Back to the Future

AT&T’s old-school vertical play for Time Warner is grounded in plans for OTT, mobile video

plus

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What started as a deal finalized over bites of salmon at a posh Manhattan office could leave AT&T stuck with a big bill — and still hungry — as it tries to effectively meld Time Warner Inc.’s diverse content assets with its own wireless, satellite-TV and wireline phone assets. Several reports have noted that both AT&T chairman and CEO Randall Stephenson and Time Warner chairman and CEO Jeff Bewkes first hatched the idea of their pending $108.7 billion mega-merger over lunch at Time Warner headquarters about two months ago.

Last week, Stephenson completed the circle by comparing the reasoning behind the deal to a vital part of the New York City Subway System.

“Time Warner is where we are going to try to touch these third rails that the industry will not and has not touched,” Stephenson said at The Wall Street Journal’s DLive conference last Tuesday (Oct. 25). “It’s where we are going to begin to experiment and test how can you bring a la carte pricing into the ecosystem.”

For those uninitiated with the subway system, the third rail is the high-voltage line that
runs along the tracks to power the underground railcars. Stepping on it usually means death, or at least a very nasty burn.

Whether he meant it or not, Stephenson’s analogy is oddly appropriate given the split reaction to the union, touted as a nod to the future of television content delivery by the participants and viewed by critics as a misguided attempt to return to an era that no longer exists.

Analysts have scratched their heads over the deal, adding that earlier benefits of vertical integration, like lower programming costs and content exclusivity, are no longer possible. To some, including MoffettNathanson principal and senior analyst Craig Moffett, the deal sounds more like an attempt by AT&T to diversify its revenue streams than a competitive strategy.

**NOT NECESSARILY VERTICAL**

“It’s easy to imagine what to do a with vertically integrated media strategy,” Moffett said on a client call last week. “The challenge is very different in practice to pull it off.”

Liberty Media chairman John Malone saw the pairing as a diversification play as well.

“If I was Randall Stephenson, I’d have done the same thing,” Malone said in an interview.

Moffett noted that AT&T’s core businesses — wireless and wired communications — have been on the decline. He said its consumer mobility business shrunk nearly 6% year-over-year in the third quarter, while its business solutions sector grew by just 0.4%. The one growth area — Entertainment and Internet services, including DirecTV and U-verse TV — grew revenue by 4.3%, but mainly due to price increases. AT&T’s video base has decreased by 0.5% year-over-year and its broadband subscriber base has shrunk by 1%.

“With back-to-back acquisitions of first DirecTV and now Time Warner, AT&T is seemingly walking... no, running... from its wireless and wired roots,” Moffett wrote.

The question is whether or not buying Time Warner will help.

Analysts for the most part are down on vertical integration because many of the benefits of owning both content and distribution have been regulated away. The Federal Communications Commission’s program-access rules prohibit content companies from providing exclusive programming or lower pricing to their parent firms.

AT&T is confident it can make vertical inte-
Call History: AT&T’s Pay TV Deals
AT&T’s plan to acquire Time Warner Inc. for $108.7 billion (including debt) might be its biggest pay TV deal, but far from its first:

1998: AT&T buys Teleport Communications Group, a CLEC consortium owned by several cable operators, for $10.3 billion.
1999: AT&T buys Tele-Communications Inc., then the largest U.S. cable operator with about 15 million customers, for $48 billion.
1999: Shortly after closing the TCI deal, AT&T agrees to pay $62 billion for 5 million-subscriber MediaOne Group, trumping Comcast’s earlier bid for the company. MediaOne pays Comcast a $1.5 billion breakup fee. Comcast also receives the right to buy up to 2 million subscribers.
2002: AT&T sells its AT&T Broadband unit with 13.5 million customers to Comcast for $72 billion.
2015: AT&T closes on purchase of satellite-TV service provider DirecTV for $48.5 billion.

SOURCE: Company reports

AT&T’s 5G offering appears to play an integral part in the decision to spend more than $100 billion on programming. For many wireless operators, 5G is being touted as the transport platform of the future, with speeds of 1 Gigabit per second, low latency and nearly ubiquitous coverage. But while 5G could potentially replace fiber networks to move consumer bits through the ether, it also is at least five years off. There are currently no standards for 5G, and AT&T said it won’t start deploying the service until 2018, scaling it in 2019 and 2020. As anyone who has been watching the video landscape for any length of time knows, a lot can happen in five years.

For Time Warner, the transaction comes as content companies face increasing pressure from over-the-top service providers. On Time Warner’s last quarterly earnings conference call, Turner Broadcasting System chairman and CEO John Martin said that like its peers, Turner has experienced U.S. subscriber declines approaching 2%.

That AT&T was willing to pay such a high premium for Time Warner stock — $87.50 per share is 36% above its Oct. 19 closing price — is both a function of its confidence in the deal and a desire to keep other potential bidders away. Already, Verizon Communications has said it wouldn’t make a competing bid, as did a former suitor, 21st Century Fox, which made an unsolicited $80-per-share bid for Time Warner in 2014.

