Enders Analysis—written evidence (FCF0050)

Communications and Digital Committee inquiry into the future of Channel 4

<u>Beyond Sustainability: Perspectives on the privatisation of Channel 4</u>

Question 1
What would be the benefits of privatising Channel 4? What are the risks and to what extent could these be mitigated?

Benefits:
We are encouraged by the Government's proposed Media Bill which will reinforce public service broadcasting and support Channel 4's obligations going forward in all scenarios, including privatisation. It is within Ofcom and DCMS's power to draft stipulations in upcoming legislation that can, at the very least, preserve existing commitments but we would encourage greater ambition than that.

Since we view Channel 4 as a business which is already sustainable, we believe that a key benefit to privatisation would be significant investment in new strands of activity, especially in production. As a guide, ITV spent hundreds of millions of pounds acquiring producers in order to build out ITV Studios. Since its acquisition by Comcast in 2018, Sky has invested several billion pounds in production facilities and original productions in the UK. Channel 4 is a renowned engine of creativity, and its own productions could lead to an international global SVOD or AVOD and strengthen its domestic AVOD strategy. The opportunity for Channel 4 to become a globally relevant producer strikes us as the major opportunity ahead.

There are examples of free-to-air broadcasters building a profile in international production, which has enhanced their sustainability through access to a much more reliable (in today's audiovisual market) source of income than advertising, namely production. For example, Viacom bought the Argentine network Telefe in 2016, and since then Telefe's production business has grown to exceed the legacy broadcast business. Viacom has also successfully built a production studio (Viacom International Studios) out of Telefe's domestic broadcast business. The Israeli company, Keshet, has launched a successful international production studio on the back of its broadcast business and produced hits which include the original *Homeland* format. Keshet International has now expanded to the US, Germany and the UK. In fact, we understand that, by and large, all commercial broadcasters today are investing in their own material and/or making for third-parties, not only as a hedge against advertising but also to compete as best they can in their domestic bases against global streamers generally commissioning for global IP.

A new owner would seize the opportunity to make efficiencies and extract synergies e.g. by combining back-office functions (finance, HR, IT and office administration) with another broadcaster. Significant savings can be effected without any impact on programming strategies (other than the potential for re-investing the savings in additional content). We have estimated that these savings could reach £100 million annually. If contractual terms for a new owner are strongly enough framed, and if the large savings available to a new owner as a result of rationalising mainly back-office costs are reinvested, it is reasonable to expect levels of commissioning in key 'public service' areas to rise.

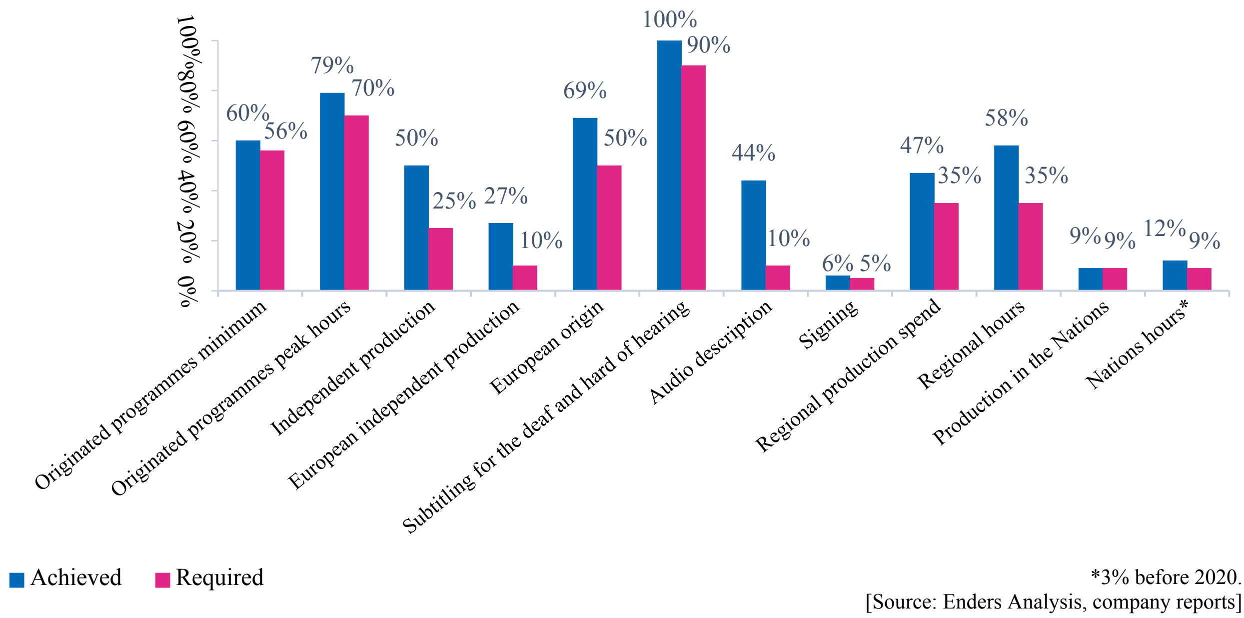
International companies with existing UK broadcasting operations and subscale streaming platforms—such as Discovery and ViacomCBS—could find channel and operational synergies in their cost base (we estimate between 12-15%) and 6-10% more in content costs. The upside from being able to produce its own content/acquire production companies or negotiate better terms with a relaxation in the Terms of Trade could certainly sustainably increase revenues.

