S&P Global Ratings

Industry Top Trends 2019

Media and Entertainment

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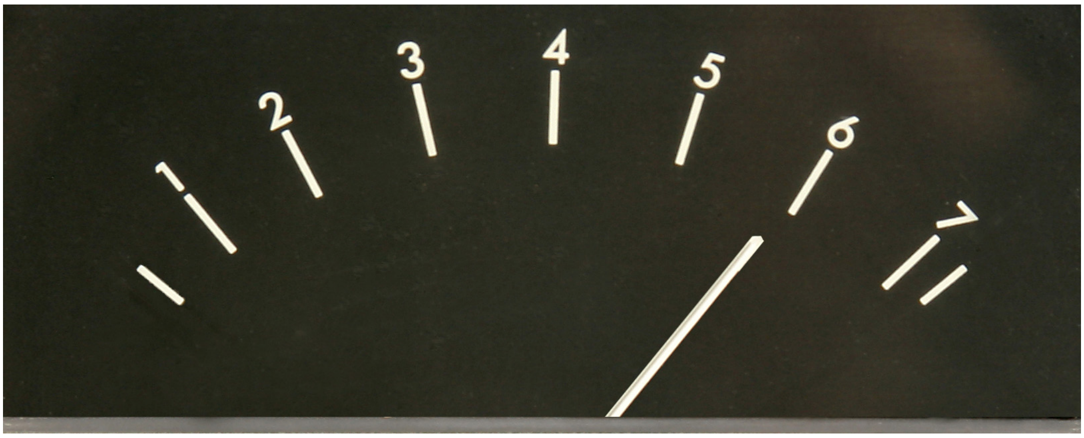


Key Takeaways

- **Ratings Outlook:** Rating trends remain broadly stable but negatively biased due to the convergence of content and distribution, ongoing secular shifts in media consumption and advertising spending, and the aging of the credit cycle. Media companies in print and publishing, radio, and television face the greatest credit pressures. Overall, we believe diversified companies with global footprints are better positioned to face secular trends than niche companies with concentrated operations in a few regions.
- **Forecasts:** Advertising spending is highly correlated to economic growth and consumer spending. In 2019, we expect low-single-digit percent growth in global ad spending. Mobile ad spending growth will continue to remain robust with social, video, and audio advertising the fastest growing segments. Traditional media ad spending will continue to slow or decline. We expect weak TV ad spending growth in the U.S. and European markets that will not have key cyclical events in 2019 (e.g. Olympics, World Cup).
- **Assumptions:** We forecast U.S. GDP growth of 2.3% and consumer spending growth of 2.4% in 2019, driven by a strong labor market, still-bullish consumer confidence, and favorable manufacturing sentiment, as well as eurozone GDP growth of 1.8% in 2019 with significant regional disparities. Our base-case forecast for the U.K. of 1.3% growth in 2019 reflects our assumption of a Brexit deal and a status quo transition that lasts until the end of 2020.
- **Risks:** Key risks include global economic uncertainty or shocks hurting consumer confidence and ad spending, more entertainment options leading to accelerated television audience fragmentation, and a continued shift in ad spending to digital media from traditional media.
- **An Economic Downturn:** In a global economic downturn scenario, we would expect the global media sector's profitability and cash flow to significantly decline, primarily due to its exposure to economically sensitive global advertising. In Latin America, cash flows would also likely be pressured due to significant currency devaluation, leading to higher interest rates to counterbalance rising inflation.
- **Industry Trends:** In the U.S. and Europe, we expect the secular shifts in viewing consumption and ad spending to digital media at the expense of traditional print-based media to accelerate in 2019 and beyond. Digital ad spending will remain healthy in 2019, driven by mobile advertising, while ad revenue for traditional sectors such as print, radio, and, increasingly, television, will continue to decline. We also expect continued industry consolidation, especially in the U.S., as media, telecom, and technology companies reposition themselves to address these secular trends.
- We expect digital ad spending to remain strong, with the largest players continuing to experience outsized gains driven by mobile, social, and video ads. However we expect regulatory pressure around user data privacy to increase, especially for the largest players following several high-profile reports of privacy breaches in 2018. Adoption of a patchwork of privacy rules across states and globally would limit companies' abilities to provide a standardized user experience, and could limit the ability to customize and target advertising.

