FPA U.S. Value Fund, Inc.

Special Presentation - Third Quarter 2015

You should consider the Fund's investment objectives, risks, and charges and expenses carefully before you invest. The Prospectus details the Fund's objective and policies, sales charges, and other matters of interest to the prospective investor. Please read this Prospectus carefully before investing. The Prospectus may be obtained by visiting the website at www.fpafunds.com, by email at crm@fpafunds.com, toll-free by calling 1-800-982-4372 or by contacting the Fund in writing.

To view portfolio holdings from the most recent quarter end, please refer to the link here.

Portfolio composition will change due to ongoing management of the fund. References to individual securities are for informational purposes only and should not be construed as recommendations by the Funds, Advisor or Distributor.

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The S&P 500 Index is an index of 500 companies with large market capitalization.

Fund Risks

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Making a case for the Pay-TV industry with the help of Mark Twain

If you listen to the media these days, you'd think pay-TV has one foot in the grave and will soon be six feet under altogether. Headlines screech about a small but growing number of people, mainly millennials, who are foregoing cable television and becoming cord "cutters" or "nevers." What's more, negative news reports trumpet declining live TV ratings, which have prompted advertisers to increase the shift of ad dollars away from TV to digital formats. All of this doom and gloom has resulted in a sector that is out of favor. Many stocks are trading at a below-market valuation and are at or near 52-week lows.

Pay-TV executives—not to mention yours truly—should be forgiven for the urge to paraphrase Mark Twain and declare that reports of the industry's death have been greatly exaggerated. So much so that, as of September 30th, U.S. media companies made up approximately 20% of the portfolio[1]. "Mr. Market" is providing us the opportunity to buy some wonderful businesses at what I believe are attractive valuations with very good, long-term growth prospects.

Valuation of investments is an important part of my stock selection process. My primary measure of value is the price/earnings ratio. I seek out companies that are undervalued compared to the present value of its estimated future cash flows and to the market (i.e. S&P 500). To provide an illustration of my valuation approach applied to the media companies in the Fund's portfolio, as of September 30 the Fund's media investments traded at ~12x 2016E EPS[2] and ~10x 2017E EPS (based on consensus estimates) compared to the S&P 500's valuation of ~15x 2016E EPS and ~13.5x 2017E EPS (based on consensus estimates).[3]

The Fund favors media companies that first and foremost possess "must-have" content including valuable sports rights locked up for many years and are priced at a good value for pay-TV distributors. I define value in terms of the ratio of ratings share to the share of a pay-TV distributor's network affiliation expenses. What's more, the companies should be poised to meaningfully grow their international businesses and ideally have less revenue exposure to advertising for non-sports programs. Exceptions to the last point are networks whose audiences skew older (median age 50+). This demographic represents about half of consumer spending and is much less likely to watch video online compared to the under 50-year-old cohort. If advertisers want to reach that older demographic, an effective way to do so continues to be through the most popular TV networks.

Robust industry economics

The large cable and broadcast networks enjoy very good economics in large part due to the subscription-based model of pay-TV, which provides a recurring, predictable revenue stream. The economics for the best networks, which own or control rights to quality content, are poised to continue to improve over time. This is due to a couple of reasons. One is expected mid-to-high single digit growth of so-called affiliate fees per

[1] The information is presented for illustrative purposes only and is not intended to suggest that the manager can or will be able to find the same or similar positions and opportunities in the future. Portfolio composition may change over time.
[2] EPS (Earnings Per Share) is the portion of a company's profit allocated to each outstanding share of common stock. It serves as an indicator of a company's profitability.
[3] The source of the consensus estimates is Capital IQ. Consensus estimates are subject to inherent limitations because they are based on a variety of assumptions and judgments that may or may not turn out to be accurate. Actual earnings may be higher or lower than estimated. The consensus estimates are provided for general informational purposes only and are not intended to suggest that the media companies in the Fund's portfolio will ultimately be sold at a profit. There is no assurance that the Fund's investment strategies employed will be successful. As with any investment, there is always the potential for gain, as well as the possibility of loss.

subscriber, which pay-TV distributors pay to cable networks. The other is retransmission (retrans) fees per subscriber—which pay-TV distributors pay to broadcast network affiliates—are expected to grow even faster. The growth of both fees should more than offset flat-to-low single digit declining subscribers and advertising revenue.

The average operating margin for pay-TV companies is ~30%. The average pre-tax return on capital is in the high-teens while pre-tax return on tangible capital is ~50%. These are very capital-light businesses with just ~5% of earnings before interest, taxes, depreciation and amortization (EBITDA) going to capital expenditures. This affords these companies the ability to return a lot of free cash flow to shareholders via dividends and share repurchases while continuing to grow organically.

