

Media Industry Year End Overview and Trends for 2008

December 5, 2007 — We at Booz Allen Hamilton wish you and your family a very happy holiday season and a prosperous and peaceful New Year.

As we enter 2008, we thought it would be useful to both reflect on 2007 and offer our perspective on the major dynamics in media and entertainment we foresee for the coming year. What should successful companies be doing to prosper in this increasingly complex and challenging media landscape? At a recent dinner party for senior media executives, the themes presented here generated some passionate discussion; we hope they resonate with you and your organization as well.

It's no secret that the media and entertainment sector has undergone a seismic shift in recent years, with all forms of media experiencing their own breakthroughs and challenges. Every media player is fighting a war for relevance. Many traditional forms of media, even while they are still profitable and generating substantial cash flows, face a major growth challenge as more consumers spend a greater amount of time with digital media, and as marketers contemplate more dramatic shifts in their advertising spending. The implications for media valuations and performance are significant. For example, "new media" company market capitalization has, on average, achieved a compound annual growth rate of 34.7 percent, compared to an average of just 6.5 percent for the top traditional media companies¹.

Interestingly, the competition resulting from a fragmenting media landscape is affecting both digital and traditional media. Traditional players have been forced to cut costs to address declining revenue across analog businesses, and are pushing even their digital units to become more efficient and deliver greater profitability. The result: more innovative ways to cut costs. For one example, consider the book publishers that have taken outsourcing beyond production and printing to include editorial, research, and indexing services. Newspaper companies such as Gannett are redefining news operations through efforts such as "crowdsourcing" (that is, incorporating more reader-generated content). The broadcast networks have shifted more programming from scripted productions to reality shows. Finally, many video game companies are already offshoring a number of elements in their content development, and most anticipate expanding those initiatives in the future.

Merely cutting costs, however, isn't going to "cut it." We believe that media and entertainment companies need to recognize that the current moment is a tipping point, when business models and operations require real restructuring, not gentle tweaks. And where there is great change, there is also opportunity for market leadership and growth for players that recognize that the game today is being played by different rules — rules that require fresh approaches, capabilities, and strategies.

¹ Bloomberg. *New media companies include Google, Yahoo, eBay, and Amazon.com. Traditional media companies include Time Warner, Time Warner Cable, News Corporation, Walt Disney Company, Comcast, CBS, Viacom, Clear Channel Communications, The McGraw-Hill Companies, Liberty Media – Capital, Liberty Media – Interactive, Gannett, and the Washington Post Company.*

Media and entertainment companies that do not embrace change quickly enough may become acquisition targets or may be forced to make hasty changes that could have been made more deliberately earlier. When it comes to creating the media company of the future, the question is whether today's giants will act decisively now – or be further forced by the market to make high-profile changes at a later stage under even greater management duress.

A Vision of What's to Come

The media industry's greatest asset in the past was its ability to profit incrementally from virtually every new platform and every technology development, while using essentially the same recipe and business model. That ability is now challenged; media and entertainment companies cannot rely solely on the approaches and business processes that worked in the past. Our perspective is that employing a new set of capabilities will be essential for media companies that want to succeed in the years to come. Specifically, we believe the winning "media company of the future" has to excel along the following five dimensions:

1. Market Sensing and Consumer Insight

Today's media environment puts consumers irrevocably and permanently in control. This situation is the natural consequence of having a myriad of outbound communications channels on the Web and elsewhere; a multitude of technologies that enable either ad skipping or outright ad blocking; an immense number of low-cost and amateur content providers; and a rich variety of on-demand and portable media, available on devices that range from wall-sized flat-screen TVs to pocket-sized iPhones. Consumers are no longer passive and conveniently available; they have instead become selective, skeptical, and demanding. Moreover, they are rejecting the information and entertainment they find irrelevant, and they are opting into those media that give them more of what *they* want: greater personalization, relevance, and interactivity.

