Strategic Benefits and Risks of Vertical Integration in International Media Conglomerates and Their Effect on Firm Performance

DISSERTATION
of the University of St. Gallen,
Graduate School of Business Administration,
Economics, Law, and Social Sciences (HSG)
to obtain the title of
Doctor Oeconomiae

submitted by

Fiona Röder

from

Germany

Approved on the application of

Prof. Dr. Beat Schmid

and

Prof. Dr. Li-Choy Chong

Dissertation no. 3402

Difo-Druck Bamberg
The University of St. Gallen, Graduate School of Business Administration, Economics, Law and Social Sciences (HSG) hereby consents to the printing of the present dissertation, without hereby expressing any opinion of the views herein expressed.

St. Gallen, October 15, 2007

The President:

Prof. Ernst Mohr, PhD
Summary of Content

Table of Contents ....................................................................................................................... V
List of Figures ............................................................................................................................ X
List of Tables ............................................................................................................................ XI
List of Abbreviations .............................................................................................................. XII
Abstract .................................................................................................................................. XIII

1. Introduction.......................................................................................................................... 17
   1.1. Research Background ............................................................................................ 17
   1.2. Problem Statement ............................................................................................... 18
   1.3. Purpose of the Study ............................................................................................ 20
   1.4. Scope and Limitations of the Study .................................................................... 21
   1.5. Organization of Research ..................................................................................... 22

2. Literature Review ................................................................................................................. 25
   2.1. The Empirical Context of the Media Industry .................................................... 25
   2.2. Influences on the Development of the International Media Conglomerate ....... 26
   2.3. Theoretical Frameworks of Vertical Integration ................................................ 38
   2.4. Vertical Integration Theories ............................................................................... 40
   2.5. Possible Diseconomies of Vertical Integration ................................................... 76
   2.6. Summary and Concluding Analysis of the Motives for Implementing a Vertical Integration Strategy ................................................................. 77
   2.7. Vertical Integration Rationales Along the Media Value Chain ......................... 90
   2.8. Vertical Integration and Its Effect on Firm Performance ..................................... 105
   2.9. Hypotheses .......................................................................................................... 106

3. Methodology and Research Design ...................................................................................... 109
   3.1. Research Goal of the Study .................................................................................. 109
   3.2. Research Model ..................................................................................................... 109
   3.3. Research Design ..................................................................................................... 112

4. Empirical Part I: Media Case Studies .................................................................................. 127
   4.1. Introduction ............................................................................................................ 127
   4.2. Case Study: Time Warner ..................................................................................... 128
   4.3. Case Study: The Walt Disney Company .............................................................. 142
   4.4. Case Study: News Corporation ............................................................................ 157
   4.5. Case Study: Viacom Inc ......................................................................................... 174
   4.6. Case Study: Bertelsmann AG ............................................................................... 187
   4.7. Case Study: Sony Corporation .............................................................................. 202
   4.8. Conclusion ............................................................................................................. 212

5. Empirical Part II: Inter-Case Analysis ................................................................................ 213
   5.1. Introduction ............................................................................................................ 213
   5.2. Extent and Direction of Vertical Integration for Leading Global Media Companies .......................................................................................................... 214
   5.3. Analysis of Each Conglomerate’s Financial Performance Variables .................. 227
   5.4. Comparison of Common Segment Profitability for the Selected Media Conglomerates ................................................................. 237
# Table of Contents

1. **Introduction** ......................................................................................................................... 17  
   1.1. Research Background ........................................................................................................ 17  
   1.2. Problem Statement ........................................................................................................... 18  
   1.3. Purpose of the Study ......................................................................................................... 20  
   1.4. Scope and Limitations of the Study .................................................................................. 21  
   1.5. Organization of Research ................................................................................................. 22  