Given the likely buyer will be a large international media company with a significant content library, another major benefit of privatisation could be All 4 becoming a much more formidable competitor to BBC iPlayer and AVOD services. All 4 could improve its functionality if the buyer has significant existing SVOD/AVOD expertise. Bundling opportunities with paid tier All 4+ abound if the buyer already has a portfolio of SVOD services, opening up an avenue to diversify further away from advertising by growing subscription revenues.

Lastly, and perhaps most saliently, we believe that there is a real benefit to Channel 4 in the absolute editorial independence private ownership would bring. As much as we like to believe the contrary, it has been a perennial feature of government-owned public service broadcasting that such bodies attract a high degree of political scrutiny. We struggle to remember an instance where governments wanted to weigh in on the corporate governance of ITV or pass comment on its editorial line in the same way that has been a feature of the stewardships of the BBC or of Channel 4.

Proposals to mitigate against perceived privatisation risks:
Firstly, the buyer could be required to increase the Nations & Regions quotas closer to Channel 4’s actual expenditure and hours produced. As of 2020, this was 47% of production and 58% of hours and spend outside of London, 12 ppts and 23 ppts over its obligations of 35%. Secondly, an increase in independent production quotas closer to Channel 4’s actual expenditure can be required. As of 2020, this was 50% of Channel 4’s production, 25ppts over its obligations of 25%. Lastly, the buyer could be set quotas for: film expenditure; the number of independents Channel 4 works with; the number of work experience placements, or partnerships driving employment initiatives; and Channel 4’s genre-specific diversity targets on-and off-screen could be ringfenced. Budgets for news and current affairs can be formalised, OOL commissioning targets and targets can be set on programming spend established at, say, £600 million. Initiatives like the Indie Growth Fund and 4Skills can also be ringfenced.

Figure 1: Proportion of hours/spend compared to minimum



*3% before 2020.
[Source: Enders Analysis, company reports]

A number of options for privatisation would attract competition concerns—a combined ITV and Channel 4, for example, would control 47% of the share of commercial impacts, although it seems pretty unlikely that Channel 4's sales house would be allowed to merge with ITV's, given that it would control over 70% of TV advertising revenues. Even if the sales houses were kept separate, advertisers and their trade bodies (e.g. ISBA) have expressed strong concerns about ITV acquiring Channel 4. This is due to the support among many for keeping ITV's CRR undertaking which was given in 2003 during the consolidation of ITV. While an acquisition by Sky may be more palatable to advertisers, they are likely to argue that a reduction of major sales points from three to two would be detrimental to competition. We believe that this could be mitigated by ringfencing the sales operation in a Sky News-type remedy.

Furthermore, there could be competition concerns on the production side; broadcasters that have stakes in large independent production companies may have conflicting interests. For example, Discovery owns a significant shareholding in All3Media, one of the largest producers and one which has an extensive track record with Channel 4.

Producers are concerned about the Terms of Trade as they believe that, over time, a proportion of content expenditure is likely to be spent in-house instead of with them. How quickly this might occur depends on the buyer—ITV possessing greater local production resources than the other likely acquirers, and Channel 5 disproportionately commissioning from indies that turn over less than £5 million—but could be addressed by a quota to guarantee outside commissions. O&O estimate £80 million of content spend will be lost to a Channel 4 in-house production arm in the first year after an initial push to move content in-house. After five years O&O have estimated that this would rise to £1 billion. We note that such a forecast lacks a real-life parallel. Historically when broadcasters have changed hands in this country there has been a significant uptick in investment. We also note that the new entity would have much greater commissioning capacity with an extra £100 million to spend every year on content.

In 2019, Channel 4 commissioned EY to look at the impacts of Channel 4 spending across the UK and found that it is already making progress on this commitment: spend for its main channel on commissions from the Nations and Regions was 47% in 2020, a GVA contribution of £274 million. It has been argued by others that there is a great risk that a private owner would want to diminish this set of obligations.