Pay-TV is made up of basic cable networks, premium cable networks (such as HBO and Showtime) and broadcasters. Basic cable networks enjoy higher operating margins than broadcasters (see table below) because they have a more balanced dual revenue stream of affiliate fees and advertising revenue and less expensive programming costs. Broadcasters don't have that balance and continue to acquire highly inflationary sports content rights. Over time, the operating margin gap between broadcast and basic cable networks should narrow somewhat as broadcast networks grow their retrans fees at very high rates in the coming years as affiliate contracts come up for renewal.

	Business Unit EBITDA Margins [3]							
	DIS	**FOXA**	**TWX**	**CBS**	**VIAB**	**AMCX**	**DISCA**	**SNI**
Cable Networks	43%	38%	37%	46%	44%	39%	53%	55%
Broadcast Networks	15%	18%		24%				
Total TV	**35%**	**32%**	**37%**	**27%**	**44%**	**39%**	**53%**	**55%**
Non-TV Segments								
Parks and Resorts	25%							
Studio / Cons Prod	22%	15%	13%		8%			
Publishing			17%	11%				
Outdoor Advertising				29%				
Other / Non-media	(4%)	9%				(26%)	26%	
Total Company	**29%**	**23%**	**24%**	**25%**	**31%**	**34%**	**47%**	**50%**

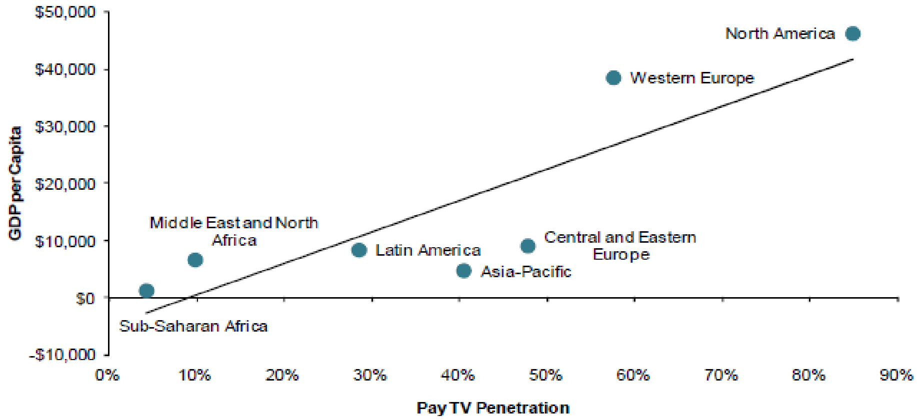
Source: Bernstein analysis

A Growing Industry

The U.S. is the leader in content origination for both TV and theatrical release. There is a strong positive correlation between GDP and the consumption of pay-TV (see chart below). As the global economy grows over time, so should the demand for high-quality content to feed a growing pay-TV industry.

[4] EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) is used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

Relationship Between GDP and Pay TV Penetration



Source: CIA Factbook, The World Bank, Bernstein estimates and analysis
As of 12/31/10. This is the most recent data available.

It is easy to see just how strong the international demand is for pay-TV content when one considers that the international box office is 2.5x the size of the U.S. and advertising on TV outside the U.S. is 2x the size of the U.S. market (see table below).

Global Media Markets (2013)

	Pay-TV Sub Fees ($B)	Pay-TV Subs (M)	Pay-TV Fees/Sub	Pay-TV Penetration	Pay-TV Adv ($B)	Adv/ Sub	Box Office ($B)
U.S.	100.0	100	$ 1,000.00	87.0%	63.0	$ 630.00	10.9
International	100.0	649	$ 154.08	46.5%	123.5	$ 190.29	25.0
Total	200.0	749	$ 267.02	49.6%	186.5	$ 249.00	35.9

Source: PWC, Ovum, DISCOP, CIA Factbook, The World Bank, government statistics organizations, industry reports and Bernstein estimates and analysis. As of 12/31/13. This is the most recent data available.

This bodes well for the growth of the international pay-TV industry, which is currently similarly sized to the U.S. despite having 6.5x the number of subscribers and a 40% lower household penetration rate (see table below).

