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The Digital Future of the News Business

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## **Introduction**

There is no greater news media event in the world than a U.S. presidential election, and the tumultuous race of 2008 has laid bare how the landscape of mass communications is undergoing a dramatic and systemic transformation that is unprecedented in modern memory.

As the old saying from newspaper journalism goes: “Follow the money.” Insurgent candidates have been able to overwhelm the establishment in this election cycle with fundraising on the web.

Sen. John McCain (R.-Ariz.), whose campaign was pronounced dead by the media during the summer of 2007, secured his party’s nomination in early 2008. As of Feb. 28, the 71 year-old, who has served in Congress since 1983 and launched a failed presidential bid in 2000, had raised a total of \$66.4 million. That was respectable, but libertarian outsider Rep. Ron Paul (R.-Tex.) raised nearly a third of that amount on the Internet for his bid for the Republican nomination in the fourth quarter of 2007 alone, making him the top G.O.P. fundraiser at the time, factoring out Gov. Mitt Romney’s (R.-Mass.) self-funding.

The long-presumed Democratic nominee, Sen. Hillary Clinton (D.-NY), dwarfed McCain’s fundraising by late February, with a total of \$173.9 million. But her rival, 45 year-old Sen. Barack Obama (D.-Ill.), whose March 18 speech on race in America became the most-viewed video on YouTube, had surpassed them all with a record-shattering \$197.3 million. An Internet sensation, Obama’s online donor tally alone was larger than Clinton’s total number of donors, and the average contribution from his donors was a mere \$96.

Traditional media outlets in print and on the airwaves were caught flat-footed by this online explosion, and with their audiences in decline and their longstanding business models being up-ended, they’re having trouble capitalizing on all the excitement. Having seen the end of the latest economic boom in the U.S., shares of the nation’s largest media conglomerates—Time Warner, News Corp., Disney, Viacom and General Electric—are all trading below where they stood eight years ago while the economy faces a likely downturn that economists say could be long and deep.

Print publishers are in the worst shape of all, as they struggle to translate online audiences into meaningful revenue while Google funnels up the ad dollars migrating to the web. Classified ads of all kinds have virtually abandoned newspapers for cheap, online alternatives, like Craigslist, and key advertising industries like autos, real estate and retail are floundering in an economic malaise. Those print assets that haven’t been carved up and sold are either owned as trophies by billionaires that don’t need investment returns, or they’re under siege by angry shareholders.

## **Old Media in Peril**

The proliferation of new sources of information amid the rise of digital communications, along with the empowerment of private individuals to disseminate their voice to a limitless audience in real-time, has overwhelmed and confounded the entrenched interests of the media establishment. Meanwhile, the massive generational shift that’s already underway from the so-called Baby Boomers to their progeny only promises to widen and amplify this transformation in the years ahead.

Digital video recording and online video is already gathering critical mass in the marketplace, and advertisers are starting to rethink their spending budgets and targeting strategies in fundamental ways as the public learns to avoid their commercials. While national TV advertising on broadcast and cable still serves as the best option for some firms seeking a mass market, increasing numbers of advertisers are realizing that these outlets cost more than they're worth, and digital ad networks are offering attractive alternatives that can be more effective and significantly cheaper.

Online advertising also offers far better metrics with which advertisers can gauge their returns on investment.

As traditional media businesses grapple to rationalize their bloated infrastructures in this brave, new operating environment, the U.S. housing downturn, along with the credit crisis it has caused on Wall Street, threatens a knockout blow. Economic uncertainty and anxiety is running high amid a weakening dollar, rising inflation and spiraling government budget deficits. This deepening slowdown has the distinct potential to crimp consumer spending in the U.S. considerably for an extended period of time. Such a development would cripple the nation's chief source of economic vitality, and it could also do untold damage to emerging economies overseas, like China, which has been bankrolling the U.S. borrowing binge and supplying a low-cost manufacturing market for the goods that are purchased with the proceeds.

Out of uncertainty and fear, opportunity arises, and it's clear that digital communications—for all the chaos they have wrought—represent an economic opportunity that can be exploited by those best-positioned for the new age. Google, the

undisputed master of web media, shocked Wall Street with the strength of its results in the first quarter of 2008, which showed 30% profit growth from the year before, compared with 17% profit growth in the fourth quarter of last year. Rising concerns about a collapse in the online advertising bonanza were quelled as shares of Google soared 20% in one day.