2. **Literature Review** .................................................................................................................. 25  
   2.1. The Empirical Context of the Media Industry ................................................................... 25  
   2.2. Influences on the Development of the International Media Conglomerate .................. 26  
      2.2.1. General Environmental Influences .............................................................................. 26  
      2.2.1.1. Development of Global Capital Markets ............................................................... 27  
      2.2.1.2. Technological Innovation ....................................................................................... 27  
      2.2.1.2.1. Convergence ........................................................................................................ 27  
      2.2.1.2.2. Digitization ......................................................................................................... 30  
      2.2.1.2.3. New Media and Internet ...................................................................................... 31  
      2.2.1.3. Globalization ........................................................................................................... 31  
      2.2.1.4. Socio-Cultural Developments ................................................................................ 32  
      2.2.1.2. Media-Specific Policy Influences ........................................................................... 32  
      2.2.1.3. Market-Specific Influences ...................................................................................... 33  
      2.2.1.3.1. Increasing Competition and Market Consolidation ........................................... 33  
      2.2.1.3.2. Increasing Fragmentation of Media Markets ...................................................... 36  
      2.2.1.4. Firm-Specific Influences ........................................................................................ 37  
   2.3. Theoretical Frameworks of Vertical Integration ............................................................... 38  
      2.3.1. Introduction and Definition of Vertical Integration ................................................... 38  
   2.4. Vertical Integration Theories .............................................................................................. 40  
      2.4.1. Static Models of Vertical Integration ............................................................................ 42  
      2.4.1.1. Transaction Cost Economics ..................................................................................... 42  
      2.4.1.1.1. Applicability of Transaction Cost Economics to the Media Industry .................... 47  
      2.4.1.2. Property Rights Theory ........................................................................................... 49  
      2.4.1.2.1. Applicability of the Property Rights Theory to the Media Industry ....................... 51  
      2.4.1.2.2. Empirical Research on the Incomplete Contracts Theory (Transaction Cost Economics and Property Rights Theory) . 52  
      2.4.1.3. Vertical Integration as a Mechanism to Prevent Exclusionary Market Power ........ 53  
      2.4.1.3.1. Empirical Research on the Exclusionary Market Power Approach ......................... 55  
      2.4.1.3.2. Applicability of the Exclusionary Market Power Approach to the Media Industry . 56  
      2.4.1.4. The Resource-Based View of the Firm and its Application to Vertical Integration ........ 58  
      2.4.1.4.1. Empirical Research on the Resource-Based View of Vertical Integration ................. 62  
      2.4.1.4.2. Applicability of the Resource-Based View of Vertical Integration to the Media Industry ............................................................................................................. 63  
   2.4.2. Dynamic Models of Vertical Integration ......................................................................... 64  
      2.4.2.1. Stigler's Dynamic Model of Vertical Integration ...................................................... 64
### Table of Contents

2.4.2.1.  
**Applicability of Stigler’s Vertical Integration Theory to the Media Industry** .......................................................... 66

2.4.2.2.  
**Harrigan’s Model of Vertical Integration** .......................................................... 67

2.4.2.2.1.  
**Applicability of Harrigan’s Strategic Framework to the Media Industry** ................. 72

2.4.2.3.  
**The Strategy-Structure Choice Model of Vertical Integration** .................................. 73

2.4.2.4.  
**A Dynamic Model of Vertical Integration under the Resource-Based View of the Firm** ........................................................................ 75

2.5.  
**Possible Diseconomies of Vertical Integration** .......................................................... 76

2.6.  
**Summary and Concluding Analysis of the Motives for Implementing a Vertical Integration Strategy** ........................................................................ 77

2.6.1.  
**Traditional Vertical Integration Factors** ................................................................ 77

2.6.1.1.  
**Transaction Cost Considerations** .......................................................... 78

2.6.1.2.  
**Reduction of Opportunistic Behaviour** ................................................................ 79

2.6.1.3.  
**Synergy Creation** ........................................................................ 82

2.6.1.4.  
**Reduction of Uncertainty and Risk** ................................................................ 82

2.6.1.5.  
**Strategic Rationales of Vertical Integration** ................................................................ 84

2.6.2.  
**Contemporary Vertical Integration Influencing Factors** ........................................ 85

2.6.2.1.  
**Innovation** ........................................................................ 85

2.6.2.2.  
**Knowledge Transfer** ........................................................................ 85

2.6.2.3.  
**Value Migration** ........................................................................ 86

2.6.2.4.  
**Increasing Product Complexity** ........................................................................ 86

2.6.3.  
**Conclusion: Vertical Integration as a Natural Strategic Response to the Given Media Market Structure** ........................................................................ 87

2.7.  
**Vertical Integration Rationales Along the Media Value Chain** ................................................. 90

2.7.1.  
**Vertical Integration Rationale for Content Producers** ........................................ 93

2.7.1.1.  
**Vertical Integration between Theatrical Content Producers and Theatrical Distribution** ........................................................................ 93

2.7.1.2.  
**Vertical Integration between Music Content Producers and Music Distributors** ........................................................................ 95