Ratings trends and outlook

Global Media And Entertainment

Chart 1

Ratings distribution by region

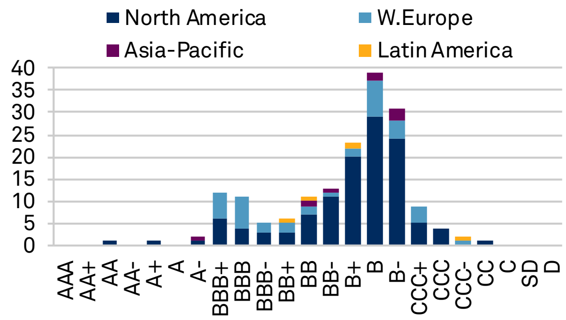


Chart 2

Ratings distribution by subsector

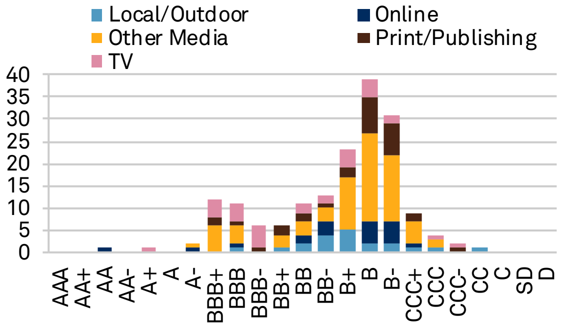


Chart 3

Rating outlooks by region

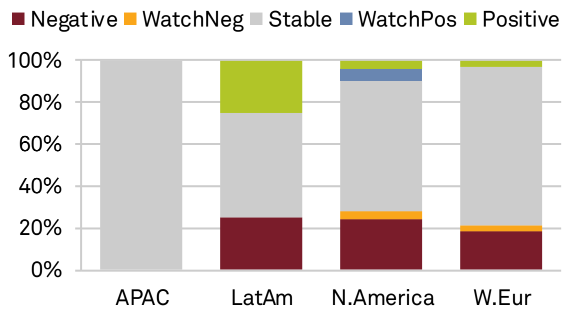


Chart 4

Rating outlooks by subsector

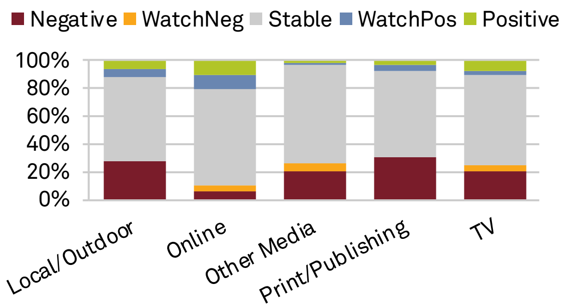


Chart 5

Rating outlooks net bias by region

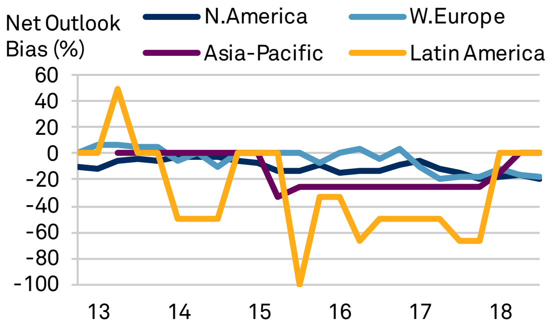


Chart 6

Rating net outlook bias by subsector

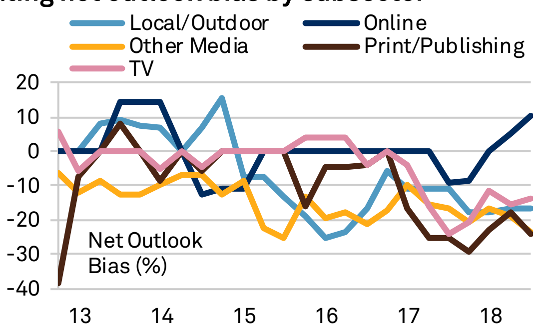


Chart 7

Rating outlooks

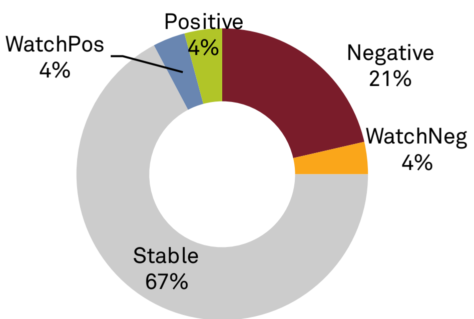
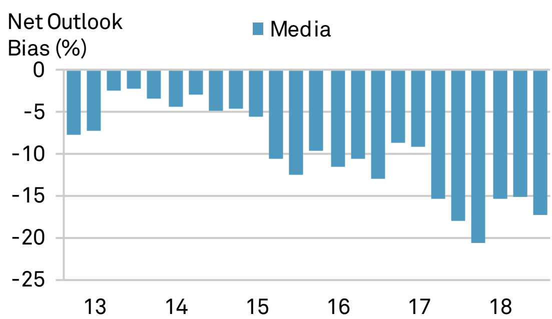


Chart 8

Rating net outlook bias



Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending Sept. 30, 2018

Industry forecasts

Global Media And Entertainment

Chart 9

Revenue growth (local currency)

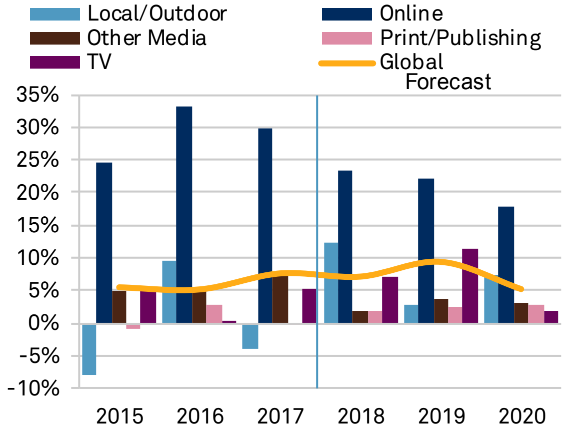


Chart 10

EBITDA margin (adjusted)

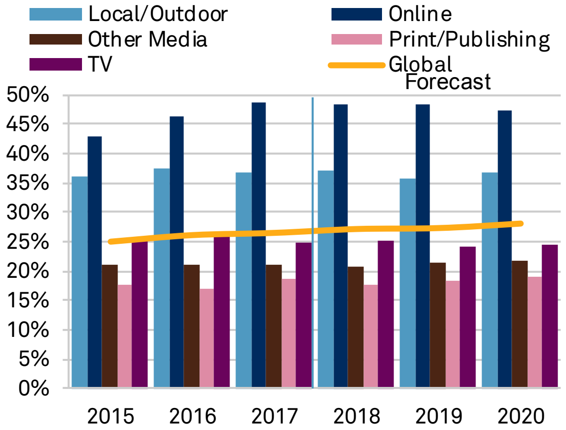


Chart 11

Debt/EBITDA (median, adjusted)