Because consumers are the new boss in the media marketplace, insights into their individual behaviors and preferences, instead of merely their demographics, can make both content and advertising relevant and valuable – and those insights, therefore, have become the most important currency for the 21st-century media company. The smart media companies already recognize this reality and are moving their interaction with consumers from monologue to dialogue. This new focus acknowledges that *knowing* what will be relevant to consumers, rather than "guesstimating," may be the only antidote to the current loss of control felt by many in media, advertising, and marketing.

Benefiting from more direct dialogue with consumers, however, requires new capabilities, technologies, and assets. Scripps, for example, is notable for its marriage of database marketing and digital media, which it uses to develop deep, granular insights into the interests and behaviors of its consumers. Using various media vehicles, Scripps has forged a powerful feedback loop that provides the company and its brands, such as Food Network and HGTV, multiple opportunities for creating value: ad-supported, branded e-newsletters; online marketplaces that connect consumers directly with relevant merchants, and behavioral insights that the company uses to improve the effectiveness of its online content, advertising, and on-air programming.

Media companies will never dominate their consumers' lives like they once did. However, they can know their consumers better than anyone else and seek to monetize that insight with their marketing and retail partners. For example, when the executives at NBC Universal describe a viewer of the Bravo cable channel, the fact that she is an affluent woman age 18 to 49 is just the starting point. They know her interests: They know that she is an early adopter of fashion and consumer electronics and that she is an "affluencer" – both affluent and influential among peers and colleagues. They also know how well she

remembers the brands that are integrated into the Bravo environment and how favorably she considers brands that appear on Bravo. All of these insights require a focus that goes well beyond traditional audience research and drills down more deeply into behaviors. And as with Scripps, the resulting consumer-centric approach not only strengthens the value of a media brand and the distinctiveness of its advertising inventory, but also informs what content will resonate and which media platforms will create the most valued touch points for consumers and advertisers.

2. A Robust Innovation Engine

A second dimension integral to media companies' ability to grow profitably will be their ability to link consumer insights more directly to a structured process for product, brand, and business model innovation. Our recent work has found that the consumer insight capability described above is the foundation on which higher growth will be built. In fact, Booz Allen's recent study of the most successful innovators across all innovation strategies found that companies that *directly engaged their customer base* and *closely tied their innovation strategy to overall corporate strategy* had more than twice the return on assets and more than triple the growth in operating income achieved by survey respondents that didn't do those things.

Several other qualities are critical to building a robust innovation engine. The first is having *an ideation process that incorporates multiple sources and functions*, encouraging experimentation and mining the entire organization to fill the innovation pipeline. This approach solicits ideas from all levels instead of only from senior management, which is increasingly critical; more junior staff may have a more intuitive understanding of new media products and technologies. Another important quality is *a consistent, structured gating process* for new and existing projects that considers their economic value and strategic fit with the rest of the portfolio. Many successful innovators are also using an *open innovation approach* that creates value by accessing a broader network of relationships with distributors, retailers, and customers. Finally, some players even house *a separate innovation function* inside their organizations to give the strategic development of new products and services more attention and breathing room and free it from the demands of daily firefighting.

We are seeing outstanding examples of all of these elements within the media industry. At ESPN, for instance, innovating around the fan experience is an ingrained part of the operating culture, championed by the chief marketing officer. This focus has enabled ESPN to extend its brand from traditional and digital media into such events as the X Games, experiences like ESPN golf schools, and even sports-related travel. Apple's development of the iPod over a six-month period involved 10 different industry players sharing technology, staff, and business models. Google has proved that consumers' digital behavior is a great source for innovation; when the company observed that people were using the search engine to do price comparisons, it created Froogle. Finally, MTV Networks has recognized that its target

consumers are shifting more of their entertainment time to social networking and video games. With that insight, the company has been moving to establish a leading position in digital virtual worlds – immersive 3-D digital environments that are developed explicitly to create a new high-engagement media platform for young people and the advertisers that want to connect with them through MTV brands. As of December 2007, MTV Networks was operating nine different "worlds" and had a 10th in development.