2.7.2.  
**Vertical Integration Rationale for Content Aggregators** ........................................ 96

2.7.2.1.  
**Vertical Integration between Television Broadcasters and Television Broadcast Stations** ........................................................................ 96

2.7.2.2.  
**Vertical Integration of Cable Content Aggregators and Cable System Operators** ........................................................................ 99

2.7.3.  
**Vertical Integration Rationale for Internet Access Providers** ................................ 101

2.7.3.1.  
**Backward Vertical Integration of Internet Access Providers into Content Production** ........................................................................ 101

2.7.3.2.  
**Forward Vertical Integration of Internet Access Providers into Product Services** ........................................................................ 104

2.8.  
**Vertical Integration and Its Effect on Firm Performance** ........................................ 105

2.9.  
**Hypotheses** ........................................................................ 106

3.  
**Methodology and Research Design** ........................................................................ 109

3.1.  
**Research Goal of the Study** ........................................................................ 109

3.2.  
**Research Model** ........................................................................ 109

3.2.1.  
**Development of the Research Model** ........................................................................ 109

3.2.2.  
**The Research Model** ........................................................................ 110

3.3.  
**Research Design** ........................................................................ 112

3.3.1.  
**Research Methodology Discussion** ........................................................................ 112

3.3.2.  
**Rationale for Adopting a Case Study Approach** ........................................................................ 113

3.3.3.  
**Rationale for Adopting the Multiple-Case Study Approach** ........................................................................ 115

3.3.4.  
**Case Study Data Collection** ........................................................................ 116

3.3.5.  
**Case Study Data Analysis** ........................................................................ 117

3.3.5.1.  
**Constructing a Vertical Integration Ranking** ........................................................................ 118
3.3.5.2. Analysis of the Relationship between Vertical Integration and Firm Performance .................................................. 119
3.3.5.3. Performance Evaluation .................................................................................................................. 120
  3.3.5.3.1. Overview of Performance Evaluation .............................................................................. 120
  3.3.5.3.2. Performance Measures Employed in the Case Studies .................................. 121
    3.3.5.3.2.1. Variables Measuring Profitability ........................................................................ 121
3.3.6. Quality Measures of the Research Design .......................................................................................... 122
  3.3.6.1. Construct Validity ........................................................................................................ 122
  3.3.6.2. Internal Validity ........................................................................................................ 124
  3.3.6.3. External Validity ........................................................................................................ 124
  3.3.6.4. Reliability ................................................................................................................ 125

4. Empirical Part I: Media Case Studies .................................................................................................. 127

4.1. Introduction .................................................................................................................................... 127
4.2. Case Study: Time Warner ............................................................................................................. 128
  4.2.1. Corporate History: Time Warner ......................................................................................... 128
    4.2.1.1. Time Warner Merger ..................................................................................................... 129
    4.2.1.2. Time Warner – TBS Merger .......................................................................................... 130
  4.2.2. Corporate History: AOL ..................................................................................................... 131
    4.2.2.1. Business Model ............................................................................................................ 131
  4.2.3. The AOL Time Warner Merger ......................................................................................... 133
    4.2.3.1. Proposed Synergies ....................................................................................................... 134
    4.2.3.2. Analysis of Benefits Resulting from the Vertical Integration of AOL and Time Warner ... 135
  4.2.4. Post-Merger Development .................................................................................................... 137
  4.2.5. Analysis of AOL’s and Time Warner’s Corporate Culture .................................................. 138
  4.2.6. Classification of Time Warner’s M&A Activities According to their Type of Integration ... 139

4.3. Case Study: The Walt Disney Company ......................................................................................... 142
  4.3.1. Corporate History: ............................................................................................................. 142
    4.3.1.1. Early Vertical Integration Moves .................................................................................. 142
    4.3.1.2. ABC Capital Cities Acquisition .................................................................................... 146
    4.3.1.3. Post-Acquisition Difficulties ......................................................................................... 147
    4.3.1.4. Disney’s Development Post Eisner .............................................................................. 149
  4.3.2. Summary of Disney’s Corporate Strategy ............................................................................ 151
    4.3.2.1. Analysis of Disney’s Vertical Integration Strategy ..................................................... 151
    4.3.2.2. Analysis of Disney’s Corporate Culture ................................................................. 153
    4.3.2.2.1. Synergies from Economies of Scale and Scope ...................................................... 153
    4.3.2.2.2. Synergies from Geographic Integration ................................................................. 154
    4.3.2.2.3. Synergies from Vertical Integration ........................................................................ 155
  4.3.3. Classification of Disney’s M&A Activities According to their Type of Integration .......... 155