Another concern is that a buyer with a significant portfolio of sports rights behind a paywall, e.g. Sky or Discovery, may want to bend/flex the FTA listed events regime, the enforcement of which has yet to be tested. There are strong financial incentives for rightsholders to allow broadcasters to reduce FTA visibility in exchange for higher rights fees, although the reduced reach achieved may in the long term be detrimental to the sport.

The career support component also needs consideration. Channel 4's various apprenticeship schemes, youth outreach programmes and production traineeships are certainly valuable, but it would be very difficult to draft prescriptive guidance that would guarantee a similar or better outcome under a different owner.

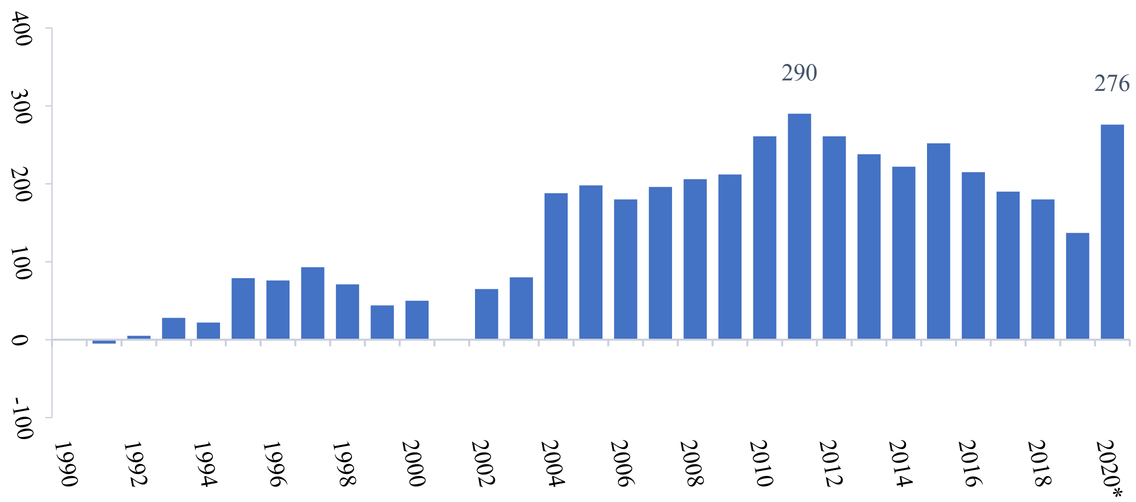
A final point about risk mitigation. As in the renewal of the National Lottery operated by Camelot, there needs to be a qualified bidding process so there is no 'open season' on Channel 4. The best way to cripple Channel 4 is an auction to the highest bidder, where a 'winners curse' scenario could lead to swift and savage cost-cutting in key areas. As an example, BT and Sky damaged their sports business models through relatively unstructured bidding processes. The best way to mitigate against that in the case of Channel 4 is to guarantee expenditures on what DCMS/Ofcom believe to be legally required public goods.

Possible supplementary questions

To what extent is privatisation necessary to ensure Channel 4's long-term sustainability, given current trends and competition in the sector?

Channel 4 may prosper more as part of a larger and more ambitious group, but Channel 4 is demonstrably sustainable, and will be manifestly more so with a new ten-year licence and broadcast legislation. One year into the ongoing COVID-19 pandemic, Channel 4 has proven remarkably resilient. In 2020, total revenues were down 5% year-on year (YoY), despite being the broadcaster most exposed to a downturn in the advertising market (93% of its income was derived from advertising in 2019) and suffering a 50% fall in linear advertising revenues at the height of the pandemic in April and May last year. Channel 4 has stated in its submission to the DCMS consultation that we will likely see 13% revenue growth in 2021 and perhaps the same in 2022. We agree with this forecast. Channel 4 successfully capitalised on the resurgence in the market in the back end of 2020, booking its highest ever monthly revenues in November 2020. Reflecting this record surplus, Channel 4's cash reserves doubled year-on-year (in part thanks to the drawn-down £75 million revolving credit facility, which we believe has now been paid back, remaining unutilised). Even so, stripping out

Figure 2: Channel 4 cash and cash equivalents (£m)