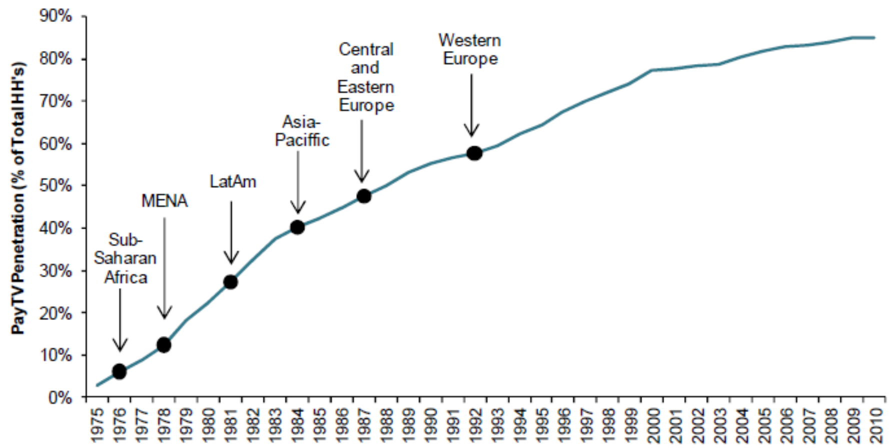
Pay-TV Penetration By Region

(in millions)		Average	# of Households			Penetration		Est. 5-yr
	Population	HH Size	Total	w/TV	w/Pay TV	TV	Pay TV	CAGR
North America (Ex-US)	42	2.6	16	16	13	97%	**83%**	2%
Western Europe	413	2.3	182	165	104	91%	**57%**	2%
Central and Eastern Europe	363	2.7	133	128	63	96%	**48%**	7%
Asia-Pacific (Ex-China)	2,467	4.4	566	393	187	69%	**33%**	9%
Latin America	595	3.6	165	150	47	91%	**28%**	12%
Middle East and North Africa	473	4.7	101	84	10	84%	**10%**	7%
Sub-Saharan Africa	892	5.1	174	39	7	22%	**4%**	14%
Total (Ex-China/US)	5,245	3.9	1,337	976	432	73%	**32%**	7%
China	1,343	3.1	433	423	217	98%	50%	8%
Total International	**6,588**	**3.7**	**1,771**	**1,399**	**649**	**79%**	**37%**	**8%**
United States	314	2.6	119	115	101	97%	85%	1%
Total World	**6,902**	**3.7**	**1,889**	**1,513**	**750**	**80%**	**40%**	**7%**

Source: Industry reports, DISCOP, Government Statistics Organizations, CIA Factbook, The World Bank, Bernstein estimates and analysis
As of 12/31/10. This is the most recent data available.

The rest of the world is 20+ years behind the U.S. in household pay-TV penetration rates (see graph below). The consumption of content should continue to increase through a combination of greater household pay-TV subscription and/or use of more affordable online services like Netflix—all of which puts content owners in a good position as more demand for their product will come through in very high-margin, incremental sales.

Regional Pay-TV Penetration Relative to U.S. Historical Rates



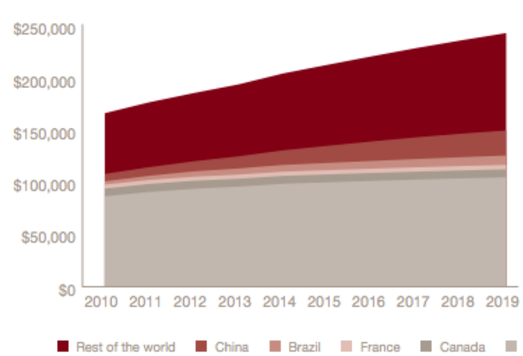
Source: Company reports, Bernstein estimates and analysis

As of 12/31/10. This is the most recent data available.

When one looks at the major U.S. media companies' revenue mix, it is currently ~70% U.S. and ~30% international. Over time, the relative size of the international pay-TV market compared to the U.S. should resemble that of the global box office market (see bar chart below, right). This should play out as international subscription video on demand (SVOD) outpaces domestic demand and international pay-TV subscribers and fees per subscriber grow at a faster rate as well (see graph below, left).

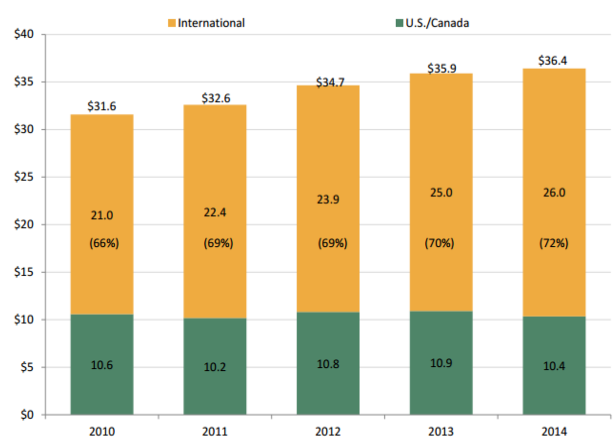
Fig. 1: Mature pay-TV markets see growth slow

