Cutting the Cord and its Implications

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Do you still pay for cable TV?

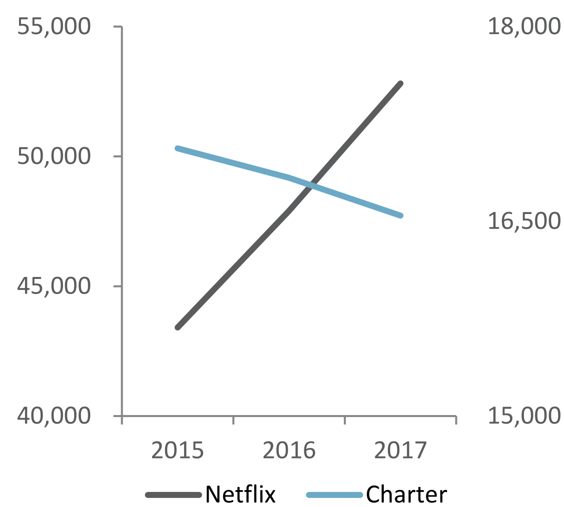
Changes in technology are affecting many parts of consumer's lives. We are in the midst of a major shift in the way people consume and pay for media. "Cord-cutting" is when a customer stops buying video entertainment from a cable company in the standard way and opts instead to use new (often internet-based) ways of accessing video entertainment. This is a trend that we believe will continue for many years and is driving significant changes in the business models of companies. As seen from Comcast's third quarter 2017 conference call: "First, our broadband business is increasingly the epicenter of our relationship with customers and ultimately where we derive the majority of our profitability."

These changes introduce risks that we will factor into our decisions while investing in this sector over the transition. We believe the more diverse companies (having multiple products and revenue streams) are better prepared to weather the storm and we will be cautious and opportunistic on less diverse companies that may need to make acquisitions or large investments to remain relevant.

For years the only real choice that a consumer had was to get television from the single cable provider that had a license to operate in their city or town. In 2005, Verizon launched FiOS as a fully fiber optic network that was a true cable alternative. While this introduced competition, it was sold to the customer in essentially the same way as cable in bundled set packages at various price points. Since the underlying video product was very similar; consumer choice was based largely on brand and price, if they were in an area in which Verizon offered FiOS. During this time, all operators upgraded their systems and broadband speeds.

Roku, Apple TV, Xbox and PlayStation all provided functionality to allow people with a broadband connection to access content another, often less expensive way. Consumers increasingly opt for accessing video through non-traditional sources delivered over the internet (OTT) like DirecTV Now, Sling, Hulu or a subscription video on demand (SVOD) service, like Netflix and Amazon Prime.

Exhibit 1: We can see the decline of video customer numbers of Charter Communications compared to the increase in Netflix subscribers



Source: Opus Investment Management estimates and company reports

We analyzed the quarterly results and operating data that Charter Communications provides to quantify this trend. The number of Charter customers taking only the broadband product has been growing substantially in the last two years and now represents over 33% of customer relationships. In addition, over the same time, due to competition and cord-cutting, the gross profit margin of the video product has been steadily declining.

We believe this is a trend that will have investment implications that will flow through our thoughts in the various sub-sectors of the Telecommunications and Media sector as follows:

Content Providers: Content providers are loosely defined as any company that creates video content (tv shows/channels, movies, etc.). Content providers over the past decade reaped the benefit of strong price increases. The entrance of Netflix, Amazon, and potentially Facebook are increasing competition for content and driving up the costs of production. At the same time, consumers are getting savvier on what and how they consume with the intent of reducing total cost and increasing flexibility. We believe this will lead to consolidation and streamlining of media companies similar to AT&T/Time Warner and the pending acquisition of a portion of Fox assets by Disney. These mergers create very large and diverse companies, which is a credit positive in this environment but will also create companies with very large absolute debt levels which can cause credit challenges.

Telecom Companies: The large telecom companies have spent tens of billions of dollars building fiber networks to be competitive with cable. In addition, the large telecom companies that own wireless companies are planning 5G wireless (the next generation of wireless technology) which in urban areas could deliver internet speeds competitive with current broadband speeds. It remains to be seen whether the commercial reality will match the tech hype but this will almost certainly increase capital expenditures. The smaller rural telcos have been behind the curve for a while and they will need to invest in expanding their networks, something which their stretched balance sheets will only allow on a limited basis. Overall, telecom companies big and small will have to spend more on capital expenditures which will reduce cash flow and pressure credit metrics.

Cable Companies: The cable companies have been winning this battle as the upgrade of their networks is more manageable from a cost standpoint. Topline revenue will face pressure as video subscribers continue to decline, which will also push them to invest in capital expenditures to maintain their speed advantage in broadband. The larger investment questions facing the cable sector will be *is there a need for wireless* (which none have in scale) and *is there an advantage to owning content*?

In summary, there are significant changes under way in the way people get and pay for video entertainment. These changes are expected to result in increased mergers within the sector, increased spending and the chance for variances in performance among the various companies. We will navigate these changes in our quest to deliver you signature performance.

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