The company's results did show a slowdown in the U.S., reflecting the weakening economy, but Google got over half its ad revenue from outside the U.S., where economic conditions have been markedly better almost across the board. Its paid clicks, or the number of times users clicked on its ads, rose 20%. That was lower than the 30% growth rate in paid clicks the company logged in the previous quarter, but it was significantly higher than expectations after comScore, the Web audience measuring firm, reported that paid clicks declined sharply on the web during the period.

Eric Schmidt, Google's chief executive, said during a conference call with Wall Street analysts that an economic slowdown in the U.S. will not derail Google's growth prospects.

"It is clear to us that we are well positioned for 2008 and beyond, regardless of the business environment that we find ourselves surrounded by," said Schmidt.

Elsewhere, Yahoo also logged a solid first-quarter performance, bolstering its case for rejecting Microsoft's takeout offer, and AOL is showing gains in user traffic to its Web sites, even as it struggles to transform its business from a subscription-based model to an ad-based model, like Google's.

These developments reflect trends viewed elsewhere on the web, where all kinds of sites are seeing increases in traffic as the public further adopts the Internet as an alternative for its entertainment, shopping, communication and information needs. Forecasting what the future may hold for the media business in this shifting landscape is a bit like spitting into the wind, and that's what the industry's largest conglomerates have been doing in trying to deal with it.

### **An Industry Struggling to Adapt**

Time Warner's infamous merger with AOL at the height of the NASDAQ bubble in 2000 was the beginning of the industry's spasmodic attempts to adapt to the Internet's rise. With shares of Time Warner now languishing well below their value at the deal's consummation, the deal is now viewed as one of the worst in U.S. corporate history. The company's shareholders are clamoring for a break-up at the company, which is viewed by investors as a nebulous patchwork of different businesses with little synergy that few can understand.

Time Warner's experience, however, hasn't stopped other media giants from embarking on a string of big web deals that have so far yielded insignificant gains to their bottom line. The companies are throwing investment dollars at the Internet in hopes of finding new frontiers for revenue growth that will in turn get their stock prices moving again. Eight years after the ill-fated Time Warner-AOL deal, Microsoft is locked in a struggle to acquire one of AOL's competitors—Yahoo—at a high premium to its market price in a move that its hopes will help it compete with Google.

With the business cycle appearing to enter a downswing, critics are comparing the deal to the Time Warner-AOL debacle, although

stock valuations are nowhere near as inflated on a price-to-earnings basis now as they were back in 2000. The risk in a Microsoft-Yahoo merger lies in the ability of management at both companies to meld their assets and cultures in a way that will benefit stockholders over and above what they can achieve as separate entities. The usual promises of synergies look especially thin with Yahoo and its Silicon Valley-based following scrambling to steer clear from Microsoft's "Evil Empire."

In the new media landscape, the pendulum is swinging away from the bigger-is-better rationale that created giants like Microsoft and the world's handful of media conglomerates. With Richard Parsons out as the CEO of Time Warner as of late 2007, the largest U.S. media empire finally looks poised to break itself up under the leadership of Parson's successor, Jeff Bewkes. If such a split were perceived as a success on Wall Street, a domino effect may spread to Time Warner's counterparts.

General Electric, which owns NBC Universal, is facing a shareholder revolt of its own, and the loudest demand from investors directed at the blue-chip behemoth is to ditch its media subsidiary. If GE's earnings results in the first quarter of 2008, which produced a rare miss in the eyes of Wall Street, are a harbinger of things to come, NBC could find itself on its own sooner rather than later. Given its low-growth mix of old media assets, it's hard to imagine investors taking a shine to NBC as a stand-alone. The company would probably find itself ripe for a leveraged buyout, which could ultimately result in painful restructurings at its venerable properties.

Sumner Redstone chose to split CBS away from Viacom at the end of 2005 to free up its cable properties, like MTV and

Nickelodeon, from its broadcasting TV and radio counterparts. Ironically, CBS shares far outperformed those of Viacom after the split as Wall Street eyed the company's cash pile. But now that the company's cash position has dwindled and hopes for a dividend payout have receded, the stock is trading below where it started 2006. Viacom shares haven't fared any better, as the content giant struggles to monetize its product line as Internet aggregators and distributors continue to rule the online advertising gravy train.

Disney has been relatively quiet since perhaps the most well-known CEO in Corporate America, Michael Eisner, was ousted in 2005 after a surprising and unprecedented 43% of the company's shareholders withheld their proxies to reelect him to the board a year earlier. That revolt stands as a landmark event in the ongoing rise of shareholder activism and corporate governance reform. It also satisfied shareholders for a while, but Eisner's replacement, Bob Iger, still hasn't boosted Disney's shares back to their 2000 highs, despite a string of acquisitions.