Global TV subscription revenue and selected markets (US$mn), 2010–2019



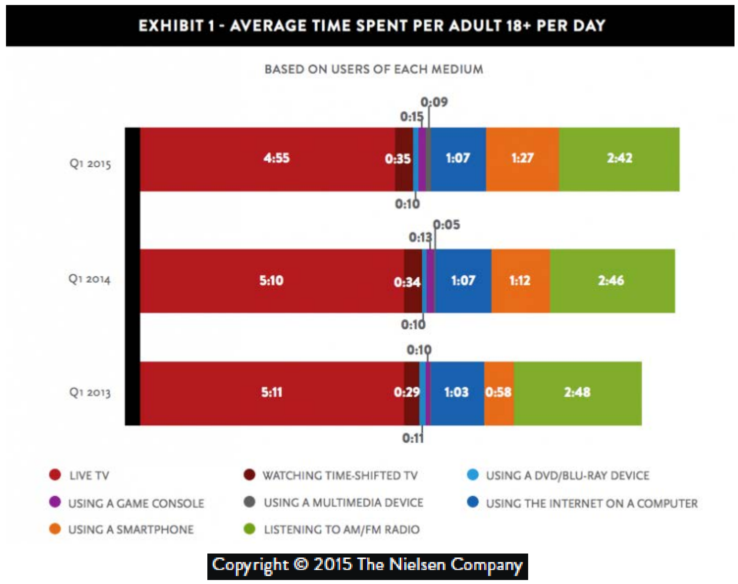
Source: Global entertainment and media outlook 2015–2019, PwC, Ovum

Global Box Office – All Films (US$ Billions)



Source: Motion Picture Association of America

While there are many headlines talking about a growing number of Americans who are becoming cord cutters, nevers or shavers, the data shows few people have done so. And the ones who do are typically younger, single people who do not have the means to afford a pay-TV subscription and primarily consume video digitally via mobile and/or broadband connections. One reason why the pay-TV bundle remains popular is because the average person in the U.S. continues to watch five hours of TV per day (see chart below). While more time spent using smart phones is at the expense of watching TV, people continue to dedicate most of their free time to television. Based on an average of 2.5 people per household with an average TV bill of ~$80 per month, the cost is just ~$1 per day per person to be entertained for five hours. Compare that to the costs of other forms of entertainment, like going out to a restaurant, movie theatre, concert, sporting event or theme park. And remember that the average pay-TV subscription has 100+ channels to choose from, which provides fantastic choice and value.



Why a cable network/broadcaster with popular content is king

All pay-TV distributors lack power to push back against most cable or broadcast networks ratcheting up affiliate/retrans fees for their channels. This is because the top nine cable networks/broadcasters air ~90% of the content viewed and, combined, represent ~80% of one's pay-TV subscription (see table below).

Cable Network Group Summary Fees/Viewer Comparison (for 2015)

Network Group	HH Viewers (000's) Prime	Average Fees ($/sub/mo)	% HH Viewers Prime	% Avg Fees	Ratio: Fee/Viewer Prime
Scripps	2,313	$0.58	3.9%	1.6%	0.42x
A&E	3,195	1.10	5.4%	3.1%	0.58x
Discovery	3,995	1.30	6.8%	3.7%	0.54x
AMC	1,321	0.77	2.2%	2.2%	0.97x
Viacom	4,411	3.01	7.5%	8.5%	1.14x
Time Warner	4,097	3.44	7.0%	9.7%	1.40x
NBCU	4,434	3.38	7.5%	9.6%	1.27x
Fox	2,908	3.30	4.9%	9.3%	1.89x
Disney	2,572	7.54	4.4%	21.3%	4.89x
Others	6,121	7.32	10.4%	20.7%	1.99x
Total Basic Cable	35,367	$31.73	60.0%	89.8%	1.50x
Broadcast					
CBS		**$0.72**	**12.0%**	**2.0%**	**0.17x**
FOX		0.70	7.0%	2.0%	0.28x
NBC		0.54	7.0%	1.5%	0.22x
ABC		0.62	8.0%	1.8%	0.22x
Others		1.03	6.0%	2.9%	0.49x
Total Broadcast		**$3.61**	**40.0%**	**10.2%**	**0.26x**
Total Basic Cable		$31.73	60.0%	89.8%	1.50x
Basic Cable + Broadcast Retrans		$35.34	100.0%		

Source: SNL Kagan, Nielsen. As of 6/30/15.