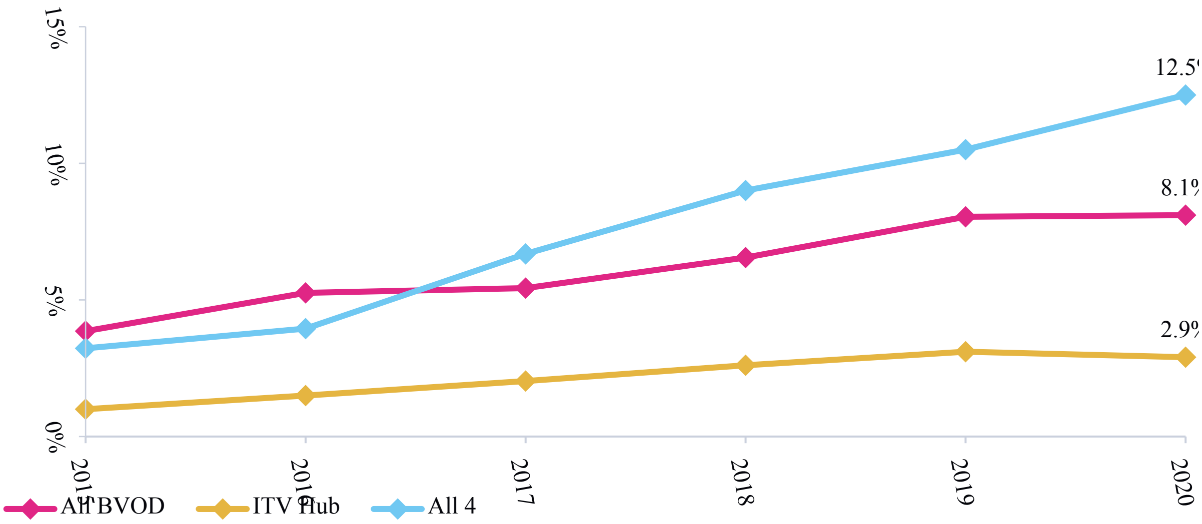
*Includes drawn-down £75 million revolving credit, to be paid back this month.
Note: the 1995 figure is net funds and is taken from the 1996 annual report. Borrowing took place in 1990 and 2001.
[Source: Company accounts, Enders Analysis]

the RCF, its cash reserves increased by £64 million YoY, and marking the first time the group has been cash positive since 2015.

Despite putting 21% less value on the screen through cuts to content expenditure, Channel 4 grew its linear viewing share in 2020, both for the main channel (5.9%, up from 5.8% in 2019) and the Channel 4 family (10.1%, up from 9.8%). This growth has continued into 2021, with a strong H1 with Q3 reasonably flat. Of course, all competitors have had the same issues with content supply and noted reduced content spends in 2020—ITV, for example, spent 14.3% less—however, this is in no way sustainable given the explosion in programming spends of the streaming services.

Channel 4 is under increasing pressure to differentiate itself to the same degree that it has done in the first four decades of its existence. The last ten years represent a step-change in this regard with the likes of Netflix, Amazon Prime and, more latterly, Disney+ as well-established as they are, chewing away at Channel 4's audience by causing young viewers to leak out of the PSB ecosystem. Channel 4’s efforts to address this drift and transition its viewers to consume content on All 4 are further along than its commercial linear competitors—a higher proportion of Channel 4 viewing takes place on its AVOD service than ITV. Channel 4’s long-term sustainability is tied to the success of its efforts to transition its audience to digital service and delivery—something that it is attempting to galvanise by lobbying for changes in the way that its impact is measured outside of linear, along with legislation, especially around online prominence.

Figure 3: Share of broadcaster’s total viewing via its BVOD platform



Note: Includes live streams.
[Source: Enders Analysis, Thinkbox, estimates based on BARB/AdvantEdge and company reports]

To what extent would Channel 4’s provision of public service content be affected by privatisation? Are there any programmes which Channel 4 has commissioned which a privately-owned public service broadcaster would not have commissioned?

In its submission to the DCMS, Channel 4 places great weight on its status as a publicly-owned institution as a critical parameter of its present output, and argues that ITV and Channel 5 have watered down their commitments to public service obligations, particularly in news. It should be noted that ITV produces significantly greater minutage of news in peak-time, and also provides regional news programming.

In terms of provision of 'public service content', privatisation won't *in and of itself* necessitate a reduction in such output, given there are examples of a) privately-owned PSBs increasing the provision of such content and b) non-PSBs making clear attempts to step up public service efforts.

For Channel 5, ViacomCBS ownership has seen a renaissance for the channel in terms of establishing a differentiated and clearly British identity, given the significant, obvious and extremely fruitful uptick in Channel 5's Out of London commitment with all things Yorkshire (*All Creatures Great and Small*, *Our Yorkshire Farm, Yorkshire Vet*, *Yorkshire Ambulance* etc.) despite C5's Out of London commitments being significantly less than Channel 4 on a statutory basis (10% of hours compared to 35% for Channel 4). Channel 5 has significantly increased spend on qualifying indies outside London since Viacom bought it. Channel 5 also has a continued commitment to children's programming, and is developing its news offering to include an hour-long programme at 5pm (this will reduce its news coverage in peak-time, but will require greater investment). This news offering will imitate Channel 4, which is currently the only PSB to have an hour-long news programme.

