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*The rise of
multichannel
networks*

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**Critical capabilities
for the new digital
video ecosystem**



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Executive summary



Video viewing habits are evolving rapidly, not just in mature markets, but globally, and especially among younger audiences. That explains the rise of multichannel networks (MCNs) — outfits that curate their own video content and partner with video websites like YouTube to distribute it. Now, traditional media companies are trying to get in on the action, by buying stakes in these new networks or acquiring them outright.

But because they are so new, and because their business models are not yet established, MCNs present real challenges to media companies when it comes to their integration and evolution toward long-term sustainability and value creation. The playbook for the traditional network and pay-TV ecosystem is not the right one for MCNs. Although traditional companies can leverage their experience and scale in building up their new acquisitions, they must be very careful not to break them in the process. MCNs have succeeded by moving very fast, developing edgy content, and being willing to experiment — not exactly key capabilities among most big media firms.

Through the lens of MCNs, media companies can master the digital video ecosystem, while at the same time using their own capabilities to improve the MCN business model. If the companies now buying these MCNs are to help them grow, they must work with them to produce more of their own content, seek out global audiences, and diversify their distribution and revenue streams beyond YouTube. Most important, they must foster the capabilities that have enabled MCNs to grow as fast as they have so far.

The advent of the MCN

The rise of digital video has been nothing short of spectacular, and most of it is attributable to one player: YouTube. The Google-owned firm now accounts for 63 percent of all videos watched around the world, according to Nielsen, and no other firm has more than a 3 percent share. YouTube attracts 1 billion unique monthly visitors — equal to 40 percent of the online population worldwide — who watch more than 6 billion hours per month.¹

These numbers have attracted a new kind of player to the media and entertainment industry — so-called multichannel networks (MCNs), which are quickly building a nascent business on top of YouTube’s massive user base. MCNs are not video “channels” within YouTube; instead, they are networks that aggregate thousands of such channels. Nor are they owned by YouTube; they partner with it, using its video platform to syndicate, monetize, and manage content they curate from digital video talent. Some MCNs have also started to produce their own original content as well. In general, YouTube is the only platform used by most MCNs, with the exception of their own websites, which feature similar video content. MCNs such as Fullscreen and Maker Studios already attract 3 billion to 4 billion video views monthly.² *Exhibit 1 (next page)* lists the most popular MCNs on YouTube by number of unique viewers.

Content on these networks is noticeably different from that on conventional video or YouTube channels. Although talent and shows are frequently organized in verticals or genres similar to those of cable networks — including news, comedy, and lifestyle verticals for cooking, beauty, music, gaming, and the like — the execution of the content differs in story selection, talent, voice, production style, and length. The tone, voice, and production all emphasize an unfiltered “authenticity” that is specially designed to appeal to a millennial or even younger-skewing demographic, as can be seen through the videos of MCN-based YouTube stars like teenage fashion sensation

