast Approaching *Are You Ready?*

A few years ago who would have thought that today you would be able to: burn a custom mix compact disc (CD) in your local coffee shop, while sipping a latte; watch a video and listen to music off your mobile phone; pick up a CD or digital video disc (DVD) of a live show as you leave the concert hall; use Internet chat and instant messaging (IM) on your TV screen while watching a program; buy snacks from a vending machine using your mobile phone to authorize payment; or, even create your own personalized broadcast channel, complete with your favorite programs, serendipitous surprises, and time shifts? Not many, we'd wager. Yet today, those things are indeed possible. Maybe not to everyone, everywhere, but they are a reality.

Because everything is moving at warp speed these days, the future no longer belongs in the realm of science fiction. Somehow, it no longer seems too far-fetched to imagine a media and entertainment landscape that is totally connected, personalized, interactive, and available on demand, anytime, over any device, anywhere in the world. The future is rushing toward us—what form it will take is the key issue that media and entertainment executives are wrestling with today.

Overview

“Digital technology is advancing at an ever-increasing pace. Technology affects media and entertainment companies more than other sectors.”

“Broadband—in a bundle—will eventually change how people get their content.”

“The big debate today is whether you need to be an integrated content and distribution model, or just have true strength in content or distribution alone.”

Never before in the history of media and entertainment has the pace of advancing technology posed so many challenges—or opportunities. Faster and faster waves of new technology are significantly impacting the market (see Figure 1, below).

Fundamental restructuring is occurring in every industry sector; some sectors, like television and music, could emerge from this period far different from what they are today. Mass audiences are giving way to finely segmented channels, and business models based purely on advertising revenue are giving way to subscriber-based or hybrid models. Expanding competition and increasing

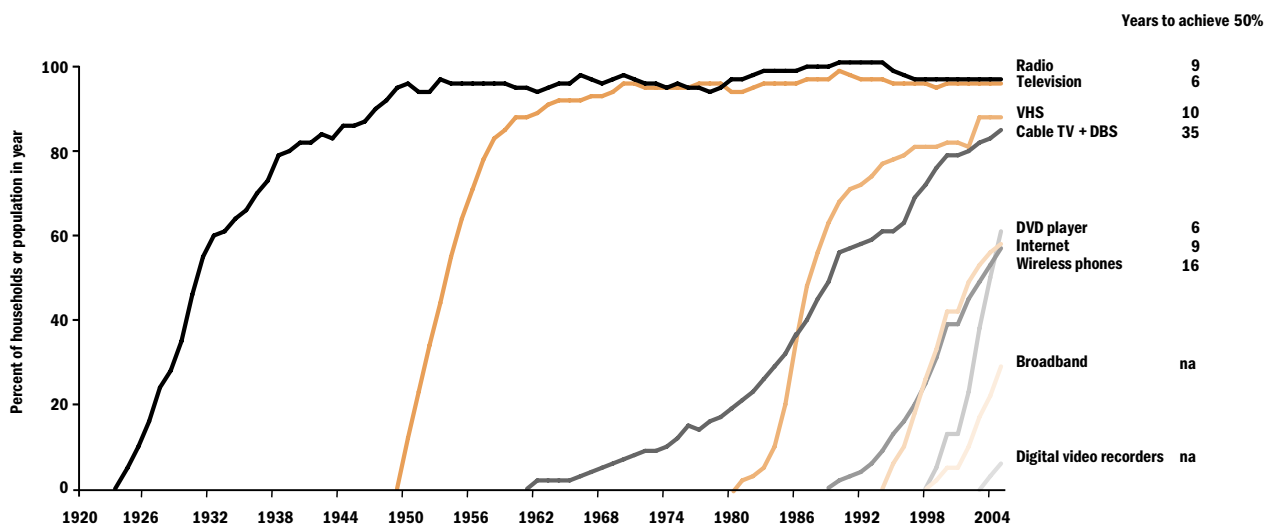
globalization are fostering consolidation and vertical integration. These are some of the rising trends to emerge from our CEO study, *Fast Forward: Technology Propels Media & Entertainment CEOs into the Future*.

Rising Trends Yield Pain for Broadcast Models

The rising trends, stated above, point toward the blurring together not only of the technologies, which has been going on for many years, but of the market-places themselves among the traditional media and entertainment, computing, publishing, and telephony businesses.

