# Worth Noting

**The Fortnightly Newsletter of L21 Management Consultants**

**Issue 1, August 27,2001**

*Worth Noting is the fortnightly newsletter of L21 Management Consultants. The aim of the publication is to provide our clients and associates with insights of relevance to their business. It will be distributed every second Monday.*

*Worth Noting* will focus on the three key practice areas of L21, namely:

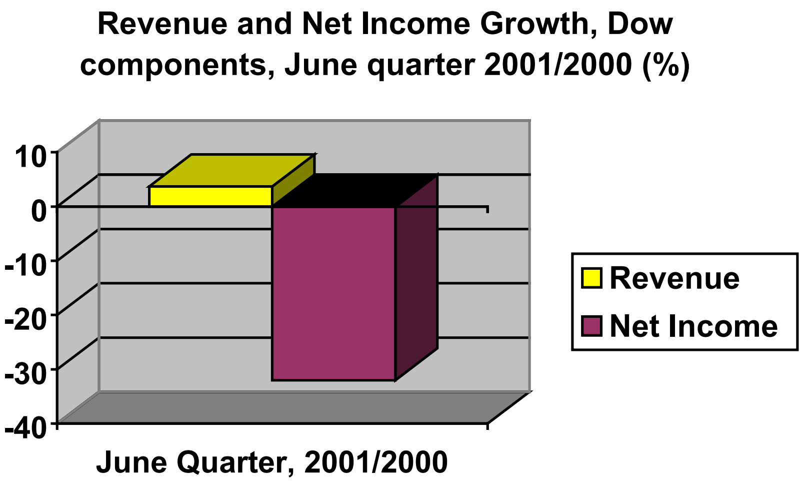
- Strategy
- Growth
- Business Development

## Practice Area: Growth

**Earnings Growth on Flat or Declining Revenues**

With the reports of all of the Dow components in for the June 2001 quarter, we thought it was worth looking at the performance of these companies on both a revenue and earnings basis. To give our analysis the most current edge possible, we compared only the June quarters of 2000 and 2001.

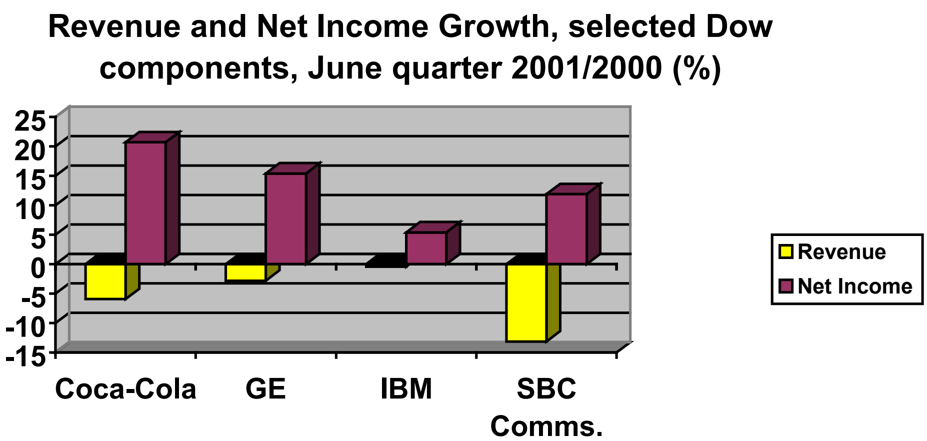
The results were interesting, one of the obvious takeaways being the disproportionate effect on earnings which flat revenue growth produces. Thanks largely to strong revenue growth from low-margin giants Wal-Mart and Exxon Mobil, the Dow components managed to eke out a small rise in total revenue. But net income was a very different story, with a total fall of over 30 percent.




