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The Moguls' New Clothes

MEDIA EXECUTIVES LAMENT WHAT THE WEB HAS DONE TO THEIR BUSINESS. BUT THAT COMPLAINT CONVENIENTLY IGNORES THE DISMAL FINANCIAL PERFORMANCE OF MOST MEDIA CONGLOMERATES IN THE PRE-DIGITAL ERA. UNTIL MEDIA COMPANIES ARE WILLING TO GET BACK TO BASICS AND JETTISON THE FLAWED THINKING THAT HAS GUIDED THEM OVER THE PAST TWO DECADES, THEY WILL CONTINUE TO DISAPPOINT THEIR SHAREHOLDERS.

By Bruce C. Greenwald, Jonathan A. Knee, and Ava Seave

TIME WARNER ANNOUNCED in May that it plans to spin off its AOL division by year end. The new AOL's value will likely be barely 1 percent of the market price of the inflated stock that Time Warner accepted in the original $175 billion merger almost a decade ago—despite the inclusion of numerous subsequent expensive add-on acquisitions. While extreme, the Time Warner–AOL combination was no aberration. The deal represents less than half the financial damage done during an unprecedented era of excess in the media business. Since 2000, the largest media conglomerates have collectively written down more than $200 billion in assets, a record that would make even Citigroup blush. These write-downs reflect a broad-based legacy of value destruction from relentlessly overpriced acquisitions, "strategic" investments, and contracts for content and talent.

One might be tempted to give media executives a pass because of the impact of the Internet. If we take Netscape's public offering in 1995 as the birth of the Internet era, on average over the next 10 years the biggest media conglomerates achieved less than a third of the returns available from the S&P as a whole. But even more telling is that these companies, as a group, had also underperformed the S&P for much of the previous decade, *before* the Internet upended their industry. Indeed, one aspect of the media business has remained largely unchanged for a generation: the lousy performance of its leading companies.

Although individual media moguls have come in for skepticism and scrutiny, the industry's underlying strategies have mostly escaped question. Executives, investors, analysts, and the press seem to agree that the primary imperatives are to accelerate growth, diversify internationally, invest in content, and exploit digital convergence. Unfortunately, these are precisely the strategies that media companies pursued aggressively during the past lackluster decade.

Understanding the fundamental flaws of these four tenets of conventional media wisdom—growth, globalization, content, and convergence—is essential to saving media shareholders of the future from the anemic returns of their predecessors. Each myth reflects its own confusion about the sources of competitive advantage. Indeed, media executives have been remarkably successful at convincing outsiders that this sector, possibly because of its reliance on mysterious creative factors, is somehow governed by unique business principles. Unless tomorrow's media moguls jettison these beliefs and return to sound business practices, their companies will remain unable to achieve the kind of returns investors can get by closing their eyes and throwing a dart at the stock tables.

Myth No. 1: Growth Is Good

Like many corporate chieftains, media executives worship growth. But all "good" things, including growth, come at a cost. In this case, that cost comes in the form of the investment needed to generate growth—whether internally or through acquisitions. When its cost is greater than its return, growth—every incremental dollar of it—actually destroys value.

Comparing the revenue growth over time of the largest media conglomerates with their respective share performances reveals a remarkable fact: a strong correlation indeed exists between revenue growth and shareholder-value creation—but it is decidedly negative. In other words, the faster revenue has grown in these companies, the worse their stock has performed. Although counterintuitive, this makes perfect sense if that growth was achieved through bad investments.

Media is the only economic sector that historically has achieved growth predominantly through mergers and acquisitions. The sheer number of transactions, as well as their later impact on share prices, raises the suspicion that they are driven by an almost blind eagerness—a suspicion reinforced by a cursory look at the biggest such deals. Some, like Time Warner's merger with AOL or Viacom's $40 billion combination with CBS, suffered from fundamental incoherence and have since been undone. Others, however, like Comcast's $75 billion acquisition of AT&T's broadband business, were strategically sound and flawlessly executed. But a closer analysis suggests that even these transactions were concluded at a price that made positive net returns almost impossible.