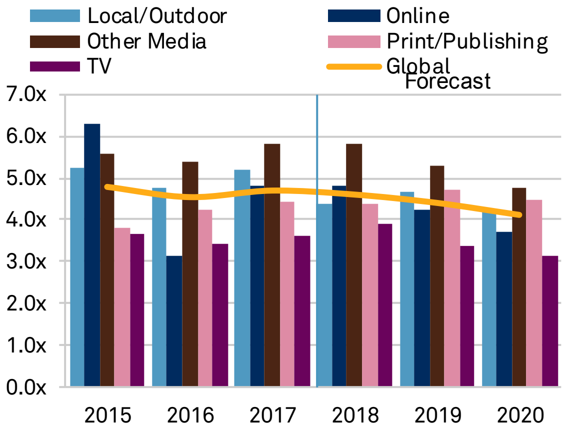
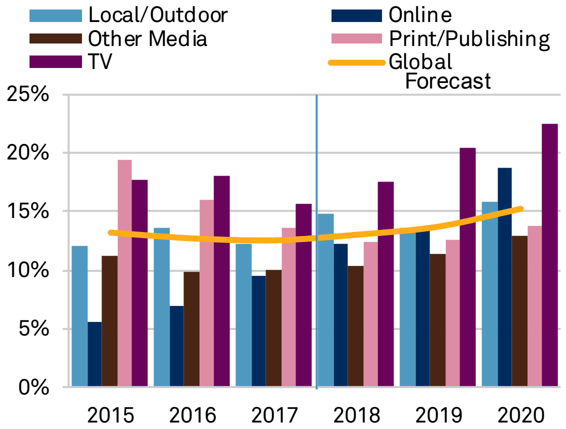


Chart 12

FFO/Debt (median, adjusted)



Source: S&P Global Ratings. Revenue growth shows local currency growth weighted by prior-year common-currency revenue-share. All other figures are converted into U.S. Dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO--Funds from operations.

Key assumptions

Television

1. Over-the-top (OTT) options will continue to proliferate

We expect more OTT options as consumers continue to look for more flexibility and OTT providers continue to experiment with offerings of various sizes and prices. In the past two years we have seen several live streaming virtual multichannel video programming distributors (MVPDs) launch offering various combination of live networks and on-demand content. However, many have gravitated towards full-sized standard cable video packages because distributors have added programming that was initially not included. For example, Hulu recently added Discovery's cable networks to its programming lineup after having excluded them when it launched. We expect virtual MVPDs to continue to experiment with even “skinnier” bundles as they try to find the right set of programming combinations that not only fit consumer tastes but that boost profitability--as the current standard offerings barely cover programming expenses. We are starting to see this with Hulu's recent announcement that it is looking to create smaller bundles that focus on live sports and news and on-demand content. We expect other virtual MVPD offerings like DTV Now and Amazon to experiment with different programming combinations as well. More of these “skinny” bundles could further differentiate between media companies' subscriber trajectories depending on the popularity of the packages they are included in.

In addition to more virtual MVPD offerings, we expect to see many direct-to-consumer (DTC) service launches in 2019. Interest is building, in particular, for the late 2019 launch of Disney's DTC product. In addition, AT&T's recent announcement of an HBO/Warner Media-branded offering to be launched in late 2019 adds to the plethora of DTC subscription video on demand (SVOD) offerings already in the market. We would not be surprised if other large content owners join the fray as well. Still, we are cautious on the long-term viability for many on-demand DTC offerings due to their low profitability, as well as the significant technology and content investments required.

2. Investment in content has not plateaued

Despite the increasing threat of unsustainable growth and oversupply, media companies are producing even more original content each year. According to FX Networks Research, 487 scripted original TV series were produced in the U.S. in 2017, and we expect production will easily eclipse this number in 2018 as SVOD providers such as Netflix, Amazon, and Hulu continue to make significant investments in original content. Netflix expects to spend over $12 billion in cash content costs in 2018, up from $8.9 billion in 2016, and we expect this to reach about $14.5 billion in 2019. We also expect increased spending from Amazon, Hulu, and greater investment from new DTC entrants such as Disney and Warner Media. More original content won't necessarily result in greater success for these companies, as the added content will compete for attention from consumers who are already bombarded with a plethora of entertainment choices.

Many newer market entrants appear comfortable with sacrificing short-term profitability to create or acquire compelling content that they believe will help drive long-term subscriber growth. However, this strategy will likely pressure established media companies' operating margins, requiring them to show considerable discipline in their programming budgets to avoid margin degradation. We also believe that while most media companies will continue to invest in their own content production, those with weaker balance sheets will need alternate strategies such as co-production partnerships and joint ventures to gain access to either intellectual property or financing to produce the content.

3. Content exclusivity will differentiate OTT platforms

As OTT platforms continue to proliferate, exclusive content will increasingly be used as a key differentiator in attracting subscribers. While the norm historically has been for media companies to license their content to as many distributors as possible, we expect to see media companies with DTC ambitions make more of their content exclusive to their offerings. This is exemplified by Disney's plan to end its licensing agreement with Netflix in 2019 as it launches its own DTC platform and puts its content exclusively on there. We expect other large media companies like Warner Media to make a large portion of their library content exclusive to their soon-to-be-launched DTC offerings. Additionally, we expect investments in exclusive original content to drive the differentiation between services and be a leading factor in growing the platform.