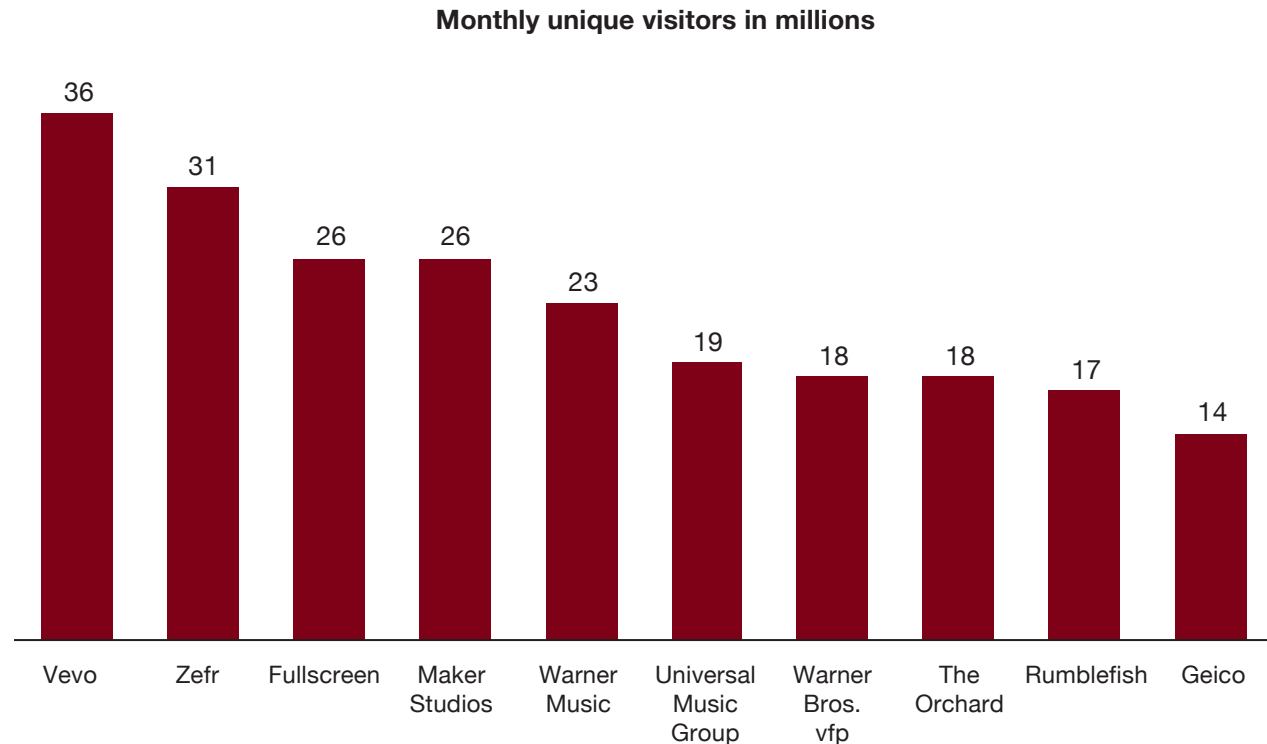
The tone, voice, and production all emphasize an “authenticity” designed to appeal to a millennial demographic.

Bethany Mota, video-game critic PewDiePie, and Truth Mashup, an online comedy show. Formats are primarily short-form video rather than the half-hour or hour-long formats typically used by conventional TV programs, and they vary considerably in the quality of their production. The topics are in tune with what is en vogue with younger audiences, and increasingly trigger the next online viral trends, in part because they are likely to be shared instead of merely viewed.

Topics on the more purely journalistic networks are often edgy and opinionated, like Internet entrepreneur Kim Dotcom and Russian rock band and activists Pussy Riot. Uninhibited by the need for future access to high-caliber interview partners, shows on MCNs often cover and say what other outlets do not. Firsthand, on-the-ground experience, accompanied by assertive commentary, is often more important than high-gloss production value.

Exhibit 1

Top 10 multichannel networks partnering with YouTube, January 2014



Source: ComScore

An M&A hotbed

The advent of MCNs has attracted considerable M&A attention from larger media companies looking to expand their participation in digital video, and more deals can be expected. In the summer of 2014, Food Network owner Scripps Networks Interactive led a US\$25 million investment round in food-centric MCN Tastemade, and European MCN Base79 was acquired for £50 million (US\$85 million) by video company Rightster. In the first quarter, Disney acquired Maker Studios for \$500 million, which could increase to as much as \$950 million with performance incentives. Smaller deals included Big Frame's purchase for \$15 million by AwesomenessTV, which itself was recently bought by DreamWorks, and Warner Bros.'s \$18 million investment in Machinima. German broadcaster ProSiebenSat.1 took a 20 percent stake in MCN Collective Digital Studio, supplementing its organic efforts to build up its own MCN, Studio 71, which launched in August 2013.