Fox’s bid was rejected soon after it was made, and Time Warner later beat that offering price through organic growth. While Time Warner stock has been a good performer so far this year — it was up 22% before the AT&T offer was made — some of that gain was due to its takeover potential (see chart, page 7).

With no dominant shareholder, Time Warner has been seen as ripe for a takeover. Minus a deal, it is doubtful Time Warner stock would have crossed the $100 per share milestone on its own anytime soon.

Shareholders, who pushed the stock to a 15-year high after the AT&T rumors first surfaced on Oct. 20, have begun to retreat as doubts about regulatory approval have crept in. Time Warner stock is down about 1% between Oct. 21 ($89.48 each) and Oct. 26 ($88.70) as several politicians have voiced their concerns with the deal.

Both Stephenson and Bewkes made the rounds last week to drum up support for the deal, which is expected to face intense scrutiny from regulators (see Rules, page 19). The overarching theme appeared to be that Time Warner’s content would serve as a launchpad for innovation.

A conference call with analysts Oct. 24 to discuss the deal, Stephenson said one of the main drivers of the Time Warner deal was removing the barriers preventing customers from sharing video clips via social media and messaging.

DirecTV Now, the 100-plus channel OTT offering that will debut in November at the extremely aggressive price point of $55 per month, will also play a vital role in AT&T’s video strategy; Stephenson added that he “borders on evangelical” about creating a nationwide competitor to cable with the OTT offering.

TRUE ‘TV EVERYWHERE’
Bewkes was equally enthusiastic, noting that the union will allow Time Warner to create the true TV everywhere product that he envisioned eight years ago.

At that time, Bewkes said Time Warner offered its full lineup to cable companies on demand at no extra charge as long as they didn’t charge consumers for it. He had few takers, he said, in part because cable companies didn’t want to invest in the necessary plant upgrades and because other content companies were reluctant to give up the rights.
“That’s not how you change consumer behavior,” Bewkes said at the WSJ DLive conference last week. And make no mistake, changing consumer behavior is what Stephenson, Bewkes and company intend to do.

Stephenson said that AT&T forged its mobile video vision more than three years ago, but was stymied by programmers that didn’t want to license digital rights. It was only after AT&T bought DirecTV — in a $48.5 billion deal closed in July 2015 — that they began to listen.

**SCALING UP FOR OTT**

“It would not be possible had we not done the DirecTV deal,” Stephenson said at WSJ DLive. “It would be impossible, because we had been trying to do this for three years. We [could not] get the media companies to participate in this until we had scale.”

But getting over-the-top programming rights doesn’t seem to be the end-all in AT&T’s mobile video strategy. Flexibility also seems to be paramount to success.

In a note to officers at both companies last week, which he called the “Magna Carta of our merger,” Stephenson wrote that the intent is to use Time Warner’s digital rights to “create new choices — skinner bundles, video created just for mobile viewing and social media, and low-cost video products supported by advertisers instead of consumers. More choice; lower cost.”

Stephenson dropped hints all last week that AT&T would like to live in a world where consumers could get the programs they wanted when and where they wanted them. Just what he means by that is unclear — is AT&T just planning to price aggressively or is the ultimate goal to go full a la carte, offering individual networks to consumers instead of the bundle, starting with Time Warner channels? The latter, the Holy Grail for distributors, is a concept that programmers, including Time Warner, have fought hard to prevent.

“In these OTT environments and platforms, we can begin to innovate our content much quicker; we’re under the same umbrella and same ownership structure, we can get past a lot of these content rights and move fast,” Stephenson said on a conference call with analysts last week, adding that he and Bewkes are “convinced as we innovate in this way and as we accelerate the pace of this innovation, it’s going to attract others to want to do the same on these platforms.”

Morgan Stanley media analyst Ben Swinburne said he believed that AT&T may actually take an opposite stance, reining in any skinny bundle activity in an effort to protect its new content assets.

“While it appears Time Warner’s networks were being carried in most new bundles anyway, AT&T may now become more a defender of the status quo than disrupter when it comes to bundling,” Swinburne said in a research note.

Pivotal Research Group CEO and senior media & communications analyst Jeff Wlodarczak agreed, adding that while Stephenson and Bewkes may hint at a more open stance on the programming front, it is motivated by a desire to win approval for the deal.

“AT&T management is going to say anything and everything to try to get this deal approved,” Wlodarczak said, adding that with DirecTV, U-verse TV and now Time Warner, 41% of AT&T’s revenue will be tied to pay TV.

**CORE BREACH**

“Blowing up the pay TV business is effectively blowing themselves up,” Wlodarczak said. “The read on this move by AT&T to buy Time Warner is they hate their core business and are diversifying out of it.”

Whatever the motivation, Stephenson doesn’t seem afraid to take big risks. And while he’s flirting with the third rail, he noted in the “Magna Carta” memo that he hopes it’s the cable industry that gets burned.

“To Cable: Watch out,” Stephenson wrote in the memo. “We aim for nothing less than the entire wireless industry confidence to disintegrate.”

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