While exclusivity is likely needed to differentiate between products, it will hurt margins in the short-term. Media companies will need to forgo high-margin licensing agreements in order to make their library content exclusive. To replace the lost licensing revenue/earnings, new DTC platforms will need to generate significant subscriber growth and achieve enough scale to justify the decision not to license their library content. Given the high hurdles to reach scale and the reduced financial flexibility of many media companies stemming from high debt leverage, we believe that it will be difficult for smaller media companies to stop licensing their library content to as many distribution partners as possible.

Local Media (Radio and Outdoor)

1. Core radio ad revenues will continue to decline

We expect radio broadcasters' share of audience attention and advertising dollars will continue to decline at a low-single-digit percent rate for the foreseeable future, or worse during periods of economic weakness, due to audience fragmentation and broadcasters losing market share to digital media. As advertising rates decline, radio broadcasters will find it challenging to maintain stable top-line growth via digital media or other revenue streams. Still, we forecast traditional radio's share of audience attention will decline only slightly in 2019 as audiences consume more digital radio and other media alternatives. We also expect the radio industry's operating margins will decline modestly due to stable or slightly lower top-line growth, offset by higher inflationary costs.

2. U.S. outdoor ad revenue growth in line with GDP with upside from digital

U.S. outdoor advertising will maintain its share of advertising in 2019. We believe the growth in digital boards and the minimal disruption from digital advertising will lead to higher ad rates, increased occupancy levels, and, ultimately, some top-line growth. We expect outdoor advertising revenue will grow in line with or slightly faster than U.S. GDP, and industry operating margins will remain robust and relatively stable.

Internet/Online

1. Digital advertising will continue to gain share

Digital advertisers will continue to improve their mouse traps to better personalize and target advertisements by harnessing the power of algorithms and data as consumers continue to increase time spent on mobile and video viewership. We expect digital advertising in the U.S. will continue to grow at low double-digit rates in 2019 and account for over half of total U.S. ad sales as revenues for traditional media channels remain largely stagnant or decline. Globally, we expect digital ad sales will account for half of total ad sales in the next two years.

As mobile usage continues to grow, so does the shift of advertising dollars. We estimate mobile advertising could account for over 70% of the total digital ad spending in the U.S. in 2019, with the growth driven by social media and video as the largest online companies look to flex their muscles by increasing the monetization of their platforms and content and as small and medium enterprises increasingly utilize digital marketing instead of traditional paper-based marketing techniques.

2. Digital keeps evolving

Technological evolution has supported greater digital ad consumption and personalization from desktop to iPads to mobile and voice-based assistants, with artificial intelligence, augmented reality, and virtual reality likely to follow. Advertising on social media, especially using video, has become one of the fastest drivers of growth because small and medium businesses have been increasingly using these formats. Ad formats continue to evolve with vertical video, programmatic video ads, shorter ad prerolls to improve customer engagement, and better-designed and targeted ad units to improve mid-roll advertising performance. We expect these trends to continue supporting the secular growth in digital advertising.

3. Subscriptions continue to grow for quality offerings

Consumers are increasingly accepting of buying services and products with online subscriptions, with revenues from many subscription businesses continuing to hit new highs. The services range from OTT streaming subscriptions to retail delivery, online dating, home advisory services, and paywall-supported news content. Nevertheless, this trend has created a few sizable winners that are able to provide quality content and service, personalization, and articulate a clear value proposition for users, with less compelling options falling by the wayside or having to rely on advertising as a primary source of revenues.

Advertising Agencies

1. Sub-GDP growth is the new normal

After years of above-GDP growth, we anticipate that the world’s largest ad agency holding companies will post flat to moderate organic revenue growth in the coming years due to smaller traditional advertising budgets and the sustained diversion of brand support into promotional spending.

Large advertisers, particularly fast-moving consumer goods companies (FMCGs), have been under pressure to increase their margins as top-line growth slows. This has led to a reduction of their advertising and promotions (A&P) expenses, directly affecting advertising agencies' top line and profitability. In addition, within the A&P expenses, promotions have taken a larger share of the budget--which is typical in low inflation markets--further adding to the pressure.

While growth also varies from winning or losing large contracts, we have witnessed an overall flat to mildly growing top line for the main advertising players globally in 2018 apart from WPP, which has recently lowered its full year outlook. WPP reported a weaker third quarter and has lowered its 2018 full-year guidance for organic revenue less pass-through costs to be down by 0.5%-1.0%. Omnicom, the world’s second-largest agency, is guiding for 2%-3% organic revenue growth in 2018. The third-largest ad agency, France-based Publicis, hasn’t given any guidance for organic revenue growth in 2018 but is aiming to reach 4% by 2020, which we view as ambitious considering its modest 0.2% organic growth in the first nine months of 2018. The fourth-largest agency, however, IPG, has been growing significantly faster, reporting a 4.9% increase in organic revenues for the first nine months of 2018 and guiding for organic net revenue growth of 4.0%-4.5% for the full year.

While we believe that growing revenues will be the biggest challenge facing ad agencies in the coming years, we anticipate that they will be able to maintain their margin profiles despite the negative pricing pressure stemming from tighter FMCG marketing budgets. This is due to ad agencies' flexible cost bases and high turnover of their typically young and creative talents, making it easier to manage labor costs, which represent the lion's share of their cost structure at about 65%-70% of revenue. These dynamics should allow ad agencies to preserve margins even in the face of an economic slowdown.