"Disney is doing well in all its existing businesses, but from an investment standpoint, the growth is slowing," UBS Investments analyst Michael Morris told me recently. "It needs to leverage new markets to find new growth, and the Internet is still a relatively new market in terms of growth potential."

Even Corporate America's largest Internet conglomerate, Barry Diller's IAC/InteractiveCorp, has recently opted for a break-up.

News Corp. is the only media conglomerate that has credibility in Silicon Valley, and that comes from its \$580 million acquisition

of MySpace, the social networking site. That came in 2005, when most media players wouldn't pull the trigger. Two years later, the site was valued at \$20 billion to \$25 billion amid an explosion in online social networking.

MySpace has an advertising deal with Google, guaranteeing it revenue from the web giant of \$900 million over three years. That said, MySpace is still not a significant profit driver for News Corp., and its ability to monetize its huge traffic flows are constrained by competition from other big social networking sites, like Facebook. Even where web traffic is huge, exploiting it is a tricky proposition for a large media conglomerate, since online audiences are notoriously savvy about avoiding the sort of blatant advertising efforts that have been a staple on TV for generations.

Despite its reputation as a mover and a shaker in media old and new, News Corp. shares haven't fared much better than its counterparts over the last decade. They're down about 40% from their highs in 2000, and the company recently spent over \$5 billion on Dow Jones, a newspaper publisher with few growth prospects. While its existing newspapers, like *The Times of London* and *The New York Post*, have been cultural successes that have helped News Corp. extend its influence and advance its interests, they have not been a profit driver for the company. Critics say the acquisition of Dow Jones was largely a trophy for News Corp. CEO Rupert Murdoch in the twilight of his storied career. Indeed, taking a seat at the table in the upper-echelons of American journalism, where Murdoch has been widely disparaged, represents a crowning achievement for a man who built a global empire from scratch by persistently flipping conventional wisdom on its head.

As a media columnist at *The New York Times* put it, “For those keeping score, Rupert Murdoch just bought the scoreboard.”

While the acquisition boosted Murdoch’s stature in the media, it remains far from clear whether it will ever boost stock returns for his shareholders. Murdoch famously muscled Dow Jones’ controlling shareholders—the Bancroft family – into selling their family legacy with a high bid in the face of a bleak outlook for the business. This was no small feat, given the journalistic traditions surrounding the publisher and its incorporation as a public trust in the spirit of the First Amendment and American democracy. Moreover, public outcry at the company from its former chairman, its employees, some prominent shareholders and other free press advocates put tremendous pressure on the disparate Bancroft family members as they struggled with the decision to sell.

A quick survey of the newspaper landscape at the time illustrates the reasons why the bid was ultimately accepted. Knight-Ridder, the nation’s largest newspaper chain, had been dissolved in a fire sale. McClatchy, which acquired several Knight-Ridder properties for what it perceived to be bargain prices, has become the laughingstock of the industry for wasting precious shareholder capital on declining businesses. Tribune was forced onto the auction block by its major shareholders, and after a string of leveraged buyout firms wrinkled their noses at its price tag, Sam Zell acquired the company by burying it in debt and saddling its employees with most of the risk.

For its part, The New York Times Company was facing a proxy fight from a fund manager at Morgan Stanley aimed at ending

the dual-class share structure that preserves control over the company in the hands of the Ochs-Sulzberger family.

The Bancroft family saga shoved dual-class share structures, a common fixture at publicly-traded media companies, into the spotlight, garnering scrutiny in an age of rising shareholder activism and strengthening corporate governance standards. Such arrangements also exist at Media General, E.W. Scripps, The Washington Post Co. and a host of other publishing conglomerates.

Ironically, Murdoch himself controls News Corp. through a dual-class share structure, and at 77 years-old, long-term holders have to be worried about the empire’s future in a digital age as the mogul prepares to pass the leadership baton to his son. Or, if giant media conglomerates are destined to be broken up for the benefit of shareholders as the Internet Revolution plays out, perhaps only Murdoch and his progeny have reason to be worried about this prospect.

The Times Co. managed to fend off Morgan Stanley and retain control in family hands. With their editorial mission a top priority for the Ochs-Sulzbergers, angry shareholders have little chance of gaining control over the company. That said, more recent events show that the company is bowing to economic realities and painful restructuring measures are in store.

Facing a proxy fight from Harbinger Capital Partners and the activist hedge fund’s partner, Firebrand Partners—an investment firm headed by a brand strategy consultant named Scott Galloway—The Times reluctantly surrendered two board seats to outside directors to represent Class A shareholders on its board in early 2008. Firebrand’s Galloway and Harbinger’s

James Kohlberg are expected to use their seats to push for asset sales that would probably be too painful to accept by insiders at the company, starting with *The Boston Globe*. The Times Co. acquired *The Globe* in 1993 for \$1.1 billion, and it's now estimated to be worth half that amount at best.

