A new style of consolidation for a new industry

There is no more interesting way to follow volatile capital markets and a fragile economy than through the eyes of a fragmented industry in massive transition. We are of course referring to the media and telecom sector, broadly defined, an industry that for several years now has seen (and continues to see) unprecedented change in the way we communicate, consume entertainment, and receive advertising. The trends that have pushed analog to digital, broadcast to interactive, paper to online, professional to user-generated (and maybe back again), fixed to mobile, programmed to customized, and the convergence and reformulation of all these facets, have been well documented. The principal questions that linger, even as the described evolution shows little sign of abatement in a slowed economy, center around P&L. How will companies in this dynamic industry sustain profit, in some cases even generate profit, and more often than not, begin by just generating revenue? As has been the case in the media and telecom world going back as far as the early days of radio, newspapers, cable television, and other traditional modes of communication, sector economics are still largely dependent on advertising, consumer spending, and when operating efficiency is tapped out, capital structure. Because all three of these factors are now being challenged by uncontrollable circumstances, we are left to wonder how the sector will fight its way through the 2009 timeframe and find ways to create value for shareholders. One of the answers, maybe the only answer for some, will be industry consolidation. This also has been a staple of the industry landscape since time immemorial, but in the current environment we look for variations on the theme, reflecting new industry realities that have emerged.

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Fundamentally, the issue is one of cash. In a slowing economy that is likely to pressure discretionary spending, as advertising dollars are by all accounts expected to diminish or grow at a much reduced rate, and as capital expenditures on network build-outs are likely to be squeezed, alternatives for cash generation seem limited. There is the traditional cost cutting strategy, but there are limits to the cutting that can occur before business suffers – and business growth will already be challenged in the described environment. In the past, such cycles could be bridged with new cash infusions – even if in the form of DIP finance, a sore subject – but capital markets do not present much of an option for new cash infusions these days, and even DIP finance is more difficult to obtain. For the fiscally sound projects, traditional financing sources that remain active are now growing accustomed to the luxury of cherry-picking the very best opportunities, and pricing these as if distressed. And in the normally private world of venture capital, high profile investors (most famously Sequoia with a slide deck that generated more page views than YouTube) are quite publicly asking portfolio companies to make do with existing resources. Private equity firms and their limited partners are in the meantime looking for ways to sell parts of their funds or LP interests in the [cough] secondary market.

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These are sweeping generalizations, of course, and there are still exceptional success stories (e.g., Huffington Post on the heels of a successful political season, raised another round of venture capital at a reported $100 million valuation). As a general notion, however, to cover the span of an entire industry and capital market, we arrive at consolidation as a nearly inevitable path to cash flow and economies of scale, even if only by process of elimination. There are, however, other reasons also.

When the media and telecom world was simpler, consolidation within a fragmented field in some cases signified the combination of geographical markets (radio and television broadcast, newspapers, cable, cellular service), in others the combination of brands or other franchise assets (magazine titles, entertainment studios, television networks), and in others still the combination of discrete and defensible assets (satellite fleets, tower portfolios, server farms). This brand of consolidation, however, which is probably not yet complete, does not add to an acquirer's or merger partner's capabilities as much as it does to size. It is a difference of quantity as opposed to quality. The Internet and its slew of constituents, dependencies, and supply chains, have changed this quantity dynamic, on account of its two principal features: ubiquity and low barriers.

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The Internet and new media brings with it a new profile that is not based on geographical markets, franchised assets, or capital intensive properties, as much as unique technologies and features, popular applications, and audiences (or advertisers) that are drawn to these at least until the next best thing comes along. Thus, when we speak of consolidation in this new environment, and the motives behind it, we are not only referring to economies of scale but also to ways that media or communications companies may find to add new features and integrate new technologies that complement an existing core application or set of services. In this environment, consolidation is not only a growth strategy, but also a defensive measure in a dynamic field.

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We saw a large symbol of such activity in what was the collapse of the proposed Microsoft/Yahoo merger, to be redesigned as a much more modest but also more focused combination based on Yahoo's search engine and related technologies alone, (reportedly under consideration). We also saw a hint of this type of consolidation in the proposed acquisition of Twitter by Facebook, which transaction was reportedly rejected on the basis of valuation (rather than strategic rationale, which was to enhance the offerings and features of Facebook with a new popular application). We are also now beginning to notice select deals that involve the acquisition of distressed new media targets at negligible prices, mainly in order to obtain high quality personnel in the process. Six Apart has done just that, reportedly acquiring Pownce but planning to shut down its service while retaining its key staff.

It can't be very long now before the traditional media and communications companies join in on this emerging wave. The development of web platforms by newspapers, radio operators, satellite radio, and even the television networks, has been a good start, but not nearly enough and probably the tip of the iceberg. In light of the sophistication and continuing innovation of digital media, it will be imperative for traditional players to keep up, and we suspect that they will. Just yesterday, CBS announced that it will take over Yahoo's Launchcast music service, combining this huge streaming platform with its popular social music and interactive Last.fm property.

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