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Communications, Media & Technology

Big Shifts in Consumer Spending Ahead

Insights from the New Communications, Media, and Technology Consumer Spending Survey

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When it comes to communications, media, and technology spending, how is consumer behavior changing in this economic downturn? Are consumers buying *cheaper* products and services or *fewer*? What are their new priorities?

On the eve of the 2008 holiday season, Oliver Wyman conducted its first annual *Communications, Media, and Technology Consumer Spending Survey*. The survey provides a broad, trackable view of how U. S. consumer perceptions of value and share-of-wallet are moving across the blurring landscapes of communications, media, and technology. Against this year's backdrop of "doom and gloom" media coverage about falling consumer spend and "batten down the hatches" company news, the initial run of the survey examines in useful detail where and how some consumers plan to cut back spending, how consumers will make trade-offs to best continue getting what they value most, and the issues, threats, and opportunities that these cutbacks and trade-offs pose for companies in these industries.

The survey findings suggest some likely losers and winners in the coming year:

- Total consumer spending on communications, media, and technology will likely decrease by 6% from the prior year.
- Device sales, and mature technologies in particular, will likely be hit hardest with an expected 10-15% decrease in sales revenue…
- …but next-generation device sales—smartphones, HDTVs, Blu-ray players, and DVRs—will continue to grow.
- "Cord cutting"—discontinuing landline phone service—will likely accelerate…
- …but Internet connectivity and mobile phone subscriptions will be most insulated from decreases in consumer spending.
- Households will continue to shift toward consuming more video entertainment in-home and from buying content (DVDs/Blu-rays) to renting it…
- …but some consumers likely will trade away from more-expensive leisure options and grow overall use of video and other electronic entertainment activities.

Overview of the Survey Findings

Oliver Wyman's November 2008 Web-based survey of 500 U.S. households suggests that if current sentiment holds, consumer spending on communications, media, and technology will decline by approximately 6% over the next 12 months. (See page 8 for research details.)

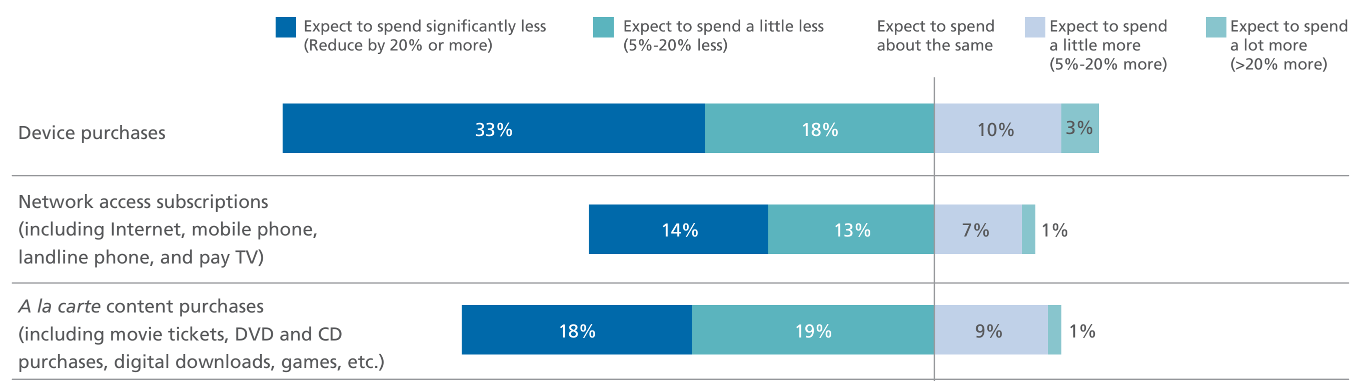
The average online[1] American household spends $4,000 to $5,000 annually on devices, subscription services, and *a la carte* electronic entertainment. Some 58% of these households intend to decrease spending, with cost-reducing households cutting spend by an average of 10% through a mix of delaying device purchases, canceling or downgrading subscriptions, and shifting entertainment usage habits (Exhibit 1).