3. Dynamic Information Technology

Ever since video killed the radio star, traditional media has been surprised and occasionally defeated by new media technologies and applications that it wasn't prepared for, such as Napster and YouTube. Traditional media has also been held back from reaping the benefits of new production technologies that could generate revenue, cut costs, or do both. To some degree, these issues can be traced back to

uncertainty over where responsibility for technological innovation should reside. Does it belong in the business units, since new technologies are integral to growth, or in IT, where expertise has traditionally existed? Certainly, there are advantages to giving technology more of a role in setting the business agenda, rather than relegating it to the back office. But the industry must develop greater technological acumen and IT organizations must become nimbler, more strategic, and more cost-effective. Media companies' technology resources must be able to deliver both more rapid development and better maintenance of new capabilities – especially concerning the integration of traditional analog with new digital activities – as well as drive down costs for the commodity services all IT organizations provide.

The first step in creating a more dynamic technological function is to structure the IT organization and its relationship to the business in a way that allows it to turn new capabilities on and off in weeks, rather than months or years. This requires development of a flexible but well-thought-out IT strategy: one that recognizes the uncertainty of today's media IT world and demonstrates the adaptability required to handle emerging technologies and small vendors. Such a strategy must determine a desired end state, set the path to get there, and enable adjustments to be made along the way. It also requires the willingness to invest in the IT "rock stars" who understand where the industry is headed and who can quickly translate that knowledge into new products and business support services, as well as the seasoned managers capable of handling large vendors and external service providers. Finally, the structure of the organization must include reporting lines and decision rights that enable flexibility in a fast-paced, consumer-driven, revenue-centered industry.

The same type of balance between strong management and rapid innovation is necessary in determining the IT organization's priorities. On the one hand, it must continue to better manage core technologies: back-office systems such as finance and HR, production and delivery technologies such as editorial production and traffic, and core infrastructure operations such as data centers, networks, and help desks. On the other hand, IT must also be poised to support business innovation, with funds earmarked for investments in projects that may be unproven, but that have high potential in efficiency or revenue. As part of its long-term strategic plan, the organization should leverage partners and vendors for such revolutionary technologies, both to access their innovation pipelines and to spread the risk. This requires a more modular approach, rapid prototyping, and greater flexibility in the construction of technology solutions and their integration into business functions.

A certain level of technophobia in traditional media is hardly surprising. IT has traditionally been a cost to be managed. IT spending was often curtailed, commodity services were rarely consolidated, and risks were often avoided. The future will require a "software company" mind-set, in which the product itself is software (or is software-enabled), investment occurs in new capabilities, talent is rewarded, and risks are managed.

4. Operational Excellence

Today's media companies have diverse portfolios of products and services. They must constantly assess how best to manage their existing offerings and constantly reassess the company's operating model.

Instead, too often, media companies focus on cost cutting that may negatively affect the company's ability to invest in growth areas. The best cost reduction efforts lead to new capabilities, reinvestment, innovation, and growth. Instead of a slash-and-burn approach, we recommend a focus in four areas:

- ***Invest in strategic bets:*** Growth through mergers or acquisitions has exacerbated media companies' operating complexity. As a result, media companies must continually examine and refine their portfolios at every level to unlock underperforming costs and reinvest in growth

areas. The industry abounds with examples of companies that are putting their money where it will grow: The launch of the CW merged the UPN and WB networks, improving scale and decreasing costs to adjust to slowing network and station revenues; CBS sold its low-growth, capital-intensive theme parks and several dozen of its 180 radio stations in order to reinvest and focus on its core businesses; Condé Nast is closing *House and Garden* magazine; NBC Universal reduced its investment in prime-time programming by moving to unscripted shows from 8 to 9 P.M. on most nights; and newspapers and magazines across the industry are rethinking their rate bases. Unfortunately, many more companies are holding on to struggling properties with little potential for improvement. For some traditional media properties that have been breaking even, at best, for the past few years, the future will only get worse. Furthermore, with a growing focus on innovation and new products, media companies must be more strategic about the length of time they allow a new property to underperform before breaking even or hitting margin targets.