Sky runs a high-quality and structurally-unprofitable news operation and has built up a public service profile with Sky Arts (now a free-to-air channel), alongside the launch of Sky Nature and the provision of Sky Kids, both of which have clear educational components—none of this is mandated by Ofcom through quotas (as an aside Comcast has an undertaking to support Sky News to 2028). In terms of arts programming, which is commonly understood as 'public service', who is to say that the next owner of Channel 4 won't launch a Corporation-branded arts channel, even if there is no inherited remit in the event of a sale? Sky has even mooted launching its own regional news operation despite having no obligation to do so.

It is undoubtedly the case shows such as *It's a Sin*, which was turned down by the BBC and ITV, and *The Undateables,* have been popular and highlighted difficult subject areas concerning homosexuality and disability. Commissioning shows such as these have buttressed Channel 4's long-standing reputation for commissioning shows that tackle subject matters that others tend to avoid. Such perceptions have held true in Ipsos MORI polling which reinforces the remit and the enduring strength of the Channel 4 brand. On diversity issues, there are numerous examples of private broadcasters taking bold steps to broaden representation and heighten awareness of certain hot-button issues. Sky was vocal in prominently presenting programming on its Sky Q interface concerning race relations as part of its endorsement of some of the Black Lives Matter movement, and has committed £30 million to the cause of 'anti-racism'. Earlier this year, Netflix and Sky jointly launched a fellowship to support BAME screenwriters through a bursary scheme. Channel 4 commendably launched 'Black to Front' some weeks ago. Such programming and intitiatives are demonstrably not the exclusive preserve of PSBs and indeed Channel 4.

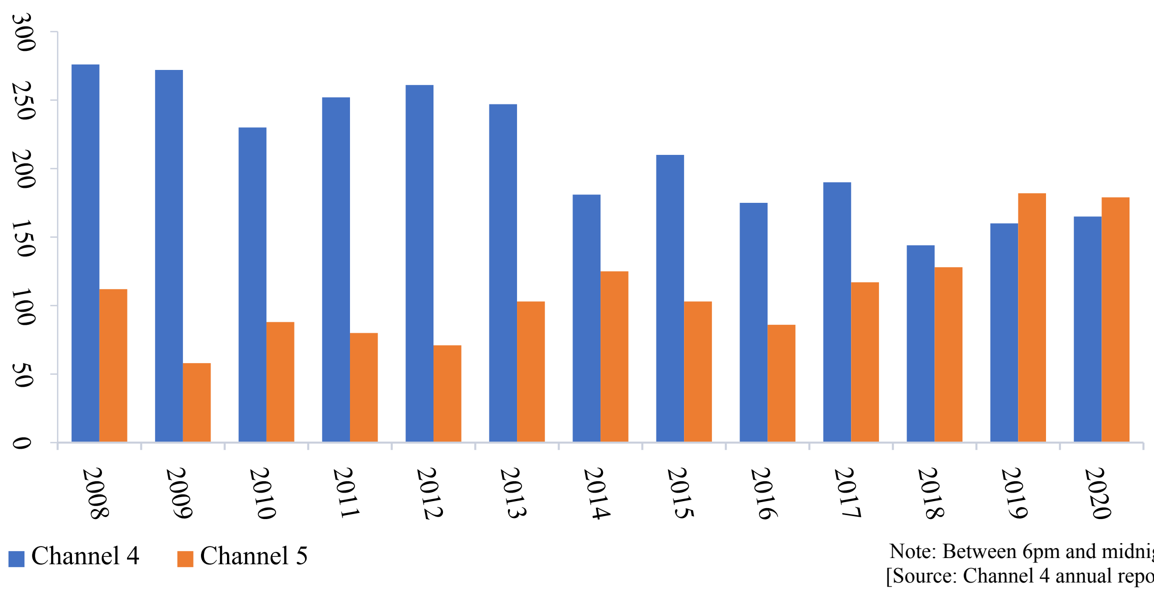
Question 2
We have heard from several witnesses about the risks of privatising Channel 4 for independent production companies – how could these be mitigated?