Device sales. Device sales will take the hardest hit from consumers' restriction of spending. About 51% of U.S. households intend to spend less on devices next year than they did this past year, with consumers six times more likely to delay the purchase of a new device than they are to "trade down" by buying a cheaper version now. Notably, next-generation device sales—smartphones, HDTVs, Blu-ray players, and DVRs—will continue to grow moderately amidst the overall decline, representing opportunities for device manufacturers, network operators offering services linked to these devices, and content owners marketing higher-value home entertainment.

Subscription services. Subscription revenues from ongoing services appear to be most insulated from household spending cuts. While such subscriptions are logically the most "sticky" because of a mix of inertia, contracts, and difficulty in replacing certain services, 27% of U.S. households still intend to decrease spending in this category. Consumers say they are most willing to cut use of traditional services, such as "cutting the cord" to use a mobile phone or VoIP instead of landline phone service, or cutting premium-TV-channel subscriptions in favor of a mix of VOD, DVDs/Blu-rays, and online video instead. A small but material group of respondents (14%) say they have already discontinued their pay TV package altogether in favor of watching TV online. Conversely, consumers are least likely to cut spending on broadband Internet access and mobile phone plans.

***A la carte* electronic entertainment content.** While overall survey results suggest that 37% of households will cut spending on *a la carte* electronic entertainment purchases (video, music, and games), certain categories are likely to simultaneously gain and lose buyers, as consumers make trade-offs among competing offers. While media and entertainment companies may benefit from a net shift toward video entertainment and away from more expensive options including dining out and attending live events, there are clear challenges to the DVD sales model in the face of rental-based offers that are less vulnerable to spend cutting. Consumers say they are

Exhibit 1 **Expected spend levels on communications and entertainment devices, network access, and content (next 12 months compared to past 12 months)**



Note: For purposes of illustration, "about the same" responses are not shown.
Source: Oliver Wyman Communications, Media, and Technology Consumer Spending Survey, November 2008.

twice as likely to *purchase* fewer DVDs/Blu-rays as they are to *rent* fewer discs as a form of cutting back, and three times as likely to cut back on purchases as they are to discontinue subscription DVD-delivery service.

Device Sales Outlook

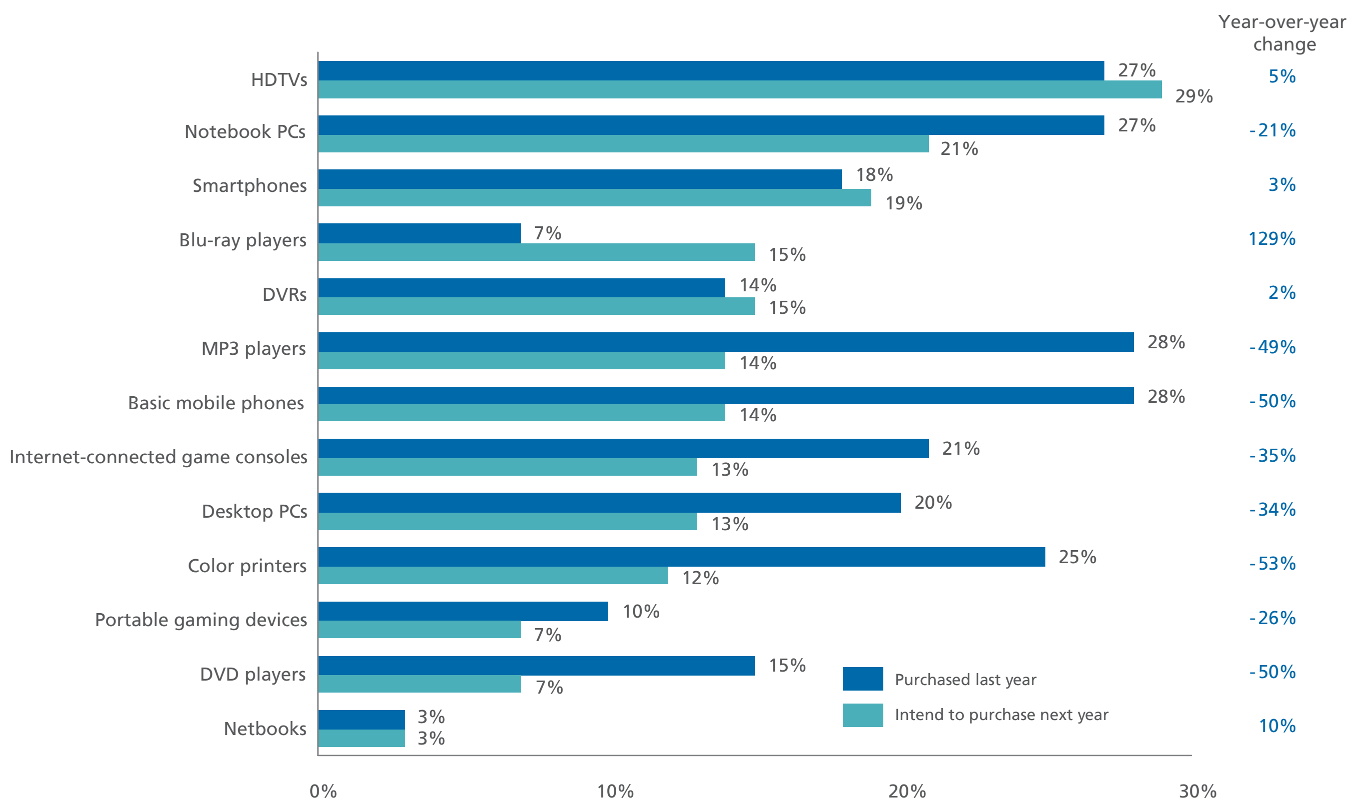
More than half (51%) of U.S. households say they will spend less on devices next year, which could translate to an overall 10-15% year-over-year decrease in device-sales revenue, with certain categories experiencing substantially steeper declines.