2. Increased transparency and simplified operating structure

We expect the large ad agency holding companies to continue simplifying their operating structures and pursuing greater integration between their businesses and dispose of strategically less important assets as they focus on the growth areas of data, technology, and creative. WPP's new CEO announced the group will dispose of its minority shareholdings and shares in associates, valued at up to £2.5 billion, and will consider strategic options for its stake in Kantar. In 2018 it already disposed of its shares in software developer Globant and digital ad exchange platform AppNexus. We also understand that Publicis is in advanced talks to dispose of its health services division, which has been a drag on the company's performance.

The trend to optimize business portfolios reflects the groups' effort to attain simpler operating structures and bring the numerous agencies they own under one roof to provide a more streamlined and personalized service to clients. We believe IPG has been ahead of peers with its "open architecture" platform, while we also see Publicis using its "power of one" to transform the way they work and address the client's need for transparency and simplicity. WPP has recently announced the merger of one of its major ad agencies Young & Rubicam with the digital agency VML.

Key risks and opportunities

Television

1. 2019 is the year of execution

If 2018 was the year of mergers and acquisitions (M&A), 2019 will be the year media companies need to execute their strategies. The Discovery/Scripps and AT&T/Time Warner deals both closed this year, and the Disney/Fox/Comcast bidding war ended with Disney posed to acquire most of Fox's assets and Comcast acquiring Sky. All of these deals are a reaction to the evolution of media consumption away from the traditional linear model and towards a more DTC model, necessitating greater scale and more global platforms.

All of these deals significantly increased leverage for the acquiring companies. Their ability to implement and execute their strategies will determine if they can successfully navigate the evolving media landscape and return to pre-acquisition credit metrics. We have started to get some indication of how these companies plan to integrate the acquired assets into their broader strategy, but details like the size of planned investments (content and technology), pace of a global rollout, and key performance metrics are still unknown.

2. Pace of M&A likely to decrease

Given the M&A activity of 2018, we expect the pace of M&A to slow in 2019. However, the trends that drove large-scale consolidation in 2018 still exist, and the pressures of an evolving media ecosystem and the need for added scale to compete on a more global basis will continue to pressure smaller media companies. While we do not expect any mega-acquisitions in 2019, more modest consolidation is possible. We still believe that smaller studios and cable networks with more limited scale will have a difficult time operating as media consumption shifts away from linear television, which will continue to be a catalyst for further consolidation in the future.

3. A sharp downturn in the global economy in 2019

While we currently do not expect a meaningful economic slowdown in 2019, the length of the current economic expansion, rising interest rates, and trade uncertainties create more risks to the economy going forward. Media companies' primary exposure to a slowing economic environment is through advertising; in addition, the pace of MVPD video subscriber declines could accelerate in the next economic slowdown as consumers shift towards OTT/SVOD alternatives. We expect companies with a higher share of revenue coming from domestic advertising, a smaller international footprint, and less-developed SVOD/OTT strategies to face more pressure. Additionally, many media companies have reduced their share repurchase programs as they look to delever after making significant strategic acquisitions. An economic slowdown would likely reduce their ability to meet deleveraging goals and could result in negative rating actions.

Local Media (Radio and Outdoor)

1. M&A environment mixed in 2019

We don't see much prospect for additional transformative radio M&A over the next 12 months. Few companies have the balance sheet capacity or desire to undertake a sizeable radio station acquisition. However, we expect there could be a resurgence of acquisitions and swaps of local television stations in 2019 as the importance of scale causes smaller station groups to be put up for sale. The failed Tribune Media and Sinclair Broadcast merger in 2018 could put Tribune's sizable assets back in play next year. We believe TV station swaps could be a credit positive for TV station operators if leverage remains similar to current levels given the potential margin expansion that TV station duopolies (more than one TV station in a particular market) would provide TV station operators. However, station swaps have proved difficult to negotiate and could end up being elusive.

2. Radio broadcasters' elevated leverage could pose significant credit risks

With two of the largest rated U.S. radio broadcasters, Cumulus Media Inc. and Entercom Communications Corp., currently carrying leverage in the low- to mid-5x area, increased economic volatility could cause a larger-than-expected decline in radio advertising rates and revenues in 2019. We expect low-single-digit percent revenue declines or worse, which would likely result in downgrades and a reexamination of whether radio broadcasters' leverage levels are sustainable. While neither company faces near-term maturities, if revenue declines start to deteriorate radio broadcasters' cash flow and ability to repay debt, we could begin to view debt loads as unsustainable, especially if leverage is over 5x.

3. A sharp downturn in the global economy in 2019

With local media revenue highly correlated to GDP and the health of local markets, a recession would hurt revenue for local media companies and magnify declines in EBITDA and operating margins. For instance, although television broadcasters and outdoor media advertisers have recovered the revenues lost during the 2008-2009 recession, the radio industry, which saw revenue decline 25%, has yet to recover. While we may not see a decline of this magnitude in the next recession, we still expect that more mature forms of media, like radio, would experience lower advertising shares that may never return.

Internet/Online

1. Regulatory concerns increase as jurisdictions pursue uncertain and divergent paths

Online and information services companies such as Apple, Amazon, Google, and Facebook face many regulations globally, including ever-evolving consumer and data protection, content limitations, privacy, network security, encryption, and payment laws. The regulations' scope and application vary by country, based on each country's public interest policy goals or desire to encourage growth or competition. These companies also operate with uncertainty as to how some existing regulations will apply as media, tech, and telecom businesses increasingly converge, or how a change in government regimes or new interpretations of laws could lead to retrospective changes. The EU's recently adopted General Data Protection Regulation (GDPR), which came into effect in April 2018, expanded the regulation of personal data processing throughout the region and significantly increased penalties for noncompliance. On the heels of GDPR, several U.S. states are in various stages of passing legislation to expand data breach notification rules and to implement various data privacy protections. For example, California passed its Consumer Privacy Act in June 2018, which goes into effect at the beginning of 2020, and New Jersey has proposed similar laws. We believe that a patchwork of privacy laws across states and countries would be costly for companies to implement and could limit their ability to target advertising and effectively monetize their ad inventory. However, the scope and timing of policy changes is difficult to predict.