Disney is a perfect example of how pay-TV distributors get pushed around. Cable networks/broadcasters bundle their channels together such that if a distributor wants Disney-owned ESPN, it has to take everything else Disney offers including ESPN2, Disney, Disney Junior and ABC Family. What's more, the distributor must also pay retrans fees for Disney's broadcast channel, ABC. The same holds true for 21st Century Fox, NBC Universal, Time Warner Entertainment, Viacom, Discovery, Scripps, etc. It's an all or nothing deal that networks make with distributors. With the exception of CBS (since it does not have channels to bundle together nor does it receive retrans fees in line with its audience share), most networks have a major economic incentive to keep the bundled system going.

The bottom line is that if a network has just one "must-have" channel, then it has the leverage in the relationship with the distributor. This is because in most of the U.S., there are at least two and sometimes three other (including a telecom provider) distributors that will likely have that "must-have" channel the consumer desires should one distributor choose not to carry it. Even with the AT&T/DirecTV merger having been recently approved and assuming the Charter/Time Warner Cable deal goes through as well, there will still be at least three competitors in all major markets and most will not want to forgo a must-have channel.

To see just how this works, consider the stand-off two years ago between Time Warner Cable (TWC) and CBS regarding retrans fees for CBS's owned affiliates. During contract renewal negotiations in mid-2013, CBS went dark in major cities including Los Angeles and New York. While CBS was hurt a little in the short term by a reduction in viewership affecting ad revenue in August 2013, CBS knew that come September when the NFL season and primetime TV were set to begin, it had the leverage. By all accounts, TWC caved as it began to lose subscribers in key markets to the likes of DirecTV.

Ultimately, it is an easy math problem distributors have to solve when deciding whether or not to continue to agree to mid-high single digit annual price increases from networks. Either the distributor pays the increase or it risks customer losses without carrying the network's channel(s). CBS, for instance, is currently asking in new contract negotiations for at least $2 per subscriber from distributors for its owned and operated CBS affiliate stations. Distributors are now paying an average of just under $1.

Distributors charge the consumer ~$70 for the ~$35 worth of content the distributor pays to basic cable networks and broadcasters. CBS is asking every distributor for a similar rate. So the safe play for the distributor is to pay the price increase and try to pass most of it, if not all, on to the consumer. The distributor also knows that CBS is the most-watched channel. At around $2 per subscriber, CBS is still a great value for the distributor as CBS would represent ~6% of network affiliation expenses (assuming other networks continue to raise their fees at a mid-to-high single-digit rate) while capturing ~12% of primetime household viewership.

Even if you assume the distributor cannot pass any of the price increase on to the consumer (historically distributors have passed most if not all on to the consumer), it needs to believe it will not lose more than ~6% of its subscribers in order to refuse to pay the increase and lose the ability to carry CBS. Given CBS captures ~12% of households during primetime, in part due to valuable sports content, the odds of any distributor refusing to pay the increase are low. What's helpful is that cable and telecom providers have the ability to raise pricing for their broadband offering, which can help offset at least some, if not all, of the cost inflation from cable and broadcast networks that they don't want to directly pass on to consumers through higher pay-TV subscription prices.

Distributors have been and should continue to be successful in passing some, if not all, of the affiliate/retrans fee price increases on to consumers given the value those viewers get out of their pay-TV subscription. While pay-TV bills have increased at a ~4% CAGR over the last five years, over that same time, the number of households with pay TV has remained steady even while the adoption of SVOD services like Netflix and Hulu Plus grew (see table below).

U.S. TV Distribution (in millions)	1983	1993	2003	2008	2009	2010	2011	2012	2013	2014	Q2'15
TV Households	83.3	94.0	108.4	113.4	114.4	115.9	116.4	117.0	117.4	118.7	119.7
Basic Cable Subscribers	31.4	57.2	66.4	64.2	62.6	60.4	58.6	57.0	55.1	53.7	52.4
DBS Medium and Full Power Subscribers	-	-	21.6	31.3	32.7	33.4	33.9	34.1	34.3	34.3	34.2
Telco Television Subscribers	-	-	-	3.2	5.3	7.1	8.7	10.2	11.8	13.2	14.4
Other	0.8	2.9	1.7	0.9	0.8	0.7	0.7	0.6	0.5	0.4	0.3
Multichannel Subscribers	32.2	60.2	89.7	99.6	101.4	101.6	101.8	101.9	101.5	101.6	101.6
% household penetration	38.7%	64.0%	82.8%	87.8%	88.6%	87.6%	87.5%	87.0%	86.5%	85.6%	84.9%
Premium Subscription Services											
Subscribers (via pay-TV distributors)											
Showtime / TMC / Flix				58.7	61.3	67.1	73.3	76.1	76.4	76.3	77.9
Starz / Encore				49.4	47.5	51.0	52.8	56.1	57.1	57.3	58.0
HBO / Cinemax				41.0	41.1	39.5	39.6	41.5	43.4	46.2	47.8
EPIX / EPIX Drive-In				-	0.3	8.6	9.6	9.9	9.9	9.9	10.4
Total Premium Subscribers				149.1	150.2	166.2	175.3	183.6	186.8	189.7	194.1
U.S. Subscribers (direct-to-consumer)											
Netflix Paying Streaming Subs				9.2	11.9	18.3	20.2	25.5	31.7	37.7	41.1
Netflix Paying DVD Subs							11.0	8.0	6.8	5.7	5.3
Netflix Total Paying Subs				9.2	11.9	18.3	31.2	33.5	38.5	43.4	46.4
Hulu Plus Paying Subs				-	-	-	1.4	3.1	5.0	7.0	9.0
Total Domestic DTC Paying Subscribers				9.2	11.9	18.3	32.6	36.6	43.5	50.4	55.4
Netflix Paying Streaming Subs (International)						0.3	1.4	4.9	9.7	16.8	21.7