Consumer purchase intent and unit volume. Mature device categories with high penetration rates will experience the most significant sales decreases.[2] Color printers, basic mobile phones, and digital cameras—and to a lesser extent desktop and notebook PCs—will be hit the hardest. Next-generation devices that are still relatively early in consumer adoption cycles—smartphones, HDTVs, Blu-ray players, and DVRs—are predicted to eke out some unit growth despite the downturn; most will grow in low single-digit percentages. The one exception is Blu-ray, which is growing over a small base and should more than double its penetration in the next 12 months. On its face, this modest growth outlook appears to have neutral to mildly positive implications for next-generation device OEMs. However, price competition and a squeeze by distribution channels and go-to-market partners creates the risk of negative revenue trends despite some unit volume growth (see discussion of price promotion impact below). On the other hand, continued modest growth of these next-generation device categories is positive for the services providers and content owners whose upgraded offerings depend on new device adoption (Exhibit 2).

Pricing and revenue outlook. Within this broad survey that covered 20 types of devices, 14 types

Exhibit 2 **Actual and projected communications and entertainment device purchases**

Self-reported % of online households that purchased each device last year, and projected purchase intent for each device in the next 12 months, 2008 holiday season through Thanksgiving 2009.



Note: Figures are rounded.
Source: Oliver Wyman Communications, Media, and Technology Consumer Spending Survey, November 2008.

of subscription-based services, and 13 formats of consuming entertainment content, we did not attempt to develop a detailed view of consumers' price elasticity. However, based on high-level pricing questions, we see a pricing-related "negative conundrum" facing device OEMs:

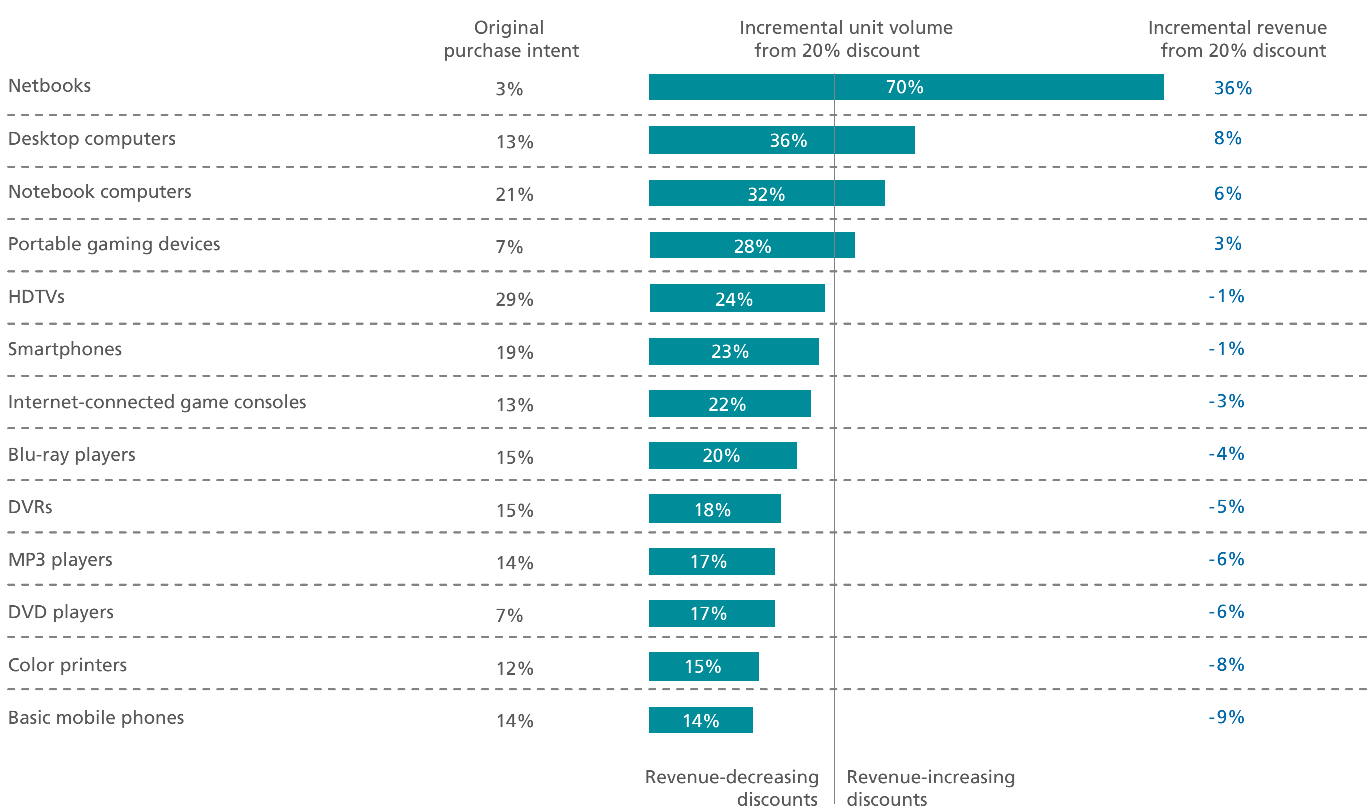
- For most categories, pricing discounts do not appear to provide a broadly viable solution to creating net growth in device revenues, let alone profits, given limited price elasticity.

- However, competitive dynamics and distribution channel pressure will likely force at least some degree of price-cutting in many categories.

As illustrated in Exhibit 3, pricing discounts appear to be most valuable in a few relatively mature device categories such as desktop and notebook PCs. For most device categories, a hypothetical 20% retail price cut would not drive unit volume increases big enough to make overall revenues go up, relative to selling fewer devices at non-discounted prices. The emerging category of netbooks is a notable outlier in terms of price sensitivity. Because consumer understanding of this category and knowledge of baseline pricing within it may be more limited than for other devices, research results should be interpreted conservatively. However, findings confirm the commonly held belief that there is substantial demand response to more-affordable mobile personal computing devices.

Note that consumer insights such as those gleaned from the survey will allow segmentation analysis of the price-sensitive consumer group as well as of the group willing to pay current prices. To the extent that distribution channels and communications media allow, smart device marketers will carefully target pricing moves to the most price-sensitive segments.