2. Unaddressed misinformation could undermine the media industry

Misinformation in the form of "fake news" and online accounts aiming to deliberately mislead readers dominated headlines globally in 2018, making transparency and trust key development needs in 2019. While large online players have made investments to weed out misinformation campaigns, this insidious problem has no easy solution, and could weaken or even damage media company brands. Trust will become increasingly important as more companies seek to create compliance and ethics frameworks, accreditation, and risk assessments to address fake news. We expect compliance and security costs to increase in 2018 as companies invest in people and technology to strengthen systems and prevent abuse. However, we don't expect a lack of trust to hinder digital advertising or the digital economy in 2019.

3. Downturn will slow revenue growth, but secular trends will likely offset some of the pressure

While advertising, especially local advertising is very sensitive to overall economic growth, we believe internet advertising will likely see fewer declines than traditional advertising due to the secular trend towards digital mobile advertising, greater use of online advertising by small and medium businesses, easier attribution of online advertising to sales, and proportionately more time spent online by millennials and Gen Z (born after 1997), attracting brands big and small to increasingly advertise online.

Advertising Agencies

1. From mass advertising to personalization at scale, there's more complexity and new rules in the ad agency industry

In the days of mass advertising, having scale in media buying to offer the best price was a key competitive advantage for ad agencies. We believe that in the era of personalization at scale, the competitive advantage of ad agencies now resides in their capacity to leverage their data, technology, and creative talents.

In recent years, a few companies have taken their programmatic advertising (automated bidding on advertising inventory in real time) in house instead of outsourcing it to ad agencies. However, we understand that the trend has significantly slowed down, if not reversed. This is due to the complexity of accessing all of the different platforms, using all of the different technologies, and the difficulty of analyzing all of the data and hiring experts on it. As advertising has become very specialized, we believe agencies' competitive advantage has moved to connecting and leveraging their data, technology, and talents.

2. Risk of new entrants higher than that of disintermediation

Given the new environment and more complex advertising, we believe that the risk of disintermediation by the FAANGs (Facebook, Amazon, Apple, Nextflix, and Google) has somewhat lessened. At the same time, they are becoming increasingly important counterparties to ad agencies. Last year, Google and Facebook were WPP’s top two media owners (Google was top four in 2012 and Facebook wasn’t even in the top 10), each receiving more than $2 billion of WPP’s spending, with Amazon and Chinese tech giant Tencent also making the top 20.

However, this new competitive environment has brought new entrants to the data and technology space: consulting firms. Consulting firms have not yet fully replicated the ad agencies proposition: while they are very capable in terms of data and technology, we believe they lack the creativity of ad agencies. We will closely monitor their expansion into creative, as we believe that if they figure out how they could help companies to connect with consumers, their ultimate value proposition will be somewhat similar to ad agencies.

So far none of the main ad agencies has reported a significant loss of contract or bid to any consulting firm, but this could change going forward if consulting firms make significant progress in the creative part of their value proposition.

3. A sharp downturn in the global economy in 2019

The advertising industry reacts quickly to changing macroeconomic conditions, so we believe a sharp downturn in the global economy could lead to a rapid and substantial contraction of advertising budgets and agency revenues. Initially, this would also hit margins, but the longer-term impact would be less pronounced. Agencies' business models and flexible cost bases would likely allow them to adapt relatively quickly. Labor costs represent the lion's share of agencies' fixed costs, equal to about 65%-70% of revenue.

Industry developments

Audience fragmentation and shifting ad dollars

The U.S. television industry continues to face two key risks: audience fragmentation and shifting advertising dollars. TV audience ratings continue to decline as consumers take advantage of a growing selection of entertainment choices, and traditional media continues to lose ad revenues to digital and mobile platforms as advertisers seek better returns for their advertising budgets. We believe TV networks that broadcast premier sports programs and live events will better withstand these pressures over the next few years.

Unlike other TV genres such as scripted programming, sports are overwhelmingly watched live and audiences generally watch the commercials, making it the best way for advertisers to reach large national audiences globally. Key sports events such as the World Series, the Super Bowl, the Olympics, and the FIFA World Cup can be found exclusively on broadcast television because only over-the-air television currently offers broad national audiences, high-quality TV production capabilities, and a dependable viewing platform. For these reasons, among others, audience ratings for key sporting events like these are less susceptible to declines. As a result, sports programming is critical to the U.S. television industry: it is the glue that holds together pay TV video bundles and the key anchor that underpins our credit view of the industry.

In continental Europe, these trends are present but less pronounced because television is primarily free and funded by TV advertising. Free TV content is typically local (local language, local actors, and adapted to local audience) and high quality, and ad break intensity tends to be lower than in the U.S. because EU regulation caps television advertising at 12 minutes per hour (versus 17 minutes in the U.S.). As a result, pay TV penetration is typically lower. In Germany, for example, pay TV penetration is estimated at 21% (versus more than 75% for the U.S.), with monthly spending per pay TV subscriber below $30 (versus close to $100 in the U.S.). In addition, pressure from OTT providers remains moderate because free-to-air TV is protected due to windowing. In France, for example, the SVOD movie window comes after both pay TV and free-to-air television, on average 36 months after the theatrical release. In the U.S. the first release window is typically 90 days after theatrical release, and both premium pay TV networks and SVOD providers (Netflix until its contract with Disney ends) get the same window. The conditions are similar in several Latin American countries, with pay TV accounting for around 30% of households in Brazil, for example.