Investing to grow bad businesses is as destructive as making bad acquisitions. Movies have attracted significant investment, driving a long-term organic growth rate that is among the fastest in media. For all the complaints about piracy, the sector has enjoyed new revenue streams from VCRs and DVDs, proliferating cable channels and distribution, video on demand, and overseas markets. Churning out more and more movies distributed through more and more avenues, the industry generated compounded annual revenue growth of 8.5 percent over the 20 years beginning in 1980. But costs grew at a compound rate of more than 11 percent annually, so for every dollar of new revenue, shareholders were actually worse off.

Investing for growth in businesses creates value only when barriers to entry—which is just another way to say "competitive advantage"—limit the competition that would destroy favorable returns. Without barriers to entry, such investments, no matter how fun, sexy, or otherwise hot at the moment, may provide psychic benefits for executives, but only heartache for shareholders.

Myth No. 2: The Gospel of Going Global

One by-product of media companies' infatuation with growth seems to be a fascination with global markets. The extent to which some non-U.S. markets are less media-saturated on the one hand and faster-growing on the other seems to promise a kind of growth-multiplier effect. Why wouldn't a media mogul want to shift more operations in that direction?

But pursuit of a global footprint can be a dangerous strategy, for three reasons:

First, it's harder to enforce barriers to entry on a global scale. Big markets by definition can support many competitors, even where fixed costs are large. Scale advantages come from the size of the fixed-cost base relative to overall costs, and in a vast global market more players can justify the fixed-cost "nut" required to operate competitively. Moreover, a niche operator or one within narrow geographic limits can defend the barricades of competitive advantage with comparative ease. That's why the highest profit margins in media historically have been found in dominant local franchises like billboards, cable systems, broadcasting, small-market newspapers, and yellow pages.

Second, the track records of great nonmedia franchises in pursuing global strategies should give anyone pause. McDonald's, the poster child for consumer globalization, has historically been more profitable in North America than elsewhere. Nestlé, the classic global corporation, is far less profitable than more nationally focused rivals like Hershey in product areas like chocolate confectionery. Media companies seeking to go global must also contend with severe restrictions on the ability of foreigners to own sensitive media enterprises.

Third, consumers are more and more interested in intensely local content. The movement to replace once-dominant American shows with local fare, for example, has been evident for more than a decade.

Among major U.S.-based consumer-media conglomerates, only News Corporation is meaningfully global today, with almost half of its revenue coming from outside the United States. To its credit, however, News has achieved this by pursuing a multi-local rather than a "global" strategy. Even Viacom, whose modest international operations have predominantly come from syndicating its MTV brands, has a policy of programming those networks with at least 70 percent local content.

Myth No. 3: Content Is King

Although Sumner Redstone likes to claim that he coined the phrase *Content is king*, it was originally popularized in connection with a series of ill-considered and now widely repudiated media deals undertaken by large Japanese consumer-hardware makers. This undistinguished pedigree has not dissuaded most major moguls of the intervening decades from continuing to parrot the slogan.

In addition to its alliterative allure, the idea that content is king has great intuitive appeal. I consume media content based on what I enjoy or find useful—surely the best company is the one with the best content! Reinforcing this simple observation is the intense emotional response that the most-powerful media can elicit. We all associate many turning points in our lives or in our understanding of the world with our exposure to a particular film, song, or book. Regardless of any developments in technology or distribution, the argument goes, the owners of this kind of precious intellectual property will also own the keys to the media kingdom.

But content cannot be king, because the talent required to create it cannot provide a sustainable competitive advantage. Even if the ability to produce compelling content perennially inhered in certain individuals or groups, there is no efficient way to monetize this skill for the benefit of shareholders rather than for the producers themselves. Big media companies may consistently exploit some creative artists, but over time, that exploitation does not produce superior corporate value. For starters, where the media companies have executives clever enough to consistently exploit the talent, these executives are typically clever enough to ensure that they are paid enough to reflect that skill. Furthermore, when particular brands seem like sure things, as in the case of a popular film franchise, more often than not a well-represented creative artist essential to that level of certainty ends up appropriating much of that value.