More than perhaps any other print publisher, The Times has come around to staking its future on the Internet, and it boasts the most popular newspaper Web site in the world. Boasting one of the largest audiences on the web, its online revenue has showed some impressive gains, but those gains are slowing. Internet revenue for The Times Co. increased 20% to \$330 million in 2007. Midway through that year, the company told investors that it expected Internet revenue to slow to 40% or 30%.

Meanwhile, \$330 million comes nowhere close to covering the \$2.8 billion in operating costs recorded by its News Media Group for 2007. Sources at the company have whispered to reporters that the annual cost of maintaining only its newsgathering operations is only \$200 million. If that's accurate, a digital future for The Times could be feasible, but getting from here to there will require a dramatic restructuring at a proud and old institution that has played an instrumental role in American history and is understandably resistant to fundamental change.

And things are getting worse. According to media reports, the newsroom at The Times Co.'s flagship newspaper is bracing for the first-ever mass firing of journalists in its 156-year history. At The Times and The Journal, older, more experienced and expensive journalists are accepting buyout offers and making way for younger, less experienced and cheaper replacements.

Meanwhile, the number of editors and researchers at those newsrooms will likely be reduced and foreign bureaus will be sacked.

The trend applies across the board at traditional media companies, where newsgathering operations around the world are being reduced in favor of talking heads and cheaper content that requires less manpower and can be flooded over the web in return for profitable advertising revenue. Overall, the business of journalism is shrinking, and the quality of the content is in decline. Demand for quality, original content backed up by solid reporting, however, is rising. Award-winning investigative stories from national newspapers have not managed to boost their bottom-lines or print circulation, but they always light up the Internet upon publication and take on a life of their own as they reverberate through cyberspace.

## **The Web's Wild West**

Currently, this situation is creating a vibrant and growing community of content creators on the web that publish their wares for free. Between this "Wild West" of bloggers, YouTube videographers and news aggregators, online ad networks and content distributors, like Google, have little incentive to invest the dollars required to produce quality content. Bloggers and other popular online news aggregators can largely use the content produced by newspapers, newswires and other traditional news gatherers as a foundation on which to make their own content. They deliver the information to an audience online in a style they enjoy, allowing them to win the eyeballs and ad dollars that are leaving traditional media outlets behind.

Meanwhile, the web has also given rise to an army of content generators that will produce quality content for free. The perfect example of this is Wikipedia, where a vast network of editors works for free to build a constantly updating online encyclopedia. The Wiki model has produced a virtual free market that ensures quality information with oversight from a discerning audience. It has yet to replace the value creation achieved by old-fashioned, on-the-scene news reporting from primary sources, but the Wiki model is still developing, and its long-term implications should send cold shivers down the spines of journalism professors everywhere.

Within this Wild West on the cyber frontier, some territory is being tamed. New business models are springing up as different forms of online advertising networks battle for dominance. It all starts around a popular site, and perhaps not surprisingly, the most popular news site on the web remains independent. It's Matt Drudge's Drudge Report, which achieved national acclaim in the late 1990's when it led the charge in breaking open the Lewinsky Scandal and the resulting impeachment of President Bill Clinton. The site is estimated to make \$3,500 a day in advertising revenue, which all goes to Matt Drudge himself.

On the other end of the political spectrum, Arianna Huffington has garnered a national audience with her "Internet Newspaper," The Huffington Post. The site is largely a blogging community centered around video clips and opinion columns from the traditional media, but its presentation of the news in a multi-platform format is breaking ground. In August 2006, it was announced that Softbank Capital would invest \$5 million in Huffington Post, and Alan Patricof's Greycroft Partners has also ponied up a round of venture funding.

Gawker Media, founded by Nick Denton, was one of the first companies to bring a traditional business model to the blogosphere. Centered around Gawker.com, the irreverent media watchdog for industry insiders, it also became home to popular blogs, like Defamer, Fleshbot and Deadspin. New York Magazine recently estimated the company's annual advertising revenue to be at least \$1 million two years ago, and possibly over \$2 million a year. That, combined with the low operating costs of web hosting fees and writer salaries, should be leaving Gawker Media with a healthy profit.

That said, Denton himself has raised skepticism about the ability of Corporate America to tame the blogosphere.

"Blogs are likely to be better for readers than for capitalists," Denton once said on his personal site. "While I love the medium, I've always been skeptical about the value of blogs as businesses."