Exhibit 3 **Effect of a 20% discount on projected device purchase intentions**



Source: Oliver Wyman Communications, Media, and Technology Consumer Spending Survey, November 2008.

Subscription Services Outlook

Subscription spending will be least affected of all categories, with 27% of households intending to cut back. The relative stickiness of subscriptions likely comes from several factors:

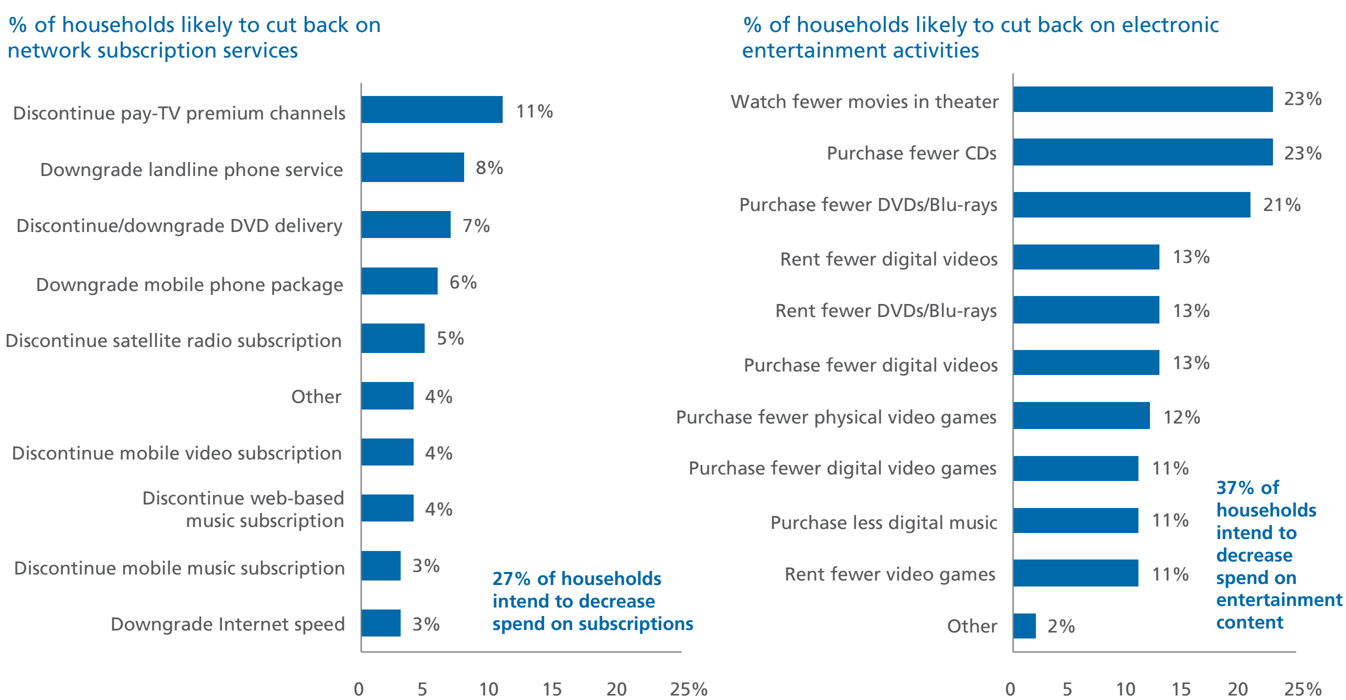
- There is a growing consumer dependence on subscription Internet and mobile connectivity as a gateway to a broad array of communications, information, and entertainment.
- The self-renewing nature requires customers to overcome inertia to change or discontinue subscriptions. Conversely, inertia favors *not* buying a device, Blu-ray disc, and so on.
- For many subscriptions, there are real switching costs in the form of cancellation fees and set-up fees with any potential replacement provider, in addition to the time and hassle involved.

In spite of the relatively small number of households who plan to cut back on subscriptions, we still predict an overall decrease in spending of 5%. Because 70% of online households spend over 50% of their communications, media, and technology budgets on network access subscriptions, cuts in this category are significant. Those who are cutting back indicated that they will decrease spending by an average of $300-500 next year.