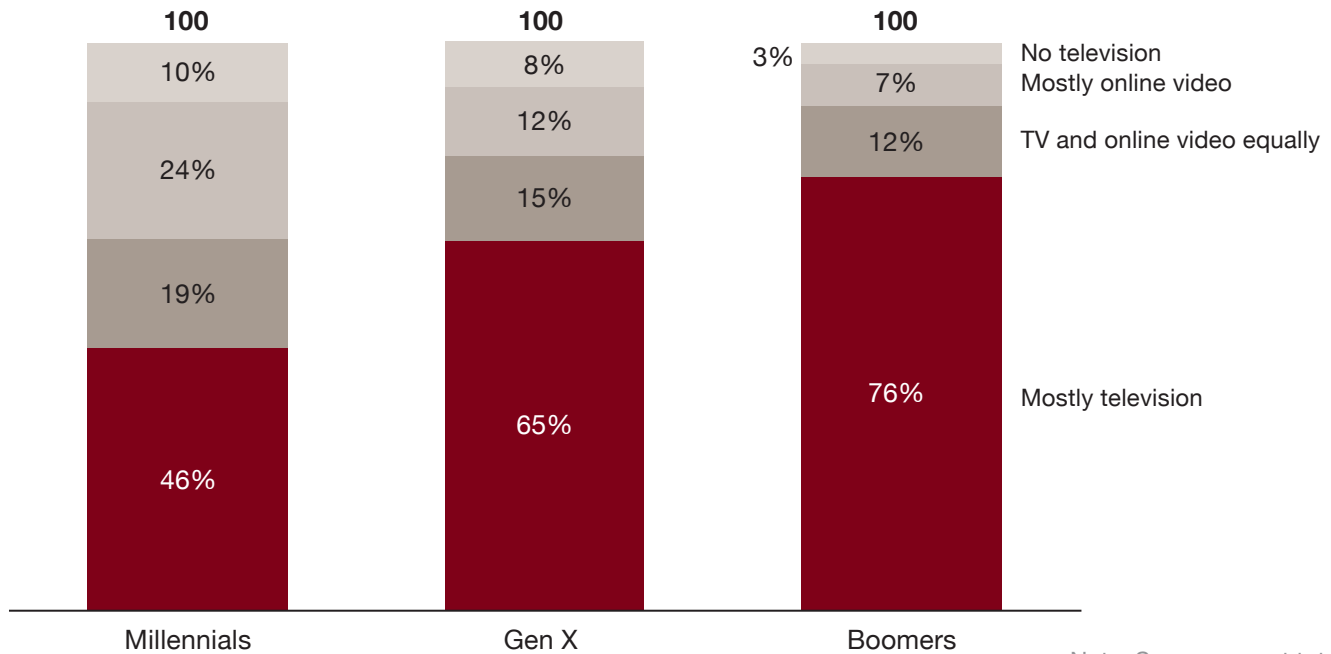
These deals are being driven by three fundamental trends involving the changing behavior of audiences and advertisers in the video and television ecosystem:

1. *Younger viewers are more likely to watch digital videos than television.* The traditional media distribution ecosystem is no longer sufficient to reach younger users and viewers. Last year marked the first time that digital video consumption surpassed television viewing among U.S. consumers.³ Younger audiences in particular are watching more and more short-form video online and on mobile devices, making them increasingly hard to reach via traditional television (see Exhibit 2, next page).
2. *Video ad dollars are migrating online.* Advertisers are following all those viewers onto digital platforms, and video spending is starting to shift from TV to digital. This trend will only increase. According to eMarketer, 75 percent of media buyers say they are likely or very

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Exhibit 2

Demographics for broadcast television versus online videos, October 2013



Note: Sums may not total 100 due to rounding.