Figure 1: Media technologies have experienced consistently rapid adoption rates, but new technology waves are coming more rapidly

U.S. Adoption Rate of Selected Technologies, 1920-2004



Note: Adoption rates are all percent of U.S. households with selected technology, except Wireless phone, which is percent of U.S. population; Years to achieve 50% is number of years needed to reach 50% adoption, beginning when technology was adopted by at least 1% of U.S. households or population

Source: U.S. Census Bureau, “Statistical Abstract of the United States,” various years; U.S. Census Bureau, “Historical Statistics of the United States, Colonial Times to 1970,” Doc 93-78, 1920-1970; National Telecommunications and Information Administration, “Falling Through the Net II: New Data on the Digital Divide,” 07/28/1998; Veronis Suhler, “Communications Industry Forecast & Report,” 07/03, IDC, “Worldwide and U.S. DVR 2004-2008 Forecast,” 03/04; Media Trends Tracker, <http://www.tvb.org/centralmediatrendstrack/tv/tv.asp?c=cable> (citing Nielsen Media Research); Kagan, “Media Trends,” 2004; Forrester Research Inc., “Consumer Devices and Services Europe,” 10/03

“The DVD boom will bail out the movie industry for the next four or five years.”

“We’ll see a higher penetration of DVRs that will make TV consumption a tailored event, not a broadcast event. This is not a good trend for mass media.”

“TV broadcasters are being chipped away by DVRs, segmented away from their customers by cable and an old, declining demographic.”

Ernst & Young conducted in-person interviews with 23 media and entertainment industry CEOs, CFOs, and leading financial stakeholders for insights into their thinking on the issues facing the industry at this *fast forward* time of change. The executives interviewed are among the top global industry executives. Counting just the media and entertainment executives who participated, they managed combined revenues last year of approximately \$214 billion and had a recent market capitalization of more than \$340 billion.¹ The executives were given anonymity in exchange for their candor. What they had to say was both insightful and thought-provoking.

Media and entertainment executives told us that cable operators in the United States (U.S.) and satellite operators

worldwide are thriving. Why? They offer multitudes of finely segmented channels, from comedy to home improvement to specific sports—enabling marketers to deliver messages directly to people for whom the messages are most relevant. Digital video recorders (DVRs) provide a simple interface for people to find, store, and watch that content on their own schedule. And the cable/satellite’s subscriber and advertising revenues make them less at risk from growing DVR penetration than purely ad-supported broadcasters. In fact, cable/satellite companies will likely thrive even more in a DVR-rich environment, and are promoting their use.

¹See *Narrative Sources*, page 31

Figure 2: Shifting market forces

Force	Emerging Reality	Executive Perspective
Global buying power	Growth relies on tapping emerging markets around the world	<i>“The only companies with growth opportunities are global.”</i>
Marketers want more precise targeting, while audiences want content matching their interests; technology enables both	Narrowcasting creates unique access and value	<i>“Advertising will follow the eyeballs. Advertising will soon pay more for segmented cable content, especially time-sensitive programs like sports and award shows.”</i>
Digital video recorders	Ads can be skipped	<i>“There is no solution to DVRs skipping over advertising.”</i>
Increased volume of segmented, high-quality content	Subscriber-based business models are thriving	<i>“Subscriber dollars have to replace ad dollars over time. This is good news for cable and satellite operators.”</i>
Intrinsic desire for interaction and challenge	Electronic games are becoming a mainstream entertainment phenomenon	<i>“Who would have thought that electronic game revenue would exceed movie ticket sales?”</i>
Technology is driving significant industry change	Management must be technology savvy all the way to the top levels	<i>“I need more technology leadership in my team. We have DVRs, HDTV, and wireless broadband coming at us. We have to figure out how to win on these trends.”</i>

“The most important defense is a good offense. If we can make high-quality, legitimate content available in a convenient manner, we can significantly reduce demand for pirated content.”

“We have to drive our business relentlessly around the world. You have to keep in mind that only a few percent of all eyeballs are in North America.”

“Competition is increasing all the time. New entrants are constantly trying to expand into our space because theirs isn’t growing fast enough. That makes it hard for us to grow.”

Strong, Growing Margins Prove the Point

We found plenty of independent data to back up the executives’ comments, but the most compelling datapoint is profitability: cable companies right now have high earnings before interest, taxes, depreciation, and amortization (EBITDA) margins, like their broadcast TV and radio competitors, but cable EBITDA dollars are growing twice as fast² (although cable operators have higher depreciation expense, which is not measured in EBITDA).