4.4. Case Study: News Corporation .................................................................................................... 157
  4.4.1. Corporate History: News Corporation ............................................................................... 157
    4.4.1.1. From Print to Television: Early Vertical Integration Moves ....................................... 157
    4.4.1.2. News Corporation’s Entry into Satellite Broadcasting .............................................. 159
    4.4.1.3. Vertical Integration of Television Broadcasting ....................................................... 163
    4.4.1.4. Vertical Integration of New Media and Internet Assets ............................................ 165
  4.4.2. Summary of News Corporation’s Corporate Strategy ...................................................... 166
    4.4.2.1. Vertical Integration as the Central Strategy ............................................................... 167
    4.4.2.2. Analysis of News Corporation’s Corporate Culture .................................................. 170

4.4.3. Classification of News Corporation’s M&A Activities According to their Type of Integration ........................................ 171

4.5. Case Study: Viacom Inc ............................................................................................................... 174
  4.5.1. Company History: Viacom ................................................................................................. 174
Table of Contents

5. Empirical Part II: Inter-Case Analysis

5.1. Introduction

5.2. Extent and Direction of Vertical Integration for Leading Global Media Companies

5.2.1. Extent of Vertical Integration of the Selected Media Conglomerates

5.2.2. Analysis of Revenue Contribution Per Media Value Chain Segment

5.2.2.1. News Corporation

5.2.2.2. Viacom

5.2.2.3. Disney

5.2.2.4. Time Warner

5.2.2.5. Sony Corporation

5.2.2.6. Bertelsmann AG

5.2.2.7. Conclusive Analysis

5.3. Analysis of Each Conglomerate’s Financial Performance Variables
List of Figures

Figure 1: Influences on Media Companies ................................................................. 25
Figure 2: Drivers of Industry Convergence ............................................................... 27
Figure 3: Overview Vertical Integration Theories .................................................... 39
Figure 4: How Capabilities, Transaction Costs and Vertical Integration Co-Evolve in an Industry .... 60
Figure 5: Harrigan’s Generic Vertical Integration Strategies .................................. 67
Figure 6: Harrigan’s Vertical Integration Framework for Established Industries ........ 69
Figure 7: Harrigan’s Strategic Framework of Vertical Integration in Emerging Industries ........ 70
Figure 8: Static Model of Marginal Bureaucratic Costs and Marginal Economic Benefit .... 73
Figure 9: Overview Traditional Vertical Integration Factors .................................. 77
Figure 10: Overview Contemporary Vertical Integration Influencing Factors .......... 84
Figure 11: Convergence Media Value Chain ............................................................ 90
Figure 12: Research Model .................................................................................. 110
Figure 13: Vertical Integration and Performance – Theoretical Framework ............ 118
Figure 14: Viacom Total Revenues by Business Segment (1996-2006) ................. 141
Figure 15: Disney Total Revenues by Business Segment (1991-2005) ................. 141
Figure 16: Time Warner Total Revenues by Business Segment (1991-2005) ........ 141
Figure 17: Sony Corporation Total Revenues by Business Segment (1991-2005) .... 141
Figure 18: Bertelsmann AG Total Revenues by Business Segment (1996-2005) ...... 141
Figure 19: Viacom Share Price Development Compared to DJ Media 1800 Index (1992-2006) .... 141
Figure 20: Time Warner Share Price Development Compared to DJ Media 1800 Index (1992-2006) .... 141
Figure 21: News Corporation Share Price Development Compared to DJ Media 1800 Index (1992-2006) .... 141
Figure 22: Disney Share Price Development Compared to DJ Media 1800 Index (1992-2006) .... 141
Figure 23: Sony Corporation Share Price Development Compared to DJ Media 1800 Index (1992-2006) .... 141
Figure 24: Comparison of the Selected Media Conglomerates’ Share Price Development (1992-2006) .... 141
Figure 25: Time Warner Share Price Development; Rebased to 100 (1992-2006) .... 141
Figure 26: Relationship between Organizational Structure and Degree of International Revenues ..... 141
Figure 27: Vertical Integration Ranking for the Selected Media Conglomerates .......... 141
Figure 28: Financial Performance Overview in Relation to Company Size and Share Price Performance .... 141
List of Tables