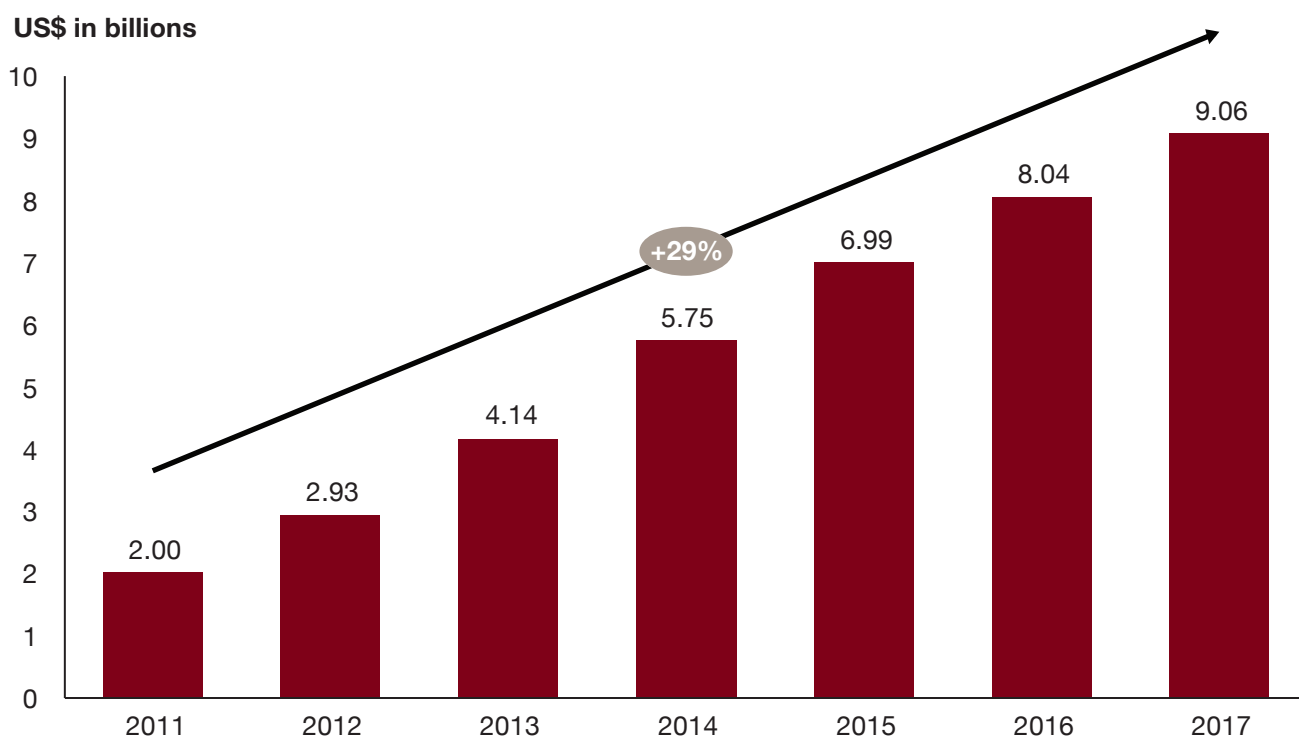
Source: *New York Times* video study, October 2013

likely to shift advertising dollars from traditional TV to digital video,⁴ and the continued rise of spending on digital video shows little sign of slowing (see Exhibit 3, next page). Advertisers like Verizon Wireless and Mondelez International, for instance, have recently shifted double-digit portions of their television ad budgets to online video.⁵ Video-focused media companies need to make sure that they have attractive digital offerings in order to meet the needs of advertisers as spending moves to where the users increasingly are.

3. *Audiences are global.* Demographic shifts are leading to rapid growth among audiences in emerging markets. Media companies are looking to build global distribution networks to tap into this growth opportunity, particularly from expanding middle classes with rising

amounts of discretionary income. Emerging economies are mobile-first, and growth in media consumption in those places is happening primarily on mobile devices. Some 15 percent of mobile users consuming video on their phones in Brazil — and 17 percent in China — do so more than three times a day. In the U.S., by comparison, just 2 percent do.⁶ MCNs can reach these audiences without the high infrastructure costs associated with traditional pay-TV, which means that media companies can achieve global scale much faster than ever before. In the near term, these international audiences may not be highly monetizable, at least not without companies standing up a global ad sales presence at scale. However, they may have significant promotional value for media companies' other assets, such as filmed entertainment. For example, Disney could leverage Maker Studios' large international audiences to promote its newest movie launches globally. As a result, these global audiences are becoming even more attractive for media companies.

Exhibit 3
U.S. digital video ad spending, 2011–17



Source: eMarketer,
March 2013

Can traditional firms keep up?

In the face of these trends, media and entertainment companies are competing to gain access to attractive new digital audiences at scale — and thus are engaged in an arms race to build up new capabilities critical for success in the video entertainment ecosystem. To do so, they have two choices: Build their own capabilities in-house or look externally for new companies to buy.