- ***Focus energy on high-impact, differentiated capabilities and shed the rest:*** Across media, many functions have been outsourced to access the best creative capabilities, better meet uneven demand, and tap into scale benefits in such areas as movie trailer production, fulfillment services, photography, and writing. In addition, outsourcing and offshoring have brought new capabilities and 24-hour service to back-office functions such as HR, finance, and IT. More media and entertainment companies should look at all of their core knowledge and creative activities to determine where outsourcing and offshoring offer potential savings; they should also ensure that they have done the same for all back-office activities. There is an emerging base of very capable suppliers able to provide high-quality service for commoditized, routine functions. Many companies are reaping benefits by changing the way they think about delivering content: For example, the *Chicago Sun-Times* outsourced home delivery to the *Chicago Tribune*. Overall, the publishing industry is leading the charge, partnering or building offshore capabilities in editing, indexing, formatting, layout, production, and circulation. Companies such as Houghton Mifflin, McGraw-Hill, Pearson Education, Reed Elsevier, and Wolters Kluwer have outsourced major parts of their operations India, the Philippines, and other locations. We expect the trends for video to follow suit. For the most aggressive companies, outsourcing and offshoring create an opportunity to not only reduce costs but provide services to others, creating a new revenue stream (e.g., Hearst's CDS and Reed Elsevier's RBI for the magazine industry).
- ***Realign the business model:*** Because so many media companies have grown through acquisitions, many find upon closer examination that they have redundant or unnecessarily expensive functions. There are many opportunities to increase scale and cost-effectiveness while still being nimble. Real estate offers one example: Given that the world's typical media footprint is in expensive locations (e.g., New York, London, Los Angeles, and San Francisco), companies are finding themselves with multiple locations within the same high-cost city. Although moving and consolidating real estate is difficult owing to transition complexities and morale concerns, it

can unlock significant savings and help bridge silo organizations. Additionally, companies can drive more savings by realigning staff to locations appropriate for their roles. Moving functions has the added benefit of providing a chance to reengineer calcified processes. There are often opportunities to streamline senior and middle management roles, especially in the wake of mergers and acquisitions. Classic span-and-layer analysis is a simple but effective tool to identify under-leveraged senior staff and allow more junior staff to have greater opportunity and impact (improving morale and infusing more new ideas into the business). In most media companies, duplicate functions are common, performed without sufficient expertise because the company has not invested in new systems and best practices. In today's environment, unless a function is truly unique for a product, parallel organizations should be consolidated and centralized. Sourcing is the best example: Not only can cost-to-serve potentially be reduced; much more importantly, the cost of purchased goods and services, which for many companies represents

several billion dollars, can be dramatically reduced by 10 to 20 percent across all commodities. We have even found that greater centralization is a good strategy for newsgathering, an area heretofore generally left alone. Companies are discovering that if a reporter is covering a story for multiple properties, both properties have better access and an ability to create higher impact through multiple platforms.

- **Modernize the operation:** The media business has long been a relationship-driven, hit-based business in which operational excellence focused on getting high-quality, professionally produced product out the door, sometimes without sufficient consideration for efficiency. Given the new challenges, we believe all media companies should ensure they have implemented leading practices that may not be sexy, but that are proven and highly effective. These include creating greater cost and productivity transparency across the organization to hold management accountable for spending – often at a line-item level, both in the budget and for day-to-day decision making. Trade-offs should be transparent and thoroughly discussed. Employing a zero-based budgeting approach can help to eliminate activities that do not provide sufficient value. Although it's usually an unpopular initiative, compensation should be realigned to recognize that media is now a mature business. Applying benchmarks, moving to 18-month appraisal cycles for high wage earners, and enforcing run-rate increase maximums are proven approaches. At the same time, more aggressive incentives could play a much larger role in both rewarding the "best and brightest" and putting pressure on managers who are not earning their way. All functions remaining in the organization should be regularly benchmarked and reviewed for use of best practices, from both inside and outside the industry. In areas such as supply chain management and production, for instance, many media companies lag the standards of other industries, in which companies have been counting pennies and searching for service improvements for decades. All efforts should place a premium on integrating digital and analog processes where possible, so data and information can be seamlessly converted. As always, quality is important; best practices and reengineering should provide an opportunity to achieve cost reductions without a decline in quality.

