Testimony of Aryeh B. Bourkoff
Wall Street Perspectives on Telecommunications Hearing
Senate Committee on Commerce, Science, and Transportation

Introduction

Good Afternoon. My name is Aryeh Bourkoff and I am a managing director and senior analyst at UBS covering the equity and fixed income debt securities of the cable TV, satellite and entertainment sectors within Media and Telecommunications. I am honored to be here today to present my perspectives on the cable television and telecommunications landscape in front of this committee.

I will provide a brief overview of the current Pay TV landscape and then discuss investor sentiment and viewpoints of valuation, highlighting key investment considerations.

Industry Background

In the mid-to-late 1990s, the cable industry deployed approximately $90 billion of capital in order to materially upgrade its network capacity to better position the industry to offer advanced digital video services, interactivity, and other applications. The majority of this investment was financed with internal cash flows and through public market debt financings. The cable industry has historically enjoyed access to the capital markets given the overall stability and predictability of its financial model.

During this period, the pay-TV marketplace became increasingly competitive. Satellite operators aggressively took market share, driving cable's share down from a peak of roughly 95% in 1994 to about 63% today. In fact cable's basic penetration – which we measure as basic subscribers as a percent of homes passed – is now as low as 50% for many of the cable operators.

As a result of the heightened competition for video services, the cable industry is seeking to differentiate its product by offering a robust suite of services to homes passed by its high-capacity network.

Current Environment and Valuation

Today, with the network upgraded and a full suite of service offerings in place, the industry is at the early stages of potentially its most operationally successful period. Nearly 85% of the country's homes will have voice available from the cable operators by the end of this year, with consumers receiving a bundle of voice, video and high speed data products at lower packaged prices with the convenience of a single bill.

Evidence suggests that consumers have embraced the bundled product offering. Penetration of voice services has proliferated at a rate above expectations – with operators like Cox Communications, Cablevision Systems, and Time Warner Cable reaching approximately 20% penetration of homes in certain markets already. In fact, Cablevision recently reported a full 24% of its subscribers now take the triple play bundle – a figure we expect to grow to nearly 50% by the end of 2007. Other advanced services including high-definition, digital video recorders and video on demand are also growing in popularity.

The cable financial model has evolved from a focus on annual price hikes to drive ARPU (average revenue per subscriber) which sacrificed customer penetration – to one focused on bundled pricing designed to attract customers and boost take rates and unit growth. Capital expenditure requirements are shifting toward variable subscriber acquisition costs rather than fixed network-related costs – with 70% of capital budgets now devoted to set top boxes and other consumer devices rather than backhaul and headend infrastructure investments.

Despite these promising prospects, cable-company share prices remain depressed, with valuations that are at or near historical lows.

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Topics Impacting Investor Sentiment

In my opinion, there are several key topics affecting investor sentiment towards the sector, and I highlight several of the most prominent here. First is the onset of intensifying video and bundled competition from the telecommunications operators, who are in the process of constructing robust wireline-based fiber networks themselves. Increased competition could result in higher customer acquisition costs and lower pricing in the mature US Pay TV market. Second is the perpetual concern over another capital expenditure upgrade cycle, particularly as higher capacity high definition services begin to fill up the cable network dial. Both of these concerns would depress expectations of future free cash flow which impact valuation.

Lastly, and perhaps most prominent, are the risks associated with disintermediation and regulatory uncertainty. Key issues that we consider in this category include the availability of content over various mediums with direct access to consumers (e.g. Apple's iPod, Google Video, etc.), a la carte cable pricing proposals, the net neutrality debate and the video franchise licensing process. As a result of these concerns, investors who typically make decisions based on fundamental views of valuation and the prospects of the business model are likely to shy away from cable industry investments given the increased risk to the predictability of cable model cash flows.

A heightened level of uncertainty and the diminished predictability will continue to weigh on valuation for the sector. Further, the financial and capital structures for the group could be at risk given an estimated $80+ billion of debt that is currently outstanding and held by investors. This is relevant given that the access to capital in the public debt markets has historically been robust due to the stability of the cable model and the well-understood and defined regulatory environment.

Conclusions and Viewpoint

As the committee reviews issues related to video franchising, I stress the importance of maintaining a level playing field among all operators while allowing consumer preferences to dictate changes to current models. Uncertainty among investors will persist if the rules surrounding obtaining a video franchise fluctuate based on the nature of the new entrants. In my analysis of the sector, I assume that there will be a fully competitive state between cable, satellite, telecommunications, and other providers with all operators given an equitable opportunity to service the customer base. With respect to the buildout requirements for new applicants of video franchises, I draw a comparison to the onset of new cable/telecommunications competition in the United Kingdom during the early 1990s where operators such as Diamond Cable, Videotron, and Telewest were required to meet certain milestones in order to preserve their licenses. Note that these cable providers were new entrants in that market competing with industry incumbents, including British Sky Broadcasting and British Telecom. Failure to build out a defined percentage of homes within the service territory resulted in fines and progress was closely monitored by regulatory bodies.

The consumption of video and other media services over the Internet is developing at a very rapid pace. I believe that it is too early to introduce regulation on key issues such as a la carte packaging and pricing and on net neutrality as the market is still in its early stages. Instead, I feel that at this point it is essential that market forces and consumer demand drive the economic model. Moving to an a la carte pricing structure would have an impact on the predictability of the distribution model as well as impose risks to content providers over the longer-term.

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The broader media and communications sector is perhaps at its most dynamic stage of its evolution as media content is available across multiple platforms under various pricing structures. This introduces investment opportunities as well as risk factors as the market place and business models are altered to meet demands of consumers. We believe that the most important place for regulation in the context of this environment is to ensure a level playing field for new entrants as well as incumbents, recognizing that we are already in a competitive situation, as well as in the close monitoring of potential conflicts that may arise. Further, we believe that there are profound risks of unintended consequences in the event that key fundamental aspects of today's landscape are regulated at such an early stage of development, innovation, and creativity. Changes are occurring at such a frenetic pace that any possible regulation today carries a risk of stunting this innovation if it does not build in enough flexibility for how the sector will look in the coming months and years.

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