Gawker Media recently announced it had sold three sites: Idolator, Gridskipper, and Wonkette. Denton said others could be more successful selling advertising on those properties.

These fledgling ventures in online news are tiny businesses compared to the advertising networks that currently dominate the web. The big ad networks serve as an advertising vehicle that a portal or media company can sell collectively to an advertiser. AOL's Platform A was the largest such network, having reached 91% of the online audience with 166.8 million unique visitors in January 2008, according to ComScore. It was followed by Yahoo's network, which garnered 155.8 million uniques that month. Google Networks reached 143.2 million uniques and Specific Media reached 142.3 million uniques.

Others have enjoyed some early success in building a network of sites around a particularly demographic or theme that is coveted by advertisers. Examples include Glam Media, which targets fashion-loving women ages 18-34. Heavy.com and Break.com, are targeting young men, ages 18-24, and they've poached talent from the shrinking world of lad magazines, like *Maxim* and *Stuff*. Martha Stewart Living Omnimedia's "Martha's Circle," and Nickelodeon's "ParentsConnect" are also efforts in targeting like-minded individuals on the web.

In the realm of news reporting, the web is still dominated by content distributors and "re-packagers" that are still piggy-backing on the efforts of traditional media outlets to gather the "who-what-when-where-how?"

### **The Shakeout: Creative Destruction**

As the process of creative destruction runs its course in the Old Media world, new incentives for content distributors to invest in the creation of quality news content should grow amid rising demand for such information by sophisticated, online audiences. The business-models that will sprout up surrounding such ventures remain a mystery, since the old forms of advertising will be largely irrelevant to these audiences. Smaller, independent players will have the edge as they strive to form a genuine bond with their niche audience.

One force that will accelerate the cycle of creative destruction is the growing convergence of various digital media platforms to a one-screen-fits-all format. Current distinctions between Internet, TV, radio, cable, satellite, phone and wireless will likely be phased out as high-speed, cheap, wireless delivery of Internet access becomes widely available to all, destroying

the business models that currently serve the entrenched interests in Old Media.

This convergence favors consumers at the expense of Corporate America, as a household's various telecommunications bills become consolidated into one and competition combines with ease-of-access to drive the price of media way down. The traditional functions of TV, the Internet and other platforms will be combined into one interactive, on-demand format available on screens of all sizes anywhere, benefiting cutting-edge hardware makers, like Apple.

As this transformation takes place, new sources of trusted content will be formed and subscription-based business models will likely come back into vogue, particularly for high-brow investigative journalism and sophisticated programming. Pay-TV channels, like HBO and Showtime, are a precursor to this, as is *The Wall Street Journal Online*. Murdoch initially indicated after he bought *The Journal* that he would do away with the online subscription model, but he quickly backed away from that as economic realities set in. The newspaper's ability to maintain one of the few successful subscription revenue streams on the web for journalism is a testament to its inherent value as the dominant source of timely information in U.S. financial markets.

It seems likely that subscription models will rise in other news categories, like sports, entertainment and politics, as the new digital order takes shape. Another possible model for journalism that could endure is non-profit, which may be where *The New York Times* is headed. Paul Steiger, former managing editor at *The Journal*, is making headlines for his new non-profit investigative journalism outfit called ProPublica, which is funded by prominent donors to the Democratic Party.

Independent news sources on public television and radio have always been a popular attraction for philanthropists, and the non-profit journalism sector could receive substantially more support from private sources as economic pressures weigh on corporate journalism.

## Conclusion

Smaller, independent players will be best-positioned to thrive as news content creators on the web as the digital revolution comes into its own and digital media technologies converge onto one screen. The trend towards national media outlets will be reversed towards local news sources and those geared towards a specific, niche segment, like a specific sport or team or a political ideology or investment strategy.

Another trend that will be reversed is the current one away from subscription models to advertising models. Online advertising is certainly a huge growth market, but online sources of news content that serve a specific niche will increasingly use subscription as a viable revenue stream, especially as consumers pay less for access to telecommunications and become more willing to pay for quality content that suits their personal taste.

Any content source that can establish a large following willing to pay for access will also be able to exploit innovative ad models and retail outlets that help businesses in a certain niche reach their core audience in a way that doesn't scare them off.

This shift promises to be a painful one for a variety of entrenched interests in the short run, but longer-term, the digital revolution seems likely to spark a sort of content renaissance that will be good for business and entrepreneurship as well as creativity

and public discourse. So, amid all the confusion, corporate downsizing and subpar investment returns, it's important to remember: the future is bright.

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