

ESG and the media sector: staying clear of the value traps

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Insights



The media sector as a whole is facing significant challenges, from media fragmentation to forthcoming regulatory change. Here we look at some of the key changes happening in the sector and analyse what these mean for investors.

Key points

- Media fragmentation and the growth in online advertising and social media are posing a number of challenges for the media sector.
- Media companies are being forced to innovate, with many currently transforming from traditional to digital media companies.
- Forthcoming regulatory change and an increased focus on ethics are also expected to be catalysts for change in the sector.

Before investing, it is important to understand not just companies' business models and balance sheets but also their risk management and corporate governance practices.

Media companies have certainly made the news headlines over the last 12 months, although often for the wrong reasons. Perhaps this is not unusual given the fundamental challenges, exacerbated by some serious corporate governance issues which the industry is facing.

The core of the media business model is quite simple: offer appealing content to attract an audience and sell the space to advertisers. However, areas that used to be monopolised by traditional media companies are subject to increased competition and there are a number of other cracks showing in the media business model.

So while advertising (and thereby revenue for media companies) is highly cyclical, there are several structural changes at play, which means investors need to do their homework and stay clear of potential value traps before rushing in to take advantage of the next upswing in the advertising cycle.

The challenges, implications and responses

Media fragmentation – more competition for the advertising pool

The rebound in *total* advertising spending immediately after the GFC masked significant media fragmentation. In short, media fragmentation means an increasing number of media channels for advertisers to reach their target customers through. The explosion of radio and TV channels in the last decades has been supplemented with a fresh wave of 'new' media channels, driven by technology change.

In some cases media fragmentation leads to more effective marketing as advertisers can reach specific target groups through providers of niche content. However, on the whole, it leads to greater competition for the total pool of advertising money, particularly during times when the key advertisers - the discretionary retailers - are facing tough markets.

Magazines and free-to-air TV are typically the victims of media fragmentation. Free-to-air TV companies like Ten Network Holdings are facing increased competition for advertising from Pay TV and now face the challenge of re-inventing themselves to adapt to the new fragmented media world.

In our view, Ten is in a particularly challenging vicious circle with falling TV ratings, which leads to lower advertising revenue, which in turn means less money to buy compelling content. In contrast, Seven West Media is outperforming both Channels Ten and Nine.

Pay TV has been a driver of media fragmentation and penetration in Australia remains relatively low compared to eg the US and the UK. That said, the Pay TV industry is also facing competition from new technologies and needs to invest in innovation. The combined Foxtel and Austar are in a relatively good position.

The circulation of magazines keeps falling as much of the content can be accessed for free online at anytime. Three listed companies Fairfax Media, and Seven have exposure to magazine publishing but this exposure is very small.

Radio companies Southern Cross Media Group and, to a lesser extent, Fairfax have remained relatively resilient to

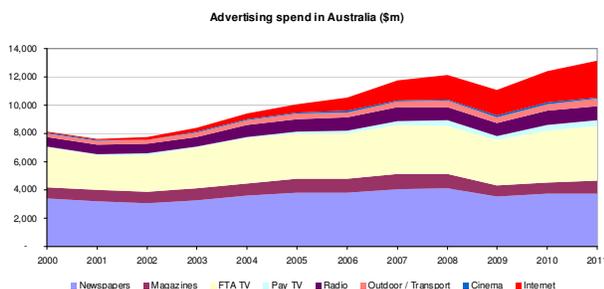
the ongoing media fragmentation, at least so far. However, the total advertising revenue is trending downwards.

Printed newspapers are facing some of the toughest conditions as media fragmentation is slowly but surely breaking down their previous advertising monopoly areas. This trend is strongly linked to the internet.

The internet – a headache for traditional media

Online advertising is growing relatively faster than other mediums and is forecast to continue to do so, particularly at the expense of printed newspapers. However, it is also expected to take some market share from free-to-air TV, radio and cinema while Pay TV and outdoor advertising are expected to be relatively resilient.

While the rise of online advertising should not come as a surprise to anyone, the biggest surprise is probably the speed of this growth. Online advertising is expected to exceed that of printed newspapers or free-to-air TV in just a few years as advertisers follow their customers online.



Source: CEASA, broker estimates

The growth in online advertising is linked to a myriad of drivers, including higher number of internet users, faster internet, more time spent online, better connectivity through mobile broadband/ internet devices, such as tablets and smart phones, more content available online as well as changing consumer behaviour, such as increased direct consumption online.

The trend poses a structural challenge for companies with printed newspaper operations (Fairfax, APN, Seven and NewsCorp), which are facing direct competition from specialised online competitors, such as realestate.com.au and carsales.com.au in areas that used to be monopolised. Newspapers have responded by establishing their own specialised publications.