Source: Bernstein

While SVOD offerings from Netflix/Hulu/Amazon can more easily be a substitute for the cash-strapped millennial generation, it is clear from data that most households view these services as complementary to their pay-TV subscriptions. After all, if one wants to watch live sports and does not want to pay for cable TV, the only viable options to do so are purchasing a ~$20 digital antenna (only good for viewing sports on broadcast networks) or going to someone else's house or a bar or restaurant.

Netflix itself admits it's not trying to create a complete alternative to pay-TV. In fact, its business model is increasingly looking more like HBO's and Showtime's —one more based on exclusive, original content to attract and keep subscribers. On Netflix's website, taken from its "Long-term View" statement under the "Netflix Focus" section, the company states:

> "Netflix is a focused passion brand, not a do-everything brand: Starbucks, not 7-Eleven; Southwest, not United; HBO, not Dish…We are not a generic 'video' company that streams all types of video such as news, user-generated, sports, porn, music video, gaming, and reality. We are a movie and TV series entertainment network…We are making great headway with our slate of original series. Any linear network would be proud to show them."

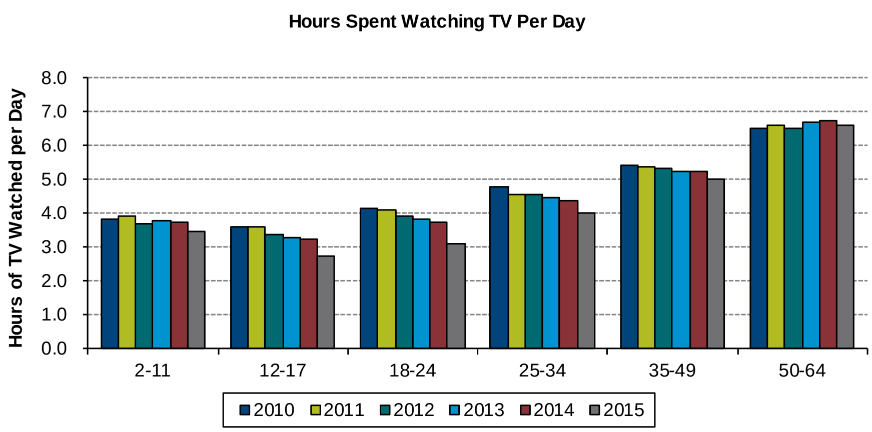
The fact that Netflix is trying to be more like HBO and Showtime is a good thing for broadcast and cable networks because that means Netflix's service will continue to serve more as a complement and less as a substitute for a pay-TV subscription. The next closest service acting like a substitute to pay-TV is Hulu, which is jointly owned by three of the largest network owners—Disney, Comcast and 21st Century Fox. All three of these companies have a vested interest to protect the economics of the pay-TV ecosystem and thus will operate Hulu over the long-term in a manner that does not cannibalize their networks' profitability.

Making a case for CBS Corporation[5]

CBS is in the early innings of its business model transformation that should help it become a much more profitable company over time. The days of advertising revenue being enough to fully support expensive, widely-viewed content (particularly sports) on broadcast TV are long gone. Over time, broadcast networks will be paid increasingly higher retransmission fees in line with the value they bring to the pay-TV ecosystem. Broadcasters command ~40% of primetime viewership, but receive only ~10% of the distributor's affiliation fees. In the words of CBS's CEO Les Moonves, "So when we look at what we're getting paid in retrans per sub and you compare it to ESPN, [on contracts up for negotiation] we're [now] getting about one third of what they're getting. And we're watched by a lot more people. So the future is very bright for us. **Remember, five years ago, we got nothing. Now we're getting quite a bit of money."**

CBS has "must-have" content that pay-TV distributors can't do without to be competitive in the marketplace. This includes its valuable sports rights locked up for the next seven plus years. It has NFL Sunday football under contract through 2022, the Super Bowl in 2016, 2019 and 2022, NCAA March Madness through 2024, SEC football and basketball through 2023, the PGA Tour through 2021 and a long-standing tradition of airing the Masters (the contract is up for renewal every three years). Finally, it successfully renewed NFL Thursday night football for this season.