A number of highly profitable media companies provide so-called must-have content to professional markets, like the legal, medical, or financial communities. But even here, the actual content rarely creates the competitive advantage. Indeed, much of the content is not even owned by the media company—for instance, public legal decisions, or the price at which two parties trade a security on an exchange. The barrier to entry raised by these companies comes instead from how they integrate, analyze, and deliver multiple sources of diverse content, much of which is widely available. Put simply, the core of any competitive advantage more often than not derives from the manner of aggregation rather than the creation of content, continuous or otherwise. It is no coincidence that Google, the most profitable and successful new media company, is an aggregator, not a content creator.

Myth No. 4: The Cult of Convergence

As the media industry emerged from the devastating recession of the early 1990s, it latched on to a new concept that represented a ray of hope. Most of the largest sectors were quite mature; others showed signs of maturation creeping into their previously relentless growth trajectory. The opportunity on the horizon for each of these very different businesses came in the form of a digital revolution that would break down the walls between distinct and unrelated business lines. New growth would come from getting into businesses that had been beyond their reach.

In 1992, a group of analysts from Goldman Sachs produced a hugely influential report that introduced a new term into the media vernacular: *Communacopia*. Goldman Sachs successfully leveraged this newly established "brand" into an annual conference trumpeting the supposed benefits to investors of these revolutionary changes. When the Internet boom came, the Goldman analysts looked even more prophetic.

Many of the Goldman analysts' predictions were largely correct. But, as the subtitle of the original report, *A Digital Communication Bounty*, suggests, they missed, or at least did not wish to highlight, the fundamental economic implication of these observations. Sure, the report acknowledged, as in every revolution, there will be winners and losers. But in this case, their view was that the former would dwarf the latter. Music companies, production studios, and any owner of copyright, according to *Communacopia*, would be big winners: “The litany of potential new business opportunities is practically endless.” Even a seemingly obvious loser like Blockbuster, according to the authors, shouldn’t be overly concerned about the negative impact of communacopia. In their view, “the beauty” of the emerging products and business models was that they would not cannibalize Blockbuster’s core franchise but instead offer “enough distinguishing features to allow [them] to be largely incremental to the videocassette industry.”

Whenever someone suggests to you that breaking down barriers to entry is good news, hold tight to your wallet. A decrease in barriers inevitably means more competition, and more competition means less-lucrative businesses. The introduction of the Internet has only accelerated this trend of value destruction among incumbent media players, without creating many profitable newcomers.

The Internet strikes at the very heart of the core competitive advantages historically enjoyed by traditional media companies—economies of scale and captive customers. First, it radically reduces the fixed-cost nut required to engage in all manner of activities. And it all but eliminates the actual or psychological cost that impedes a user from trying an alternative product or services.

Even as they blame the Internet for their travails, the largest media companies, like moths to a flame, continually reach out to it as their imagined salvation. Time Warner, Sony, News Corporation, Viacom, CBS, NBC Universal, and Disney together have completed more than 100 digital-business deals since the Internet bubble burst in 2000. These have ranged from early-stage investments to major strategic acquisitions, and have represented almost every business model, subject area, and geographic region. Most have been misguided or overpriced, and many have been both. And regardless of their individual merits, the relentless process of identifying and adding and integrating these businesses has distracted leaders from the crucial task of just running their existing assets, which face genuinely unprecedented challenges.

Without drastic action, the performance of media enterprises during the next 10 years is unlikely to improve—and is likely to get much worse. The drastic action required here entails jettisoning all four entrenched media myths and going back to basics: understanding the key characteristics of various media segments and applying established business principles to determine the best way forward. Although such an approach is hardly revolutionary on its face, the stark contrast between it and the conventional wisdom suggests how much work needs to be done.

In the media industry, senior executives seem to prefer “strategic visionary” to “first-rate operator” as an appellation. There is nothing wrong with searching for ways to reinforce competitive advantages under threat. But once the barriers have fallen, managers are left with the most unglamorous of activities—improving the efficiency of their operations. In the absence of investments likely to generate superior returns, an executive committed to shareholder value would not diversify for the sake of diversifying or reinvest in a clearly dissipating franchise, but simply return the money to investors.

Empire-builders may find that course distasteful, but over the past two decades, media investors would certainly have been far better off if this had been the road taken.

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