Like other newspapers all over the world, Australian newspapers have extended their mastheads online. However, by rushing out online without charging for their content, newspapers are now faced with a big dilemma. While online newspapers are cheaper to operate, the costs for printed newspapers (printing and distribution) need to be covered. However, relying solely on online advertising revenue is unlikely to suffice and convincing readers to pay for content will be a big challenge. Among the daily broadsheets, only The Australian (NewsCorp) has dipped their toes in while others are waiting cautiously. The success rate for overseas newspapers' paywalls is very mixed.

Social media – challenging the need for advertisers to go through media companies

The social media sector is expected to be a game changer. While its name suggests it is the forte of media companies, investors need to think twice before buying into the social media strategies of media companies. While media companies have been quick to jump on the bandwagon, the key question remains how they are going to make money from it.

While media companies used to be the obvious intermediary between customers and advertisers, social media enables advertisers to shift from one-way communication to active engagement with their customers, effectively circumventing the media companies. According to social research, active engagement is what consumers are increasingly demanding.

So, rather than being the next big thing for media companies, social media can be a significant threat to many companies' earnings unless they can successfully re-invent themselves and become part of the new value chain. Australian media companies are at particular risk as Australians are relatively significant users of social media in an international perspective.

To illustrate the significance of the intensified competition for the pool of advertising spend and the reduced reliance on paid media for brands, consider the recent change in Unilever's advertising strategy. The company is planning to reduce the proportion of their marketing impressions from paid media from 80% to 60% by 2015, while increasing that from 'owned and earned' media from 20% to 40%. In Australia, Unilever is one of the top 10 single biggest advertisers.

At this point we struggle to see any winners from social media among the traditional Australian media companies. However, we believe advertising companies such as STW Communications Group are in a good spot to help advertisers to improve their direct engagement with customers.

Media convergence – increases the value of content ownership

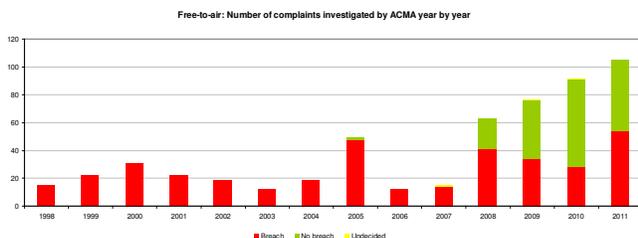
As a response to media fragmentation, the media sector is undergoing convergence where media companies are increasingly cross-selling advertising space to offer advertisers cost-effective multiple delivery platforms to reach their target audiences. Convergence is driven by technology change, eg digitalisation and the internet as well as higher consumer demand for quality, customisation and personalisation.

Convergence means that companies that generate a high proportion of their own content, eg NewsCorp and Seven, are in a relatively better position as their content can be broadcast over a wider range of platforms. Also, companies that sell the advertising will have this displayed over a greater audience. In contrast, buyers of content, e.g. Ten and Prime Media Group, need to increasingly invest to become multi-platform providers without cannibalising existing advertising revenue.

Digitalisation lowers production costs, which is positive for content producers. However, it also lowers the barriers to entry, for instance in the areas of news and factual content,

which reinforces some of the challenges for traditional newspaper publishers discussed above. In the past, newspapers had a competitive advantage in superior editorial quality. Now they are facing increased competition from bloggers and online low-cost papers.

Finally, we believe convergence could benefit advertising companies, such as STW, as advertising interfaces (for instance, PCs, tablets and smartphones) are increasingly becoming transactional commercial interfaces too.



Source: the Australian Communications and Media Authority (ACMA)

The ongoing Finkelstein Review regarding journalistic standards for Australian newspapers is not expected to lead to more regulation. However, it will likely lead to increased powers for the industry's self-regulatory body, the Australian Press Council (APC), which could lead to higher editorial costs for newspaper publishers. Although the APC has been criticised for being 'toothless', given our discussion about the importance of ethics and high standards, it is difficult not to be concerned about Seven's decision to withdraw from the APC to set up its own system of handling complaints.

Bearing in mind the many challenges facing media companies, investors need to understand how media companies are managing their risks. Our analysis shows that investors ought to be highly concerned about the general lack of discussion about ethical standards as well as lack of codes of conduct for staff among the listed Australian media companies. Our conversations with management of many of the listed companies about these issues do little to alleviate our concerns.

Corporate governance issues

As we have outlined above, the media sector as a whole is facing significant, although not unsurmountable, challenges. The job for investors is to evaluate how companies are placed and how they are responding to meet these tests.

As a starting point, successful navigating through the challenges facing the media industry requires good corporate governance and, crucially, good capital allocation. However, our review shows that compliance with the ASX Corporate Governance guidelines is poor in listed Australian media companies. Only a small minority (Fairfax and Ten) have a board where the majority of the directors are independent. Of the companies covered in our analysis, only 40% of the directors can be considered truly independent.

Only some (Fairfax and Seven) have independent chair persons. For example, while the number of affiliated directors on the boards of Consolidated Media Holdings and Prime Media Group reflect the capital and votes held by the main owners, the board structures raise the question about the board's accountability to the minority shareholders.