The cable and satellite story is powerful, but other sectors will thrive as well. New technologies have historically led to explosive growth in the total size of the market for entertainment firms, dating all the way back to the introduction of television, followed by videocassette recorders (VCRs), compact disc read-only memories (CD-ROMs), and digital video discs (DVDs). Electronic game providers can ride the same segmentation trend, as can film and video content creators who figure out how to deliver their product with cost efficiency. And being in broadcast is still a big business with large margins—it’s just that the really big growth has moved on to newer distribution channels. As one executive so aptly stated, *“New technology always triggers a higher revenue level. You never really cannibalize old dollars with new dollars.”*

Technology Makes It Possible

Enabling these changes is advancing technology, and Figure 2, page 8, shows selected prime examples. Two fundamental changes underlie all: the move from analog to digital content and widespread broadband Internet access. Three-quarters of our interviewees named DVRs the highest-impact new digital-content technology, because they not only organize access to the overabundance of cable and satellite content, but they also let people skip commercials. In the U.S. alone, we’re talking \$4 billion worth of commercials skipped by 2007, according to analysts’ estimates.³

But DVRs aren’t alone: digital cable and satellite, online content distribution (as is happening already in music), DVDs, and the mainstreaming of electronic games are all technology-based trends that are reshaping the media and entertainment landscape. And all these technologies are enabling new entrants into media and entertainment, some of which are large companies looking for growth beyond their traditional markets, like the computer makers now selling TV sets, and software companies (and coffee shops and restaurants) that sell music, electronic game systems, or subscription-based online video content. Thus, competition is broadening overall, and globalization is accelerating.

^{2, 3}See *Narrative Sources*, page 31

“We have to push our overseas operations, especially Asia. This takes a lot of work. I’ve been going to banquets in China for six years.”

“I’ll be successful if I put executives in place who understand the digital revolution and can respond faster than traditional executives.”

Opposing Views Surface

Three global industry-defining questions found the executives sharply divided:

- Will piracy affect film and video the way it has music?
- Are companies better off focusing on either content or distribution, or will the integration of both into one company maximize success?
- Likewise, are conglomerates or focused companies better positioned?

Because of polar disagreements regarding the answers to these questions, CEO choices will dramatically affect their company’s success should market conditions evolve to support one way over the other. See Figure 3, below, for highlights of key opposing executive comments.

Global Differences Evident

The average U.S.-made movie grosses more than half its revenue outside U.S. borders and entertainment markets are becoming increasingly global. Content must be aligned with local tastes and expectations, as learned the hard way by several U.S. players who jumped overseas with a U.S. model that failed in the new markets. Happier, and equally enlightening, is the example of a music television channel that reaches more than a billion people in 164 countries, based on a strategy of 70 percent local content.⁴

⁴See Narrative Sources, page 31

Figure 3: Polar views acknowledged

Polar View A	Impact	Polar View B	Impact
Piracy will have little affect on film and video content	<i>“Music lends itself to illegal downloading more than movies do. Music is a quick download of a single song; movies take a long time commitment.”</i>	Piracy will have big effect on film and video content	<i>“Film will face the same piracy threat as music, just 24-36 months lagging.”</i>
Content and distribution must be combined in one company to maximize success	<i>“The ideal is if you own content and distribution. That’s a hard combination to beat, because your distribution competitors have to buy their content from you.”</i>	Content and distribution require individual focus to maximize success	<i>“For content, success will depend on being agnostic toward distribution channels to the customer.”</i>
Multidisciplinary conglomerates will thrive because of their scale	<i>“Concentration into big conglomerates certainly makes management harder. But you then have the potential to push a lot of resources in the same direction for promotions and for technology launches.”</i>	Focused companies will thrive because they can better optimize their operations	<i>“The strongest companies are focused, and stay focused.”</i>

“You can’t let the accountants run the place because we sell creative products. But you can’t let the creative guys run it without adult supervision, or else you’d have the inmates taking over the asylum.”

“Management will have to learn to squeeze a nickel until it screams.”

Consensus Requisites for Success Emerge

There was global agreement, however, on three things that all companies need to succeed:

- **Technology-savvy leadership:** With technology leading ever-accelerating waves of change, success requires management teams steeped in technology expertise who can make smart decisions fast.
- **Financial discipline:** Balancing creative content with cost control is a tough act. Many companies deal with the problem of combining creative products with the principles of cost accounting, and many face pressure from investors to achieve high growth and returns as media and entertainment results lag the overall market.

- **Better decision-making:** CEOs said they have good people and good data, but too often bad decisions result. Their decision-making processes need improvement.

Management’s Self-test Agenda

Given the technology-induced changes, the trends, and the state of the industry, two places in our report provide ‘self-diagnostics’—the kinds of questions CEOs around the globe can ask themselves, their boards of directors, and their management teams. Your answers to these questions will help guide your company through these fast-moving, turbulent times of challenges and opportunities.

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