CBS has an audience with a median age of 57 that is less likely to watch video online, which bodes well for advertising on its network. As one can see in the bar chart below, the older demographic (50-64 year-old cohort) continues to watch the most TV with little change to that behavior over the past five years. So, for instance, if a pharmaceutical company wants to reach millions of 50+ year-old Americans with an ad for one of its prescription drugs, it would be difficult to find a better way than advertising on CBS.



Source: Nielsen Media Research

CBS is the most-watched TV network in the U.S. and has been for 12 of the last 13 years thanks in part to the viewing loyalty of this older demographic. CBS garners approximately 12% of primetime household viewers but just over 2% of the distributors' affiliation fees. With many of CBS's affiliate contracts coming up for renewal with distributors over the next five years, the odds are good CBS will be able to increase its haul from retrans fees (which carry 100% incremental margin) from ~$0.6b in 2014 to ~$1.0b in 2016 and over $2.0b in 2020.

Additionally, CBS owns Showtime with approximately 23 million paying subscribers. Showtime has a lot of very good, critically-acclaimed original content, much of which it partially owns or owns outright. Recently, its streaming service on Showtime.com was introduced at $10.99 per month. CBS believes this direct-to-

[5] CBS Corporation (CBS) represented 5.41% of the FPA U.S. Value Fund, Inc. as of 9/30/15.

consumer offering can, over time, help Showtime bridge part of the subscriber gap with HBO, which has about 6 million more domestic subscribers paying approximately $15 per month. Each incremental Showtime subscriber carries a very high contribution margin as there are very few additional expenses against those incremental revenues. Additionally, this online offering helps CBS in its endeavor to accelerate the monetization of Showtime content internationally.

CBS also owns some very valuable, non-core assets. In addition to nearly 40% of CBS affiliate stations in many major cities across the U.S., CBS owns several CW, independent and UPN affiliates in these large markets. Affiliate stations not tied to a major broadcast network such as CBS generally do not have robust profits as the audience share tends to be low, which translates into relatively low retrans fees and advertising revenue. What these affiliate stations do have in their favor is very valuable spectrum that can be monetized through government auction. Some of the largest buyers of spectrum tend to be the major U.S. wireless carriers as demand for their services continues to grow in line with greater mobile consumption of video and data. Therefore, CBS could look to sell these valuable assets in the future, allowing it to return more cash to shareholders. These asset sales would have a minimal impact on earnings.

I believe that the market is not currently focused on these long-term opportunities for CBS. Rather, it is fixated on the industry's weak live TV ratings year-to-date as viewership patterns continue to change with several ways to view programs much later and on various devices.

This is all a long way of saying that now is a nice entry point to invest in a well-managed, good, non-capital intensive business with clear growth drivers for the next several years. Despite these positive attributes and relatively low leverage, CBS is being valued at 10-11x 2016E EPS (based on consensus estimates) even though it has the ability to grow EPS at a 10%-20% CAGR through 2020, absent another recession.

One final note. There have been rumors that the controlling shareholder of CBS and Viacom, Sumner Redstone, would like Viacom to buy CBS since Viacom is in a relatively weak negotiating position with distributors. Viacom, which owns ~170 networks around the world as well as Paramount Pictures, lacks "must-have" sports content. Its viewers are spending increasingly more time watching video online, which has had a greater impact on its networks' ratings than on its competitors. If Viacom were to bid for CBS, I believe that would open the door for a higher, competing bid from the likes of Time Warner (TWX) since the synergies of combining CBS and TWX are much greater than CBS rejoining with Viacom. The benefits of marrying the sports rights CBS has for broadcast and TWX has for cable would be compelling, similar to what Disney has done with ABC and ESPN. What's more, there would be synergies across the two companies' news divisions. Finally, the ability to have a joint direct-to-consumer online HBO/Showtime offering (priced at a discount compared to individually subscribing to each service) would likely accelerate subscriber growth for both offerings in the U.S. and even more so abroad.

My view on where the Pay-TV industry is going

In the words of Wayne Gretzky, "I skate to where the puck is going to be, not where it has been." Within the next few years, pay-TV in the U.S. is likely to undergo three key changes that will affect how people will consume content as well as how cable networks and broadcasters will be compensated. These are all changes for the better as it will enhance the consumer's TV viewing experience and result in better economics throughout the pay-TV ecosystem.