Subscriptions for Internet access, mobile phone access, and some entertainment content subscriptions are most insulated from the economic downturn. For example, 59% of households say they would never consider downgrading their Internet connection to a slower speed, and another 27% are unlikely to do so, implying that only about one in seven households would meaningfully consider this as a budget-cutting option. Some 42% of consumers would never consider downgrading their mobile phone service, and another 37% are unlikely to do so.

Landline phone service shows continuing and perhaps accelerating vulnerability. Some 18% of households report they do not subscribe to a landline phone, and another 14% are somewhat likely to "cut the cord"—discontinue landline service—in the next 12 months. This segment of the population

Exhibit 4 **Areas of intended decreased communications and entertainment spending**



Source: Oliver Wyman Communications, Media, and Technology Consumer Spending Survey, November 2008.

is predominantly under age 35 with annual household income of less than $100,000. The acceleration of cord-cutting presents opportunities for mobile and VoIP players able to offer a "cost savings" value proposition, especially to mid- to low-income young people anxious about the economic slowdown. At the same time, there are defensive implications for telecom providers, with potentially high value to be gained from successfully using bundling to slow the rate of landline losses.

As mentioned earlier, there is a point of connection between this subscription outlook and the strategic situation for device OEMs and content players: High-performance home and mobile connectivity is important to many consumers, and devices and content that have "better together" stories with this network-based value proposition generally have stronger outlooks than those that don't.

However, this service-provider-prominent world has important business model implications for device OEMs and content owners. First, take further steps to optimize the "service-provider-led go-to-market" models and subsequently preserve value within them. Second, redouble efforts to explore "over-the-top" or "end-around" distribution that can thrive alongside, rather than through, subscription-based services providers.

Entertainment Outlook

The survey found that 37% of households intend to cut back on *a la carte* electronic entertainment purchases, resulting in a decline in spending of up to 5% in this category overall. This implies an average annual spending cut of $120 for those who are cutting.

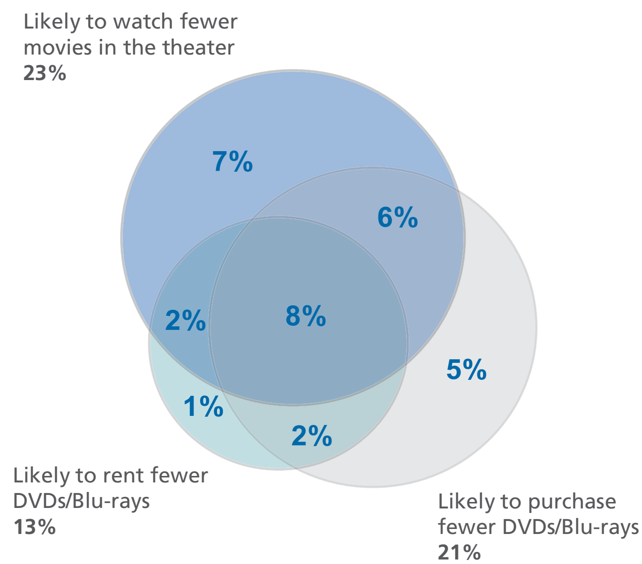
In the movie category, most households aren't cutting back across the board, but rather making trade-offs among different options for watching video. While 21% of those who intend to decrease spending on entertainment are likely to cut back on all traditional channels (going to the movies, purchasing DVDs/Blu-rays, and renting DVDs/Blu-rays), almost 80% intend to make trade-offs among these channels, decreasing usage of some but not others.

For example:

- 20% of those intending to decrease spending (about 7% of the overall population) say they will go to fewer movies in the theater but are unlikely to cut back on purchasing and renting DVDs/Blu-rays.
- 25% of households say they already watch movies at home on VOD or DVD instead of going to the movie theater, and another 14% are likely to make this switch in the coming year.
- 13% of those intending to decrease spending (about 5% of the overall population) say they would cut back on purchasing DVDs/Blu-rays but not on seeing movies in theaters or renting them (Exhibit 5).