Table 1: 2003 Media Industry Segments’ Concentration Ratios .......................................................... 34
Table 2: Time Warner: Classification of M&A Activities According to Type of Integration .......... 141
Table 3: Disney: Overview Corporate Strategy .................................................................................. 151
Table 4: Classification of M&A Activities According To Type of Integration .................................. 156
Table 5: News Corporation: Overview Corporate Strategy .............................................................. 166
Table 6: News Corporation: Overview Joint Ventures .................................................................... 169
Table 7: Classification of News Corporation’s M&A Activities According to their Type of Integration ......................................................................................................................... 173
Table 8: Overview of Viacom’s Corporate Strategy ......................................................................... 181
Table 9: Classification of Viacom’s M&A Activities According to their Type of Integration ........... 186
Table 10: Overview of Bertelsmann’s Corporate Strategy ................................................................. 194
Table 11: Classification of Bertelsmann’s M&A Activities According to their Type of Integration .... 201
Table 12: Synergies between Sony’s Hardware and New Software Products after the CBS/Columbia Tristar Acquisitions ............................................................................................................. 209
Table 13: Classification of Sony’s M&A Activities and Joint Ventures According to their Type of Integration .................................................................................................................................................. 212
Table 14: Comparison of SIC Sector Presence of the Selected Media Conglomerates .................. 215
Table 15: Activity Profile of the Selected Media Conglomerates ....................................................... 217
Table 16: News Corporation Development Revenue Contribution per Business Segment ............ 219
Table 17: Viacom Development Revenue Contribution per Business Segment .............................. 221
Table 18: Disney Development Revenue Contribution per Business Segment ............................ 222
Table 19: Time Warner Development Revenue Contribution per Business Segment .................... 223
Table 20: Sony Corporation Total Revenues by Business Segment ................................................. 225
Table 21: Sony Corporation Development Revenue Contribution per Business Segment .............. 225
Table 22: Bertelsmann AG Development Revenue Contribution per Business Segment ................ 226
Table 23: Shifts in Content and Distribution Revenue Contributions ............................................ 227
Table 24: Analysis of Financial Performance Variables of the Selected Media Conglomerates .......... 228
Table 25: News Corporation’s Average ROS Per Business Segment – Historical Evolution .......... 230
Table 26: BSkyB’s and FEG’s Average ROS Per Business Segment (2004/2005) ............................ 230
Table 27: Viacom’s Average ROS Per Business Segment – Historical Evolution ............................ 231
Table 28: Time Warner’s Average ROS Per Business Segment – Historical Evolution ..................... 232
Table 29: Disney’s Average ROS Per Business Segment – Historical Evolution ............................. 234
Table 30: Bertelsmann’s Average ROS Per Business Segment – Historical Evolution .................... 235
Table 31: Sony’s Average ROS Per Business Segment – Historical Evolution ............................... 236
Table 32: Comparison of Average ROS 2000-2005 Per Segment for All Conglomerates ................ 237
Table 33: Average Total ROS for all Selected Media Conglomerates .............................................. 257
Table 34: Empirical Research on Vertical Integration and Performance ........................................... 270
## List of Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC</td>
<td>American Broadcasting Corporation</td>
</tr>
<tr>
<td>bn</td>
<td>Billion</td>
</tr>
<tr>
<td>CAGR</td>
<td>Cumulated Annual Growth Rate</td>
</tr>
<tr>
<td>CBS</td>
<td>Columbia Broadcasting System</td>
</tr>
<tr>
<td>CNBC</td>
<td>Consumer News and Business Channel</td>
</tr>
<tr>
<td>CNN</td>
<td>Cable News Network</td>
</tr>
<tr>
<td>DBS</td>
<td>Direct Broadcast Satellite</td>
</tr>
<tr>
<td>DJ</td>
<td>Dow Jones</td>
</tr>
<tr>
<td>DTH</td>
<td>Direct-to-Home</td>
</tr>
<tr>
<td>DTT</td>
<td>Digital Terrestrial Television</td>
</tr>
<tr>
<td>DVR</td>
<td>Digital Video Recorder</td>
</tr>
<tr>
<td>EBIT</td>
<td>Earnings before Interest and Tax</td>
</tr>
<tr>
<td>EBITDA</td>
<td>Earnings before Interest, Tax, Depreciation and Amortisation</td>
</tr>
<tr>
<td>e.g.</td>
<td>Exempli gratia,(Latin), for example</td>
</tr>
<tr>
<td>ESPN</td>
<td>Entertainment and Sports Programming Network</td>
</tr>
<tr>
<td>FCC</td>
<td>Federal Communications Commission</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>HBO</td>
<td>Home Box Office</td>
</tr>
<tr>
<td>IAP</td>
<td>Internet Access Provider</td>
</tr>
<tr>
<td>i.e.</td>
<td>Id est (Latin), that is</td>
</tr>
<tr>
<td>IPO</td>
<td>Initial Public Offering</td>
</tr>
<tr>
<td>ISP</td>
<td>Internet Service Provider</td>
</tr>
<tr>
<td>IT</td>
<td>Information Technology</td>
</tr>
<tr>
<td>M&amp;A</td>
<td>Mergers &amp; Acquisitions</td>
</tr>
<tr>
<td>MSO</td>
<td>Multiple Service Operator</td>
</tr>
<tr>
<td>m</td>
<td>Million</td>
</tr>
<tr>
<td>MTV</td>
<td>Music Television Network</td>
</tr>
<tr>
<td>N/A</td>
<td>Not announced, not applicable</td>
</tr>
<tr>
<td>ND</td>
<td>Net Debt</td>
</tr>
<tr>
<td>NI</td>
<td>Net Income</td>
</tr>
<tr>
<td>NYA</td>
<td>Not yet acquired</td>
</tr>
<tr>
<td>NYE</td>
<td>Not yet existent</td>
</tr>
<tr>
<td>PPV</td>
<td>Pay-per-View</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>Research and Development</td>
</tr>
<tr>
<td>ROA</td>
<td>Return on Assets</td>
</tr>
<tr>
<td>ROE</td>
<td>Return on Equity</td>
</tr>
<tr>
<td>ROIC</td>
<td>Return on Invested Capital</td>
</tr>
<tr>
<td>ROS</td>
<td>Return on Sales</td>
</tr>
<tr>
<td>SCP</td>
<td>Structure-Conduct-Performance</td>
</tr>
<tr>
<td>S&amp;P</td>
<td>Standard and Poor’s</td>
</tr>
<tr>
<td>TNN</td>
<td>The National Network</td>
</tr>
<tr>
<td>TV</td>
<td>Television</td>
</tr>
<tr>
<td>TW</td>
<td>Time Warner, Inc.</td>
</tr>
<tr>
<td>U.K.</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>UPN</td>
<td>United Paramount Network</td>
</tr>
<tr>
<td>U.S.</td>
<td>United States of America</td>
</tr>
<tr>
<td>USA</td>
<td>United States of America</td>
</tr>
<tr>
<td>USS</td>
<td>U.S. Dollar</td>
</tr>
<tr>
<td>USD</td>
<td>U.S. Dollar</td>
</tr>
<tr>
<td>VOD</td>
<td>Video On Demand</td>
</tr>
<tr>
<td>VoIP</td>
<td>Voice over Internet Protocol</td>
</tr>
<tr>
<td>WB</td>
<td>Warner Brothers</td>
</tr>
</tbody>
</table>
Abstract