Source: Company Reports, Hoover's

Excludes JP Morgan Chase, Citigroup (reporting issues caused by recent mergers/acquisitions)

One of the more striking outcomes of the analysis was the performance of four of the Dow components, which have managed to grow net income despite falls in revenue. Most companies' net income fell proportionately more than revenue, making the performance of these Dow components outstanding.




Source: Company Reports, Hoover's

This issue – how to grow earnings in times of flat revenues – is one of the most important of 2001. In the next issue of *Worth Noting* we will look at the strategies that each of these four companies have employed to grow earnings despite falling revenues.

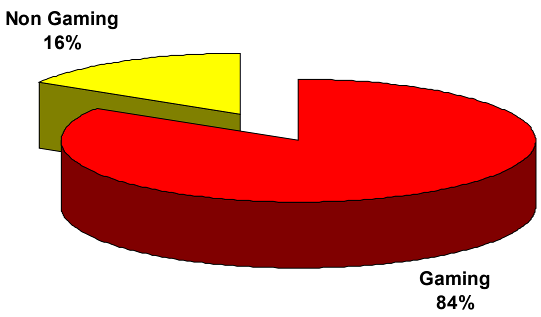
## Practice Area: Business Development

### New Products in Television

Over the past few weeks we have been spending some time looking at the market for interactive television services in Australia and overseas. The promise of ITV, and what we tend to read about, is the incremental revenues that can flow from new paid services. The conventional wisdom is that the medium's promise lies in its ability to drive new revenues through shopping, financial services, paid viewer response activities and so on.

Interestingly though, things aren't turning out like this in the world's most developed interactive TV market, the UK. Market leader BSkyB's report for the year to June 30 makes compelling reading. BSkyB was the early leader in interactivity, pioneering among other things ITV shopping with software developer Open TV. It is easily the largest provider of both Pay and interactive TV services in the UK. BSkyB's ITV revenues accounted for just 4% of all its revenues for the 2000/2001 year, with the breakup of those revenues being starkly in favour of gaming.

**BSkyB Interactive Revenues, Year to June 2001**

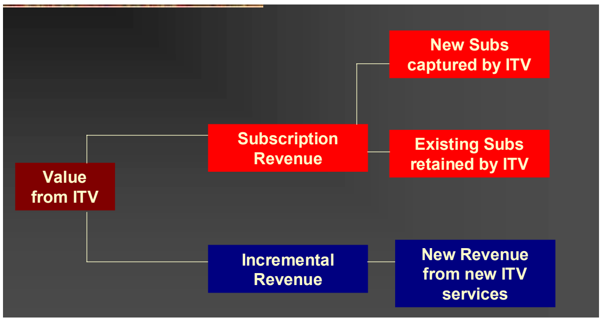



Source: Company Report

Excluding gaming, ITV revenues accounted for less than 1% of the total, and unsurprisingly costs were significantly higher than revenues.

The company is winding back its investment in ITV in most areas, having recently taken a charge for the restructuring of its interactive unit. Gaming is where its ITV focus is going, while investment in areas such as shopping is being wound back.

It is tempting to be sceptical about ITV on this basis. But we think it is important to remember that ITV should not be judged on its ability to add incremental revenue alone. Particularly for Pay operators, ITV can contribute significantly to earnings even if revenues from discrete ITV services are insignificant. Quality ITV services will drive subscription revenues, as consumers switch to the operators who provide them with the best quality experience. And equally, quality ITV services can help retain existing clients.




Source: L21 analysis

In the figure above, the blue section represents the growth that is generally attributed to ITV – its capacity to bring in discrete new revenues. But just as importantly – and we think more so – ITV can attract new paying subscribers to an operator or help to retain subscribers who might otherwise leave one operator for another, or discontinue Pay TV altogether. Quantifying the red section of the chart is difficult but an important analysis that should be done by all Pay TV operators.

The key for management, in our view, is minimizing ITV capex while providing consumers with a service of sufficient quality to encourage new subscriptions and operator switching. It is clear, though, that limited evidence exists to support business models that project large incremental revenues from ITV.