Global media companies expand OTT platform experiments

As the pressure on the traditional video bundle increases, media companies in Europe and the U.S. have embraced virtual OTT bundles. Seven virtual MVPD options have launched in the U.S. (DIRECTV Now, FuboTV, Hulu Live TV, philo, Sony PlayStation View, Sling TV, and YouTube TV), with varying degrees of success. We expect a rationalization of the number of virtual MVPD services in the next few years, as many will remain unprofitable and will either shut down or merge. In their place, we expect the number of DTC, SVOD, and OTT services such as CBS All Access, HBO Now, ESPN Plus, and the soon-to-be-released Disney SVOD service to accelerate, resulting in a confusing myriad of OTT options for consumers.

We had initially viewed the virtual pay TV operators as potential disruptors of the pay TV ecosystem. Instead, we may now view the majority of the virtual pay TV services as quasi-full-sized bundles (SlingTV, with its 30-plus lineup being the exception), not much different to what the traditional pay TV operators offer, with the key exception that these virtual bundles are priced below the cost of programming. We believe none of these virtual bundles are currently profitable.

Traditional media loses revenues as ad spending shifts to digital

We expect overall ad spending in the U.S. to increase by 2.7% in 2019 despite tough comparisons to 2018 (Winter Olympics and midterm elections). Excluding those two events, core ad spending (local and national) will likely increase by only 2.6%—modestly ahead of our U.S. GDP forecast of 2.3%. In 2019, we expect digital advertising to grow at a mid-teens percent rate as it takes market share from traditional media, with only the digital, outdoor media, and TV sectors growing, while other advertising in other media sectors (newspapers, magazines, and radio) continues to decline. In the television segment, we believe cable networks will face the largest declines and local TV advertising will be the least affected. Still, we believe TV ad spending will remain resilient despite some investor concerns that television will soon join print media as a declining industry. As long as brand building remains a key component of advertisers' marketing strategy, which requires reaching broad audiences instead of targeting demographics, demand will continue for TV ad spots. Television—especially live (including sports and news) and special events—remains the best media for reaching the broadest audiences, even though we expect audience ratings will continue to decline.

We expect that in Europe digital disruption and expanding digital ad spending, particularly mobile, video, and programmatic (digital advertising sold via an automated selling process), will drive robust ad spending growth. At the same time, we see significant differences among various European markets. For example, digital media spending will likely overtake TV spending in Germany, while TV will remain the dominant media type in Italy, with TV ad spending twice as large as digital. In Western Europe, we expect ad spending growth will remain stable at around 3.5% in 2019, with some disparities among the counties. In the U.K. ad spending will likely continue to outpace that of Western Europe, supported by an ongoing shift from traditional media to digital. However, we note that growth in 2019 will be slower than in 2018, and in case of a no-deal Brexit (which is not our base case at the moment, but we see greater chances of it happening), the U.K. economy could go into a moderate recession. A material reduction in U.K. ad spending would initially follow in such a stress scenario. Meanwhile, at the other end of the spectrum, Italy and France will continue to post very modest growth, despite ongoing economic growth. Central and Eastern Europe will continue to grow well ahead of mature western European markets due to stronger macroeconomic fundamentals and lower saturation of the advertising market, powered by particularly strong growth in mobile.

Financial policy

Vertical integration and subsector consolidation will continue to drive M&A

We expect the pace of M&A in the media and entertainment industry--and between the media, telecom, and technology sectors--to slow in 2019, given the frenetic pace in 2017 and 2018. The industry saw several major transactions during the past 12 months, including two vertical integration deals (Comcast's acquisition of pan-European distributor Sky PLC and AT&T's acquisition of Time Warner) marrying content creation and video distribution. The others were horizontal mergers (Discovery's acquisition of Scripps Networks Interactive and Disney's pending acquisition of parts of Twenty-First Century Fox).

We are skeptical on the merits of vertical integration because the potential synergies may be more difficult to achieve, and the clash of corporate cultures could disrupt the acquired company. Although some media, telecom, and technology companies may feel strategic pressure to emulate the integrated platforms of AT&T and Time Warner and Comcast/Sky and NBC Universal and opt for vertical mergers, we believe more are likely to participate in horizontal mergers, especially U.S. TV station operators. For cable network operators, we don't believe added scale (having more cable networks) is the long-term solution to the secular pressures affecting television, and consolidation only makes sense in conjunction with reducing the number of second-tier cable networks. We still believe that smaller studios and cable networks with more limited scale will have a difficult time operating as media consumption shifts away from linear television, which will continue to drive further consolidation in the future.

In Europe, however, we don't expect any transformational M&A. Instead, we believe media companies will focus on smaller bolt-on acquisitions to bolster their existing operations and improve their geographic footprint, and fund these acquisitions with generated cash flows. We also expect TV broadcasters and pay TV operators will focus on deals that extend their digital offerings and content production. Overall, we believe the absence of large M&A will have a neutral to positive impact on leverage for European media companies in 2019.