First, how ratings are measured will likely change. Nielsen's current rating system does not take into consideration viewership outside of a C3 (current day + 3 days) or C7 (current day + 7 days) window. At the same time, current ratings do not capture non-linear viewing on such devices as mobile phones, tablets and PCs. In all likelihood, ratings will capture a C30 (current day + 30 days) window. For a typical non-sports TV show, viewership approximately doubles over the course of 30 days compared to live viewing. Given the ever evolving viewing habits of consumers, C3 or even C7 will no longer be a reasonable measurement of ratings. Additionally, the future ratings system will capture non-linear viewing as greater use of “TV Go” applications are increasingly used by authenticated pay-TV subscribers to consume content on mobile devices, tablets and PCs.

Second, what will make C30 ratings relevant to advertisers is the utilization of dynamic ad insertion (DAI) across all distributors. DAI allows an advertiser to change the ad within a video-on-demand (VOD) show to make the ad that much more relevant to the viewer. For example, a studio advertising a movie would be able to change that ad as time goes on and, as a result, be willing to pay for that viewership since DAI helps keep the ad pertinent. While the technology of DAI is available today across all distributors, the current antiquated ratings system doesn’t accurately capture viewership and so advertisers are reluctant to pay up for advertising slots. However, it is only a matter of time before this gets resolved and once that happens, DAI can ultimately help lower the cost of a pay-TV subscription to the consumer.

Best of all for advertisers, ads on VOD shows cannot be skipped. Ultimately, this should result in lower ad loads and higher rates. Further down the road is the potential to use DAI on live TV, which will allow advertisers to target households based on geography and matching demographics (i.e. a luxury car manufacturer would be willing to pay a higher rate to target areas of the U.S. with household income above a certain level). The ability to effectively measure ratings on a C30 basis and monetize those viewing impressions has the potential to be a win-win for subscribers, networks, advertisers and distributors.

Finally, networks will increasingly offer full, in-season stacking rights for shows they air on TV as distributors increasingly incorporate these rights into the affiliate/retrans fees they pay networks. Stacking rights give subscribers the ability to watch any episode of a program’s current season through VOD once it has aired. Time Warner Entertainment and 21st Century Fox have been leaders regarding this effort but other networks will likely see the value in this and jump on board over time. Consumers want to watch whatever they want, whenever they want on which ever device they want. Allowing consumers the ability to catch up on a show can build a bigger audience over time, which ultimately makes that content and the pay-TV subscription much more valuable in general. These stacking rights will allow one’s traditional pay-TV subscription to act more like Netflix’s and Hulu’s user-friendly services. Since networks get paid an affiliate fee per subscriber, keeping a robust subscriber base is in their best interests. At the same time, full in-season stacking of shows should provide more ad inventory for networks to sell to advertisers.

Imagine a pay-TV world in which once a show has aired, a subscription included the ability to watch a show anytime and on any device via VOD for no additional cost. Not only would it make a pay-TV subscription much more valuable to the consumer, it would also greatly reduce the need to record shows. This, in turn, would result in a lot more effective ad-supported content, which could help lower the cost of content to the consumer.

Conclusion

Often, the market overreacts to short-term dynamics and loses sight of what is most important. Today, the market is focused on the declining number of pay-TV subscribers (at a rate of 1%-2% per annum) and waning live television ratings, which are no longer relevant metrics to measure total viewership. Additionally, the market is unsettled by advertisers increasingly shifting ad dollars away from TV towards digital formats.

But what is most important is that people across the globe continue to consume more content than ever before. The international pay-TV/SVOD markets are far behind the U.S. and, as a result, should continue to grow at high rates for many years to come. Investors should not lose sight of the fact that the contribution margin from leveraging existing content is very high on an incremental dollar of sales. That extra revenue can come from more advertising, syndicating programming or licensing content to SVOD providers and/or international pay-TV distributors.

One other important thing to keep in mind is that nine of the top ten largest media companies make up ~10% or less of the U.S. distributors' affiliate/retrans fees. This means there are various, highly-synergistic M&A combinations in which industry players could engage to bolster their consumer offering and competitive position. This helps protect the downside of an investment in these companies.

So while one might argue in the short-term that the industry has not performed well, the future is bright for broadcasters, cable networks and studios that control long-term sports rights and/or own popular, high quality content. As these aforementioned issues become settled over time, I believe increasing industry profits will come back into focus for the market. As Doris Day would sing, "Hooray for Hollywood"!

Respectfully submitted,

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