Although big media can invest in building new digital video capabilities from within, the history of big media on the Internet has proven that legacy companies find it very difficult to build innovative, highly scaled offerings with large user bases on their own. All too often, incumbents try to “export” the success they have had in their natural media domain to the digital world, using many of the same structures, systems, processes, business models, and talent. Experience over the past decade and more has shown that a digital “win” has to be genuinely earned — and that more often than not it requires a new approach that is more about reimagination than repurposing from a legacy platform to a new one.

Moreover, the nature of traditional media requires a great deal of planning, lots of meetings, and market testing. In contrast, most digital-native successes are the product of a more agile “launch and learn” process that shows a bias for action, gets product into market faster, and puts an emphasis on user experience combined with rapid-cycle iteration. Although MCN content selection can be very data-driven and far from random, there is also an element of scrappiness — testing an idea in the market quickly and cheaply, and then improving it. The ability to do so hinges on an innovative, experimental culture as much as on systems and processes. Finally, the structure and setup of many incumbent media companies make it difficult to attract the talent needed to drive a native win in digital

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— a challenge that isn't always resolved simply by paying big salaries and bonuses to big stars and producers.

At the same time, incumbent media and entertainment companies bring to the table many capabilities that can complement most MCNs. They typically possess considerable expertise in monetization, which will be critical to creating value from a newly acquired digital-native video asset. And large media players often have strong agency and marketer relationships, cross-platform packaging and brand integration prowess, and leading entertainment brands that can accelerate the advertising monetization of MCNs. Looking beyond advertising, many major content producers have significant intellectual property (e.g., television or film brands and characters), which MCNs can now access for use and distribution via their digital channels. In our view, this is central to the reason that Disney acquired Maker Studios. Along with brand IP, many media companies also have capabilities in licensing, merchandising, and packaging shows for output on traditional TV, gaming, and e-commerce platforms, which could help diversify the revenue streams derived from the content produced by MCNs.

Given those inherent capabilities and the recent M&A volume, major media and entertainment companies appear to be increasingly choosing the inorganic option. Doing so can generate several advantages quickly:

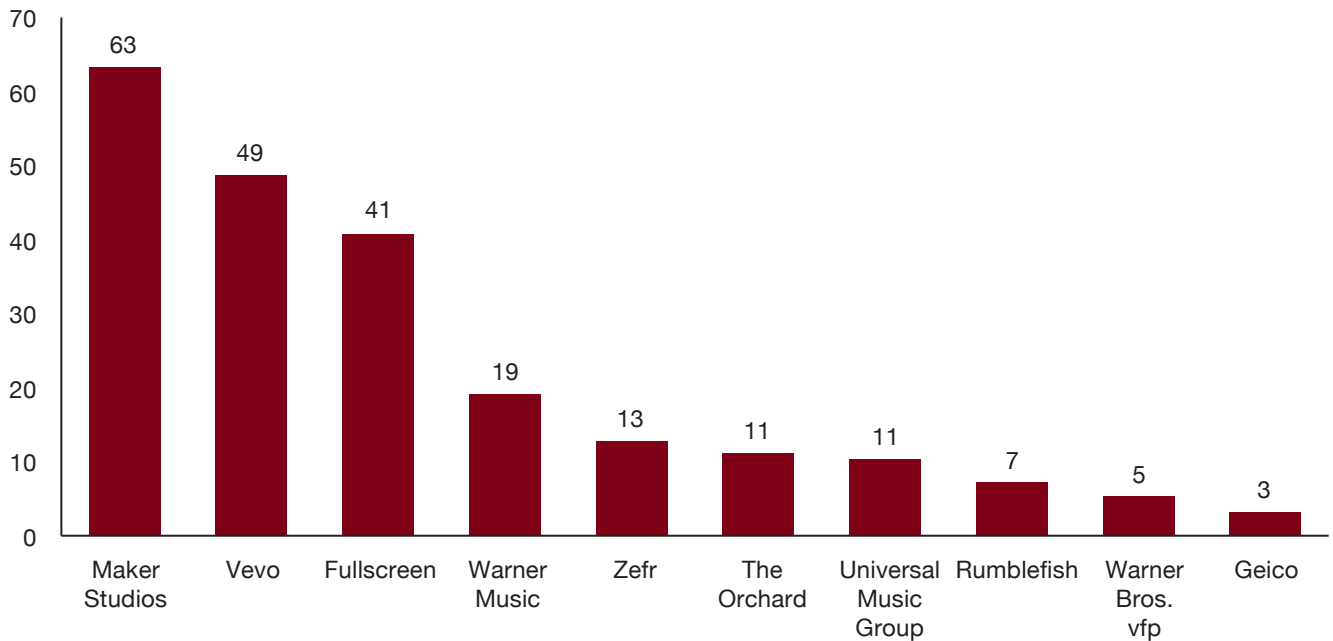
- *Learning agenda.* With their experience in the medium, MCNs can provide media and entertainment companies with significant opportunities to experiment and learn about what works in short-form original video content for digital platforms, about over-the-top (OTT) distribution, and about building direct relationships with viewers. Understanding how to make existing TV and film content even more successful online, as well as how to build fan bases for digital-first originals and monetize them via advertising and other revenue streams (such as subscriptions and e-commerce), is a critical new capability that can drive real value for traditional firms. In addition, MCNs can serve as a kind of “farm team” for new show ideas, brands, and creators that can perhaps eventually produce for major TV channels and filmed entertainment distribution.