Related Research

- When The Cycle Turns: How Would Major Media Companies Face In A Downturn?, Oct. 29, 2018
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- And The Next Leader Of The U.S. Media Industry Is..., July 9, 2018
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- Conversations On The Road: Will Rising Demand For Local Language TV Content In Europe Push English Language Content Out Of The Spotlight?, April 5, 2018
- How Does S&P Global Ratings Calculate Leverage For U.S. Diversified Media Companies? (2018 Update), March 3, 2018
- Will U.S. Tax Reform Rewrite The Script For U.S. Media And Entertainment Companies?, Jan. 29, 2018
- U.S. Film Industry: Are Big-Budget Films More Successful?, Jan. 9, 2018

This report does not constitute a rating action.

Cash, debt, and returns

Global Media and Entertainment

Chart 13

Cash flow and primary uses

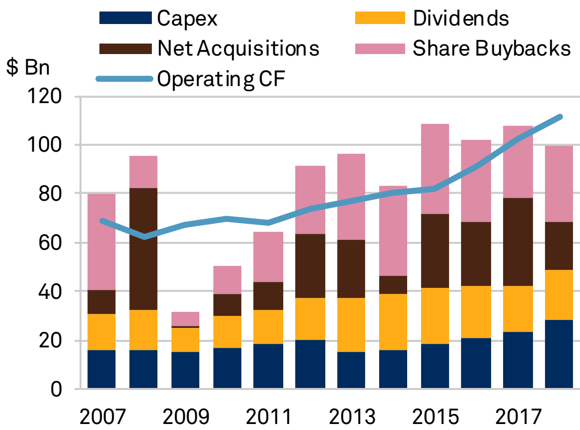


Chart 14

Return on capital employed

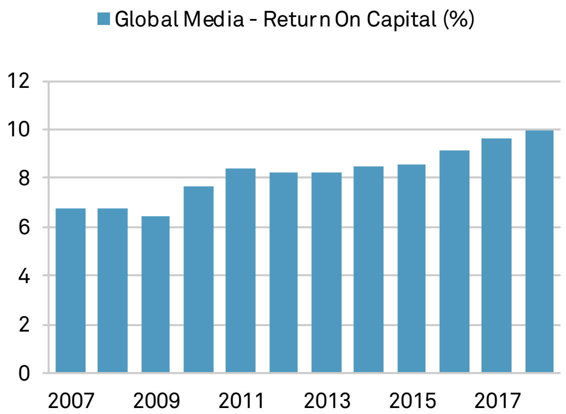


Chart 15

Fixed- versus variable-rate exposure

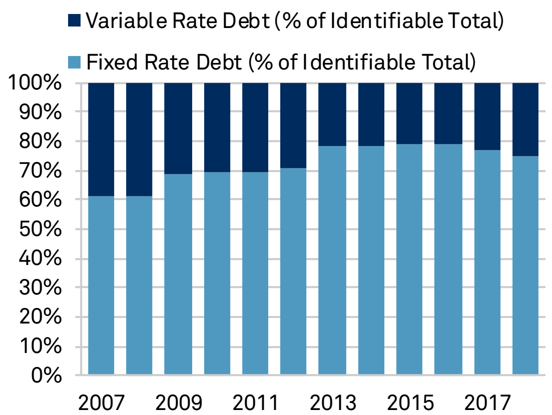


Chart 16

Long-term debt term structure

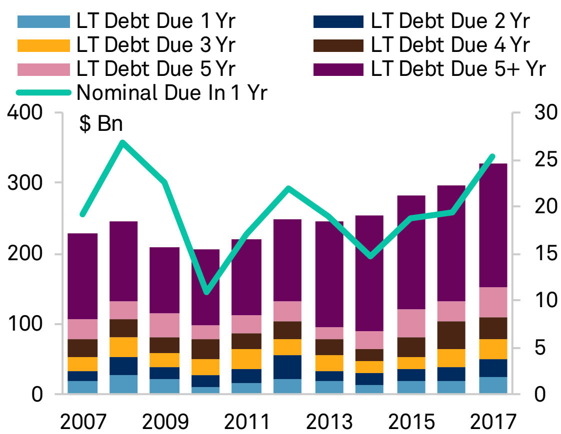


Chart 17

Cash and equivalents/total assets

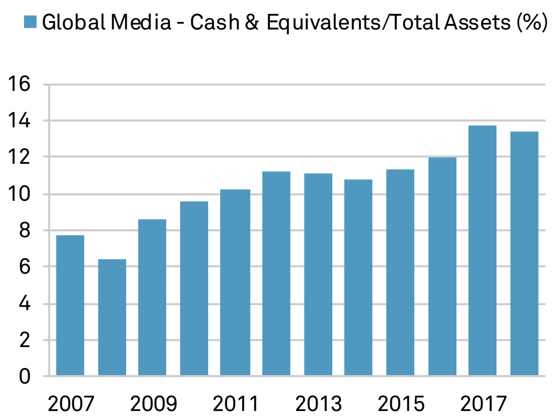
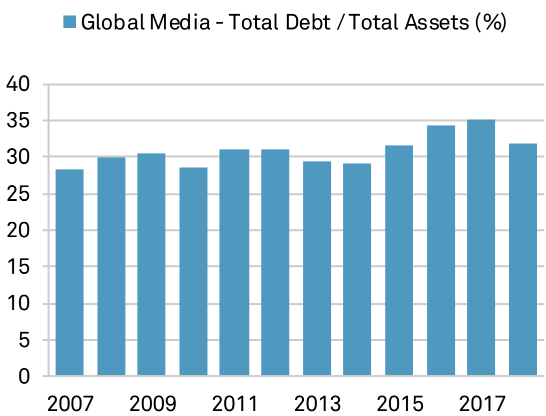


Chart 18

Total debt/total assets



Source: S&P Global Market Intelligence, S&P Global Ratings calculations

spglobal.com/ratings