5. Strong Talent Management

There is one more dimension along which the winning media company of the future must excel. For many years, media and entertainment companies have focused their talent management on actors and actresses, artists and writers, and top executives. Far too often, more junior staff were not allowed to fully develop as they were kept in the same functional department or were tied to a more senior manager who took them along to each new place of employment. Traditional media companies are frequently unwilling to take risks with younger talent, alienating the staff who are most eager for change and investment. Even more problematic, today's younger workers often have priorities and values different from those of their baby-boomer bosses. There will always be extremely talented and dedicated people in the media business, but more and more, lifestyle issues, desire for job fulfillment, and the possibility of job switching take center stage. Given the increasing complexity of today's environment and the growing cross-functional nature of today's issues, we believe talent management best practices should be applied across the business and at all levels.

There are a number of qualities critical for successful talent management, and they should be applied across the organization instead of reserved for the elite. Talent needs should explicitly be established from the top down on the basis of business priorities – not from the bottom up via the budgeting process. The company's leadership criteria should align with its strategy and be consistent with its culture, and should form the basis of a rigorous, disciplined evaluation process that clearly communicates expectations. High-potential employees at all levels should be notified of the company's interest in them,

and senior management should hold regular reviews of those employees to outline specific actions for their development – including job rotation, transfers across business units, special projects, additional mentoring, and cross-functional training. Media companies need to break down the silos that exist between functions and between media properties – not just by restructuring the organization but by putting individuals in situations where they can interact with their peers, assess one another’s strengths and weaknesses, and learn how the business operates more broadly. High-performing employees should receive visible rewards (financial, such as stock or a bonus, or nonfinancial, such as public recognition) based on business performance and true value creation.

Some of these practices are already in place within parts of the industry, but they need to be more broadly applied. Ad sales organizations, for instance, have always been big proponents of rewarding performance, but these practices should expand to circulation, editorial, marketing, and production organizations, as well as back-office functions such as finance, IT, and HR. Within the media industry, Time Warner and NBC appear to be the most advanced, having a department dedicated to developing talent or an explicit strategy to develop talent by putting employees in new roles. As the business challenges continue to grow and media properties continue to morph into overlapping businesses, more and more companies should adopt these progressive practices.

Create a Crisis

It is our strong belief that the path forward is becoming clearer. Although many elements will shift – technology and content, consumer engagement models and platforms, revenue streams and business models, players and priorities – media organizations’ core imperatives will remain the same. Thus the challenge is how to move ahead quickly. Unfortunately, many companies are unable to make the leap without a looming crisis. For some, a look at the news, a stagnant stock price, or an impatient board is sufficient. For others, extrapolation of cost and revenue trends may show that a highly profitable business today will be breaking even, at best, in 10 years. The challenge is creating the feeling of crisis while maintaining positive morale. For that, strong leadership is mandatory.

Once they have a crisis mind-set, we believe the best companies will actually not engage in long, time-consuming, consultant-rich “opportunity identification” diagnostics. Rather, the need for speed and the fact these are proven opportunities mean that media companies should skip consideration of whether these concepts apply, and proceed to figure out where and how they do apply.

We believe 2008 will be another year of continued innovation, change, and challenge. It is our view, though, that it is now time for media and entertainment companies to reorient themselves toward the new capabilities that will be required for their long-term success. Whether it is bringing deep and unique consumer insight to the market, developing the ability to work with marketers to deliver the leads and sales they seek across all media, upgrading technological capabilities, enhancing talent management, or truly achieving operational excellence, it is now time to act.

There are many time-tested approaches to make this work. We look forward to sharing our thoughts and experiences in more detail. On behalf of Booz Allen Hamilton, we wish you a successful and prosperous 2008.

Sincerely,

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