Perhaps more alarmingly for investors, our review highlights that many companies' audit committees, which have been put in place to monitor and review on behalf of the board the effectiveness of a company's control environment, reporting practices and responsibilities for accounting, risk management and compliance, do not exclusively comprise independent directors.

Of course, structural corporate governance issues such as those mentioned above do not automatically result in disasters for shareholders but they increase the risks of, for instance, related-party transactions, excessive executive remuneration and other issues that are not aligned with shareholders' best interests. We have already seen a number of value-destructive examples in recent years and the current board structures do little to prevent new ones.

With this in mind, AMP Capital continues to vote against a number of remuneration reports and director elections. In recent years, AMP Capital has, for instance, voted against the remuneration reports of Austar United Communications and NewsCorp. In addition to voting, AMP Capital has also engaged with many companies and highlighted our main concerns.

Staff engagement – analysing the 'black box'

As discussed above, investors should be concerned about the general lack of discussion about ethical standards and codes of conduct for staff among the listed media companies. In addition to potential direct financial consequences, poor focus on ethics can also have an impact on staff morale and attractiveness of a company as a potential workplace.

As media is a people's business, the ability to attract, develop and retain people who can drive innovation is a key issue for earnings growth. Companies committed to training and development run the risk of becoming career springboards unless they can successfully retain their staff and getting new people up to a productive level is time consuming.

With that in mind, it is a concern that it difficult to get insight beyond the usual metric of staff injury rates. Few companies are disclosing performance on leading indicators for staff engagement, such as diversity, absenteeism and voluntary staff turnover. Fairfax has recently launched a staff engagement program and has improved its disclosure. In contrast, we have found little meaningful disclosure about staff engagement for APN, Ten, Southern Cross and Prime Media. In the absence of publically available data, knowledge that at a company is at least tracking its performance is a good sign. STW says that its retention rate has improved and churn rates are now well below industry average.

The media industry is a large employer of women. This is why investors should be concerned about the lack of disclosure on management of gender diversity among listed media companies. Fairfax is one of few companies that disclose their gender diversity. However, while 52% of the organisation are female, only 18% of the senior management positions are held by women. There is also a notable lack of gender diversity on the boards. Disparity between the total level and management level can sometimes be a lead indicator of voluntary staff turnover.

Some companies, eg Seven and STW, are at least acknowledging the importance of diversity.

Environmental footprint and community relations

Relatively speaking, the media sector's environmental impact is low when compared to other sectors, which means that environmental issues are a relatively low risk for investors. The main issues, which differ widely from company to company, relate to energy and water consumption in head offices and data centres, travel, CO2 emissions from printing and distribution and consumption of newsprint and other paper. In terms of recycled newsprint, the Publishers National Environment Bureau (members include, for instance, Seven, NewsCorp, Fairfax and APN) has driven Australia to a relatively good position compared to many other western economies. This is important as it lowers the risk of stricter regulations. NewsCorp became carbon neutral in 2010 and Fairfax is planning to set a CO2 reduction target.

Media companies play an important role in terms of social sustainability as a provider of vital services to local communities. Maintaining good relationships with the local communities is important to attract audience and advertisers as well as staff, particularly for regional operators (APN, Southern Cross, Seven and Prime Media). Our review shows that most companies are donating to local or national charities on a corporate level. Perhaps more importantly, many are donating advertising space to not-for-profit organisations.

Conclusion

The significant changes currently occurring in the media sector are putting pressure on companies to innovate. This requires sound corporate governance and capital allocation. Many companies are currently transforming from traditional to digital media companies and there will be good and bad investment decisions made along the way. This is why poor corporate governance structures and, consequently, decisions that are not aligned with shareholder interests pose a real risk to investors.

Social media is a game changer and investors would do well to establish how and if a media company will make money from it. Investors also need to consider how the media value chain is changing and how companies are placed. For instance, some are facing opportunities from the increased strategic importance of content ownership while others are facing increased risks as a result of lower barriers to entry in other areas.

Media companies also need to maintain a strong focus on risk management. Failure to do so will hurt the brand, lead

to loss of audience and advertisers and, in extreme cases, the loss of licence to operate. This is why investors need to have a good understanding of how companies are managing their social, community and, to a lesser extent, environmental risks. Perhaps the key issue is the ability to attract, develop and retain the right people to take the company forward in an increasingly complex world.

Overall, disclosure on these issues is poor across the board. However, investors that do their homework can detect the risks before it is too late.

In conclusion, our review favours a long-term portfolio positioning with overweight content owners and 'new' media, including facilitators, such as STW, while underweight 'traditional' media and buyers of content, such as Ten. The dismal share price performances of many media stocks and the resulting valuation levels might be tempting for investors. However, we believe investors need to see beyond deceptive value traps. Based on our ESG review, we would argue that in many cases, the risk/ reward ratio remains poor.

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