Exhibit 5 **Decreasing spend on movie consumption: trade-offs and overlap among behavior patterns**

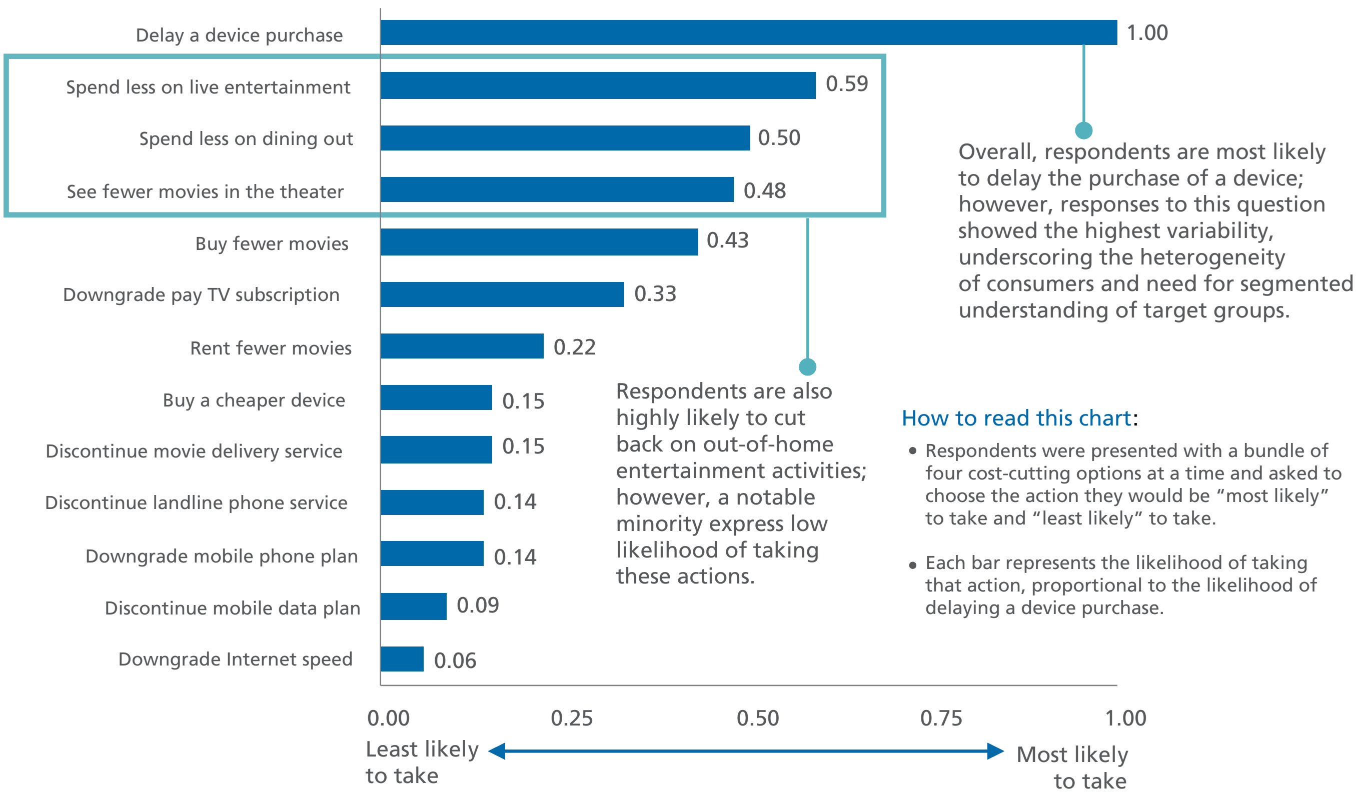
Overall, 31% of consumers are likely to spend less on movies



Source: Oliver Wyman Communications, Media, and Technology Consumer Spending Survey, November 2008.