There is legislation in place guaranteeing that PSBs adhere to the 25% indie quota; this would not be necessarily affected in the event of a C4 sale. In the event of a change of ownership, one change that could be made would be for that quota just to apply to smaller indies, rather than to the likes of globally-established production behemoths. This quota can co-exist alongside in-house production capabilities: the BBC is a case in point. Creative hubs need to be maintained and supported outside the M25; independent production quotas may need to be required on a region by region basis.

The receptiveness to potential buyers of various initiatives like these is likely to be highly variable, but we have strong reason to believe that such carve-outs won't hamper the sale process to an appreciable degree, given the inescapable gamesmanship between potential buyers i.e. "how much do I lose out if another bidder gets Channel 4". Such gamesmanship gives the Government leverage to include certain obligations.

The chief mitigation is that a new entity will have a significantly larger budget to bring to bear on the UK's creative ecosystem, allowing much more substantial investment. This will come through vertical integration of commissioning and production, something that major media companies have reaped the rewards of through sustained increases in share prices. This largely applies to a Channel 5/Channel 4 combination—Channel 5 is still largely a publisher-broadcaster. Sky already is a vertically-integrated entity when it comes to production. In terms of bringing new and original programming to the viewer, it is clear that Channel 4 is doing less, whilst Channel 5 has increasingly performed the reverse, galvanised by the superior resources the parent can bring to bear.

Figure 3: New or one-off programmes on Channel 4 and Channel 5



Note: Between 6pm and midnight.
[Source: Channel 4 annual reports]

<u>Possible supplementary question</u>

How significant is Channel 4's support for small independent production companies, relative to other public service broadcasters?

According to the 2020 Pact census, the independent production sector had a total turnover of £3,330 million, of which £1,686 million originated from the UK.

Of that £1,686 million, £1,296 million comes from PSB commissions, of which Channel 4 is the second largest at £332 million (26% of the total).

The production sector also relies heavily on commissions from the UK's other commercial PSBs, ITV and Channel 5. For the 62% of the 171 production companies that have worked with ITV in the last two years, ITV's commissions represented half or more of their total projects, and it spends roughly £60 million on commissions from studios with turnover less than £10 million.

Channel 5 operates on a smaller scale than ITV and C4. Of the 139 tracked production companies the broadcaster worked with in the past two years, Channel 5 represented half or more of total commissions for 56% of them (as previously noted, Channel 5's Made outside London performance has dramatically improved under its current ownership). The annual Pact Census shows that the proportion of Channel 5's £77 million commissioning spend going to producers with a turnover of less than £5 million rose from 3% in 2018 to 20% in 2019. This put it ahead of the BBC (16%), Channel 4 (9%) and ITV (5%). Moreover, Less than 10% of Channel 5's budget went to the top-end super-indies in the £70 million+ bracket—a far cry from ITV's 49%, Channel 4's 38% and the BBC's 36%.

Channel 4 still compares very favourably. In an examination of the 207 production entities that have worked with C4 over the past two years, for 66% of those companies, C4 represented over half of their announced TV projects during the period (Ampere). Channel 4 has consistently sourced on average over 43% over five years of its content spend from smaller indies with a turnover of between £5 million and £25 million. Historically speaking, Channel 4 is still the standout performer among PSBs, commissioning more programmes from qualifying indies (turnover less than £10 million a year) than other PSBs between 2015-2019, according to O&O.

The BBC is also a critical component of the independent production sector. It spent a higher proportion of its external commissioning budget (36%) with small independents than did Channel 4 (23%). Furthermore, Channel 4 spent more last year (£174 million) with production companies owned or controlled by other media companies than with qualifying independents (which was £155m). Independent production has fallen from 64% of C4 productions in 2015 to 50%, however this is still well above the minimum required, despite content pipeline issues in 2020.

If Channel 4 is privatised, how should the proceeds be spent? Would a fund for public service content mitigate any potential reluctance of a profit-oriented owner to commission such content?

Proceeds will vary according to what is on offer in terms of reforming the status quo in terms of production. The potential for Channel 4 to build out its international profile heavily depends on its ability to gain more control of IP. We cannot think of examples where broadcaster consolidation has led to the purchased entity to reduce its overall outlay on programming; parent companies are keen to extract as much value as possible through investment.

We encourage key stakeholders to think of the Channel 4's potential international profile by freeing a parent entity to exploit the buoyant secondary rights market. Maintaining the status quo regarding Terms of Trade would lead to the new entity being held to a somewhat arcane competitive disadvantage, one that would also deter potential buyers who already have a vertically-integrated production architecture. Even with a turnover cap limiting producers eligible to sign deals under the Terms of Trade, the new Channel 4 would still have to negotiate terms for each show with the producers who do not qualify. And while these terms may potentially be better than current terms, it is difficult to see how Channel 4 could negotiate for, say, control of IP longer than three years, without paying a lot more: the starting point of negotiation would still be guided by the terms that the other PSBs continue to adhere to, along with the current Channel 4 agreement.