Incumbent companies possess considerable expertise in monetization, which will be critical to creating value.

- *Demographic leadership.* YouTube has become the aggregator of choice for video content among millennials — a highly desirable audience for advertisers. Unlike traditional media companies, which are finding it increasingly difficult to engage young people via broadcast television, MCNs excel in this category. About 80 percent of the Maker Studios audience, for instance, is in the 13-to-34 age bracket.⁷
- *Engaged audiences.* Audiences for MCN content spend a great deal of time viewing that content. During January 2014, viewers of Maker Studios videos watched an average of 63 minutes, three times the time spent by viewers of Warner Music, the most popular traditional media player’s YouTube channel⁸ (see Exhibit 4).

Exhibit 4
Top YouTube partner channels, January 2014

Monthly minutes per viewer



Source: ComScore, January 2014

- *Instant global scale.* Acquiring an MCN would quickly give traditional media players an anchor position within the YouTube ecosystem. Maker Studios, for instance, has 55,000 YouTube channels and a global presence, with more than half of its audience outside the United States.⁹
- *New capabilities.* Large MCNs can provide traditional media companies with access to the creative talent, ideas, and storytelling angles that drive video content innovation for millennials at scale — capabilities that traditional media companies need to augment their own content development capabilities if they are to produce viable, attractive content for younger viewers and users.

Moreover, these digital video firms are quickly creating new ways of developing content that are far less based on intuition and far more analytical than their television and film counterparts. Armed with data from thousands of online video channels, YouTube networks have the digital tools and processes needed to generate insights that can help content creators develop and build audiences. The analytical insights needed to understand what's working, what gets viewed and shared, and why are not traditionally a strong suit of traditional video content producers and distributors.

- *Advanced technology.* Digital-native companies such as MCNs also possess proprietary technology — in digital production, content management, and predictive analytics — as well as talented in-house technology development teams, that traditional companies can benefit from.

Acquiring an MCN would quickly give traditional players an anchor position within the YouTube ecosystem.

The case for acquisition

Combining their inherent capabilities with the advantages that MCNs already possess can help media and entertainment video incumbents establish a position at scale in the digital video world and gain access to critical capabilities. There will certainly be risks and challenges. First, traditional players must formulate a clear strategy that establishes whether an MCN is needed to achieve an expansion into digital video, and what to do with the MCN once it is acquired. They must also decide which MCN will be most likely to add the complementary capabilities needed to deliver a sustainable competitive advantage — and therefore a viable ROI.

With a clear strategy in place, they must also find ways to integrate and leverage their new asset without “breaking” it. As past media acquisitions have shown, a business-as-usual integration process can limit or even destroy the digital-native capabilities of newly acquired firms, and thus lead to significant loss of value. Successful digital integrations preserve the acquired operating model or create a specific transition plan that details how each feature of the operating model will be implemented in the combined entity. They also protect the informal factors — “soft stuff,” like the target’s startup culture — that contributed to the acquired company’s success.¹⁰ At the same time, media companies must also keep the cost of an acquired MCN’s content in line with its revenue and monetization potential.