The last point illustrates a shift seen from several data points in this survey: movement from owning movie content to renting it. Consumers say they are twice as likely to purchase fewer DVDs/Blu-rays as they are to rent fewer discs as a form of cutting back, and three times as likely to cut back on pur-

Exhibit 6 **Relative likelihood of taking specific cost-cutting actions**



Source: Oliver Wyman Communications, Media, and Technology Consumer Spending Survey, November 2008.

chases as they are to discontinue subscription DVD delivery service (Exhibit 6).

Implications and Questions for Executives

Taking stock of survey findings across devices, subscription services, and *a la carte* content, there are three cross-cutting themes that emerge:

- Consumer reaction to the downturn is *not* homogenous. There are distinct patterns of behavior and clear inclinations among consumers to make different types of trade-offs based on what they value.
- Many behavioral shifts, while motivated by near-term economics, make sense as part of longer-term movements. In many cases, the economic situation may simply be catalyzing or accelerating changes that have been developing anyway.
- To the extent that some changes we see in the next year are simply an acceleration or deepening of underlying trends, some shifts that occur will persist even when economic conditions improve. Executives thus should focus on making judgments about which changes are temporary and which signal new realities that demand evolution of business models.

1 100% of survey respondents subscribe to an Internet connection at home, versus an 80% home Internet penetration rate in the U.S. We assume that non-online households spend less annually on communications and media entertainment.

2 Raw data answers about purchase intent were adjusted down using a standard "dampening" coefficient to account for the typical discrepancy between stated intent and actual behavior.

About the Research

Research was conducted with 500 U.S. households in mid-November 2008, using a Web-based survey with sophisticated trade-off techniques to simulate actual consumer decision behavior. Respondents represent a range of demographic groups across age, gender, and income, but include only adults 18 and over who participate in some way in making household decisions.

The survey included a Maximum Difference Scaling exercise, which is a unit-free scaling method that measures the importance of a set of choices relative to each other. Respondents were presented with a series of trade-off questions and asked to choose the actions they would be most and least likely to take. Using a multinomial logic model, answers were scaled to an easy-to-interpret likelihood index.

To draw market-wide conclusions, the survey sample was normalized on age and gender, and calibrated against actual market data to ensure that respondent income, early-adopter status, and other possible skews of the Web-only sample did not meaningfully affect projections.

On all questions that asked respondents about purchase intent, a standard "dampening" coefficient was applied to account for typically observed discrepancies between stated intent to act and actual behavior. All other questions reflect respondents' self-reported behavior and likelihood of taking particular actions, and were not adjusted. Response data includes statistically valid subsets of many types of device owners, network subscription users (Internet, phone, pay TV), and entertainment content purchasers (movies, music, games, etc.).

Categories covered by the survey

Devices

- Desktop computers
- Notebook computers
- Netbooks
- 3G wireless cards
- Regular TVs
- HDTVs
- DVRs
- Other set-top boxes
- DVD players
- Blu-ray players
- Internet-connected video game consoles
- Non-Internet-connected video game consoles
- Portable gaming devices
- Basic mobile phones
- Smartphones
- Satellite radios
- GPS navigation systems
- MP3 players
- Digital cameras
- Color printers

Subscription services

- Landline phone service
- Mobile phone service
- Internet access
- Pay TV
- Premium channels
- Sports channels
- HDTV channels
- DVR
- Wireless router
- DVD/movie delivery
- Satellite radio
- Web-based music
- Mobile music
- Mobile video

Entertainment activities

- Watch movie in the theater
- Watch PPV / VOD
- Purchase a DVD/Blu-ray
- Rent a physical DVD/Blu-ray
- Purchase or rent a digital movie/TV show
- View ad-supported video on-line
- Use shareware to view (pirated) video on-line
- Purchase a physical CD
- Purchase digital music
- Use shareware to download (pirated) digital music
- Purchase a physical video game
- Purchase a digital video game
- Play an ad-supported video game

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About Oliver Wyman

With more than 2,900 professionals in over 40 cities around the globe, Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm helps clients optimize their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is part of Marsh & McLennan Companies [NYSE: MMC].

Oliver Wyman's Communications, Media & Technology practice provides growth strategy, customer analytics, operational performance improvement, and M&A support services across all industry sectors.

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