There is currently a boom in demand for British content overseas, with finished programme sales topping £1 billion for the first time in 2019/20, according to Pact. This is despite the Terms of Trade regime inhibiting the UK public service broadcasters' ability to act as dynamically in overseas markets as US content exporters. The key to unlocking further investment to ride this wave is to give these broadcasters an added incentive to invest heavily in programming that can travel—through allowing some ability to gain access to long-term, international rights. Of course, separate arrangements can be maintained for small independents, with further carve-outs for those in the Nations and Regions.

Question 3
What effects could likely buyers of Channel 4 have if any on the wider ecology of UK public service broadcasting?

The experience of Channel 5 through Viacom and Sky through Comcast are instructive in showing that consolidation inevitably leads to exchanges in technology and production which enhance long-term sustainability, leading to an automatic increase in spend on new programming. The merger of the Dutch subsidiary of the German free-to-air giant RTL with the large Dutch production company Talpa is also a useful parallel. Aligning Channel 4 with this M&A activity is in keeping with broader market trends toward vertical integration. Certain broadcasters have expressed to us that the current Terms of Trade regime have made it tough to exploit their domestic content portfolio to the full so it can participate in their parents' global AVOD and SVOD strategies. Be that as it may, the likes of Channel 5 will see more of its content travel well now that it is investing more heavily in long-form drama. Sky is a much more dramatic case, with the Elstree Studios proof of Comcast’s commitment to growing Sky's content slate, which is set to double to £1 billion by 2024, which will in large part come through UK originated programming (unsurprising, given it is Sky's largest market by far), take for example UK-originated hits like *Save Me* and *Gangs of London*. Sky is also investing hundreds of millions annually in its Elstree studios facility.

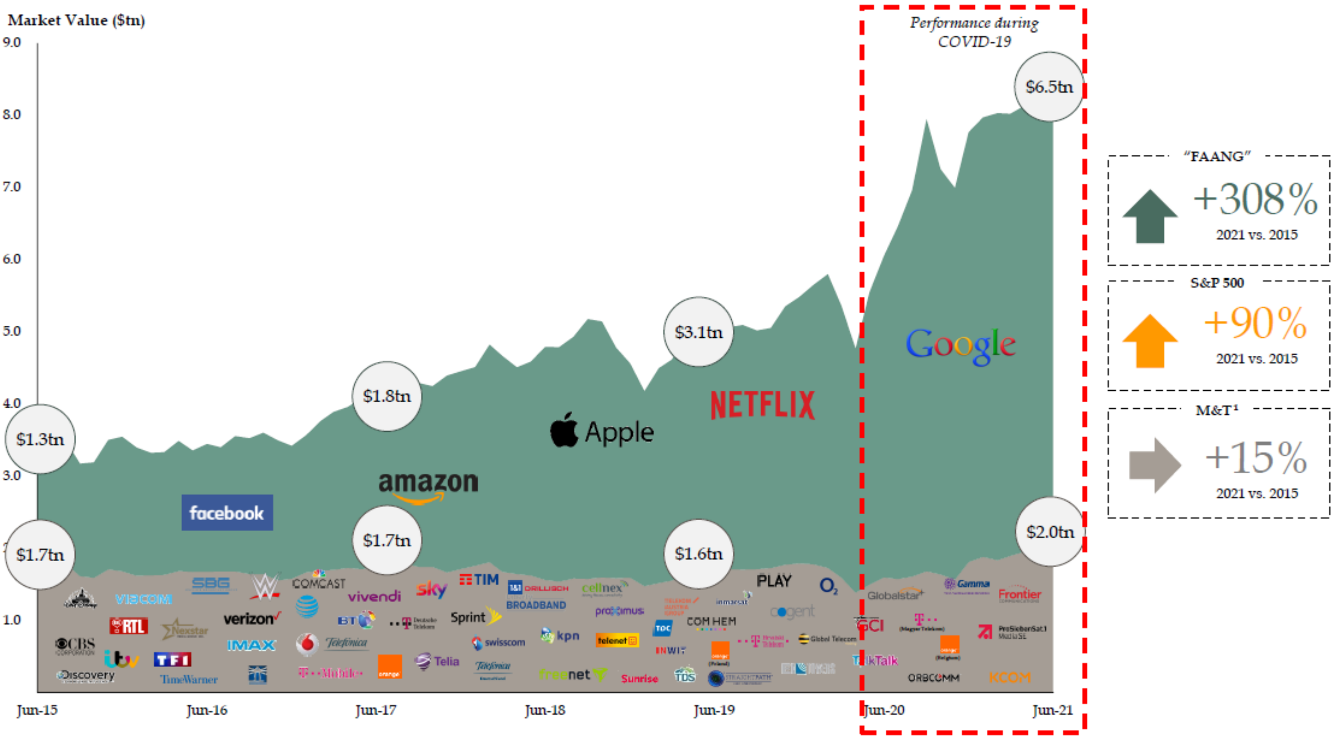
In the case of consolidation with Channel 5/ViacomCBS, we believe that this scenario could encourage significantly higher investments in UK production and build on Channel 4's existing missions—a healthy mix of continuity and an improvement in content investment (partly contingent on what DCMS envisages for Terms of Trade), without triggering major competition concerns. ViacomCBS already has a portfolio of brands that marry well with Channel 4's existing younger, more diverse constituency—pay-TV channels MTV and Comedy Central for instance have strongly overlapping agendas and identities with Channel 4 and E4, giving ViacomCBS a strong incentive to maintain Channel 4's existing profile. It is relatively straightforward to envisage content and commercial synergies when much of the buyer's portfolio shares a certain editorial ethos.