A business-as-usual integration process can limit or destroy the digital-native capabilities of acquired firms.

After the acquisition

Although the future of MCNs appears bright, incumbent media companies that decide to acquire or invest in one are advised to pay close attention to how the digital video business itself is changing and what that means for the MCN strategies that will win in the future.

Key to that effort will be to focus on converting the newly purchased MCN's sheer scale into a sustainably attractive business model. Thus far, MCNs that depend on YouTube have found it challenging to build a high-margin, stand-alone digital business within that platform. Currently, MCNs typically share 45 percent of their revenue with YouTube and an additional 35 to 40 percent for creative talent. As a result, MCN margins may lie between 15 and 20 percent, but because MCNs are growth businesses, they must often invest heavily in technology, in their own websites, and in building presence on other platforms — a requirement that often makes them unprofitable.¹¹ Depending on a single advertising revenue stream through Google to monetize a new asset will likely not be enough to create an attractive, sustainable business.

For the foreseeable future, YouTube will remain so important in the online video ecosystem that it will be able to defend its position as a “must-have” partner for MCNs. However, MCNs will likely evolve beyond YouTube, in several important ways:

- *Content creation.* MCNs will need to get closer to the process of creating their own content, moving from the role of pure aggregator to that of aggregator-producer. Developing more

MCN margins may lie between 15 and 20 percent, but because MCNs are growth businesses, they must often invest heavily.

original, premium digital content in a smart way — through the use of technology and new tools — will be crucial to reducing their current dependence on external creative talent, building their content library as a strategic asset, and strengthening their margins.

- *Platform diversification.* Pursuing distribution on platforms beyond YouTube is paramount for MCNs. Distribution channels may include other digital destinations such as AOL and Facebook, as well as players like Roku and Hulu. MCNs should also consider building out their own digital properties, where advertising and possibly even subscription and e-commerce monetization have potential as additional revenue streams. For instance, MCNs could use YouTube as the “top of the funnel” acquisition source for online video users, driving both the discovery of new videos and sampling by new customers, and then migrate these fans to other wholly owned digital assets with more favorable economics than YouTube. Their ownership by large media companies with their portfolios and cross-media experience should be a plus and an accelerator in this regard.
- *Direct audience access.* MCNs should focus on building more direct user relationships with audiences who want to subscribe to their channels. An intricate, data-driven understanding of and relationship with audiences is becoming increasingly critical in driving engagement, traffic, and monetization.
- *Next-generation monetization.* Developing revenue streams beyond advertising will become an increasingly important component of the business case for MCNs. Nearly all successful media businesses have at least two viable revenue streams. MCNs like StyleHaul that focus on lifestyles have already begun to explore advertising-adjacent models, such as product placement and sponsored

reviews. Others like Machinima are pursuing B2B partnerships in content production. MCNs need to intensify these efforts, along with other new business models such as licensing, merchandising, or gaming.

- *Global audiences.* The MCNs' potential audiences are now global, and users in emerging markets will play an increasingly central role in driving growth in video views. MCNs should pursue these audiences rather than relying only on the more mature markets of the U.S. and Europe. This will require that they broaden their content offerings to suit local markets around the world, and focus increasingly on pursuing local partnerships.

Conclusion

In video entertainment, viewers (particularly the coveted younger ones) are rapidly migrating to digital platforms and advertisers are following. Online video is expanding in terms of audiences and ad spending, and major video-focused media companies need to be there — quickly. MCNs represent an opportunity to achieve these strategic objectives, and at significant scale. Their success with advertisers and large media companies remains to be proven, as does the long-term viability of their business model. Traditional media companies looking to play in this area will need to make the right strategic choices, both when acquiring or investing in MCNs, and when managing those properties going forward. There will be challenges — most notably in the effort to grow revenues and expand margins, as well as integrating MCNs into traditional media cultures and their ways of creating content and doing business without breaking them. Done right, however, the MCN approach to digital video curation offers a great opportunity for large media and entertainment companies to develop new revenue streams and accelerate the development of capabilities they need to move forward in an increasingly digital media environment.

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