## Practice Area: Business Development

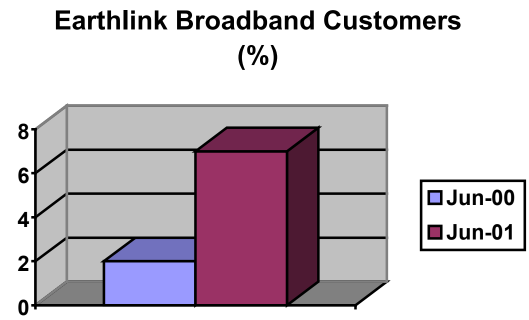
### Increasing Revenue per customer

Part of the story of corporate earnings this year has been stagnant or falling revenues per customer. This is a particularly important metric for subscriber-based industries such as media, telecommunications and Internet Service Providers. Most of these companies are seeing declining revenues per subscriber – mobile revenues in Australia being a clear example.

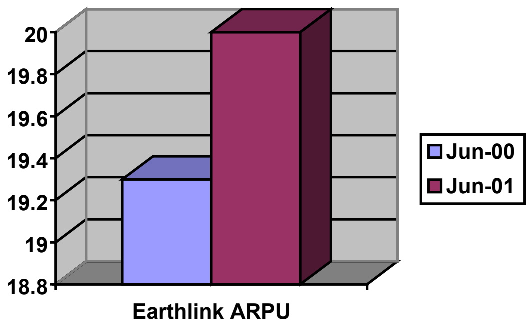
Two examples of businesses bucking the trend that we thought were worth noting are No.2 US Internet Service Provider Earthlink and the Time Warner Cable business. Both have shown increased revenues per customer in the most recent quarter.

Earthlink has grown revenues per customer by convincing significant numbers to switch from its traditional dial-up Internet service to the more costly Broadband service. Interestingly, the company's revenues per customer actually declined over the past year for both its Dial-up and Broadband services. However, a relatively modest shift in the balance of customers towards the higher value Broadband product had the effect of increasing overall revenue per customer by 4% - a good achievement in a difficult market.

Earthlink drives more customers to its higher value service …




And increases monthly ARPU by 4%.




The company has used both a carrot and stick approach to drive customers to broadband. Along with emphasizing the benefits of the new product, Earthlink is increasingly discouraging new customers from subscribing to its traditional dial-up services. The company has recently announced a 10% price increase for its narrowband service which it expects to lead to further switching to the more expensive broadband service.

The largest US cable company, Time Warner Cable, also produced outstanding ARPU results in the last quarter. With anemic subscriber growth of just 0.4% year-on-year, the company increased revenues from its basic cable subscribers by more than 10% - or $US 150 million.

The success was driven by both of the company's revenue sources – subscription revenues and advertising. On the advertising front, TWC increased revenues by a stunning 19%. This achievement is particularly notable given the "advertising recession" which currently has a grip on most major markets, as evidenced by News Corporation's results earlier this month. TWC's advertising revenue growth makes good the promises of CEOs Steve Case and Jerry Levin when trumpeting the merger in early 2000. Bundling of advertising products between AOL and TWC properties has been identified by the company and numerous analysts as the major driver of the increased revenues. To underscore the point, advertising revenues for AOL properties are also making big strides – up by 26% year-on-year in the June 2001 quarter. Given the collapse of the Internet advertising market, the benefits of cross-selling are very clear.

The company increased average subscriber revenues through a combination of price rises and increased value-added channels. Time Warner's unparalleled entertainment library provides it with a noted content advantage over most of its competitors. This content advantage has allowed TWC to build the largest subscriber base – at 12.7 million – and supports aggressive pricing.

*In the next issue of Worth Noting, look out for our profile of the 4 Dow stocks which boosted earnings in the June 2001 quarter despite falling revenue: Coca-Cola, GE, IBM, and SBC Communications.*