In the event of an ITV/Channel 4 combination, there is reason to believe that this can preserve policy agendas that appeal to the governments PSB goals. ITV is best placed to offer firm commitments to invest above and beyond production in the Nations and Regions to aid with the government's policy of "levelling up". With regional production centres already producing significant amount of content, alongside ITV's acquired production companies located outside London it would be relatively easy to offer a higher quota for regional hours/% of budget.

Possible supplementary question
To what extent would consolidation improve public service broadcasters' competitiveness in the international video market?

Wave after wave of consolidation in the entertainment industry has progressively dwarfed European operators: in 2010, the revenues of the region's largest broadcaster, the RTL Group, already amounted to just 20% of Disney's, and by 2020 this ratio had halved. The last decade has seen the emergence of global vertically integrated content producers and distributors such as Netflix and Amazon and the spread of this model to Hollywood-based studios, while the likes of Facebook and Google have grown to become direct competitors to TV channels that used to be seen as 'licences to print money'. Therefore, sustainability in UK terms is inherently a short-term perspective to adopt: flourishing in new ways is a much more ambitious project to enhance and protect cultural sovereignty and value creation.

Figure 4: Media & Telecom Sector Market Value vs. 'FAANG'



Covid-19 is accelerating the transfer of value from traditional Media and Telecom to 'FAANG'

Source: Capital IQ as at June-2021. Market value taken from Capital IQ using the following CIQ formula: "CIQ([company ticker], "IQ_MARKETCAP", [date (as of)], "USD", "H")"
1. Includes companies with a Market Cap greater than $500m in Europe / US

The lessons from this recent history are clear, UK broadcasters and the wider creative economy benefit greatly from the strategic flexibility that investment by a large overseas buyer can bring, alongside the ability to diversify their business models through the ownership of IP. New ownership could hand Channel 4, the potential of major international content partnerships. This would require considerably more investment in content than currently available, where Channel 4 is domestic-facing due to its remit and has sculpted its current agreement with independent producers to support that particular mission, and that one primarily.

Those broadcasters that have developed in-house production capacity have improved the sustainability of their business models, for instance ITV, where production is around 40% of total revenues, where ten years ago it was around a fifth. ITV has built, through a series of acquisitions, a global production profile only matched by BBC Studios in the UK. Sky now spends roughly the same on UK-originated programming as Channel 4 and will almost certainly surpass it in the coming years under Comcast's aegis. Comcast is partnering with ViacomCBS in their SkyShowtime joint venture as part of a joint SVOD strategy to expand Sky's presence to all of Central and Eastern Europe. Sky has partnered with ViacomCBS as well in its Western European markets, where we could start to see Channel 5 programming appear on Paramount+ in all its markets in the coming years.

It is almost certainly the case that such market events wouldn't be on the table if it weren't for the consolidation events that occurred. When seen in the light of these events, statements from Pact such as "If Channel 4 were to make their own programmes there is a question mark whether it would have the tenacity and self-motivation equal to that of indies to exploit content rights” leave us puzzled, when the evidence points to the contrary in the industry.

Channel 4 is a creative powerhouse, but there are signs that make the case quite clearly for greater investment in content, while there is little to no indication the Government will increase Channel 4's borrowing limit. Put all this together, it is nearing time in our opinion that a broadcaster of Channel 4's stature needs access to an owner that can draw on global partnerships, globally relevant technology and on global capital markets.

12 October 2021