This study addresses the risks and benefits of a strategy of vertical integration for the leading international media conglomerates and assesses their effect on firm performance. It sheds light on the corporate dynamics of six of the world’s largest media conglomerates and on their vertical integration strategies in particular.

In its theoretical part, the study first analyses the structural characteristics of media markets, and explains the market- and firm-specific trends that can currently be observed in each of the media value chain segments. Secondly, static and dynamic models of vertical integration are compared and critically discussed, and a set of influencing variables that are applicable to the specific characteristics of the media industry in general and the media conglomerates in particular, is derived from the presented theories. Prior empirical research relating vertical integration to firm performance is critically analyzed with a specific emphasis on studies linking vertical integration and firm performance in the field of mediaeconomic research, and the general strategic risks and benefits of vertical integration are outlined and critically analyzed. The theoretical part concludes with an analysis of the efficiency justifications of a strategy of vertical integration for the major segments of the media value chain as postulated by the Transaction Cost Economics and market power explanations of the existing vertical integration literature.

In its empirical part, the study presents case studies for the major six media conglomerates Time Warner, News Corporation, Viacom, Disney, Bertelsmann AG, and Sony Corporation. The study finds that the selected media conglomerates have all, for the time frame selected, predominantly followed a corporate strategy of vertical integration and are today characterized by extensive vertical links between as well as within the media industry value chain segments. The study finds also that the direction of vertical integration has been mostly downstream, i.e. content producers vertically integrate into distribution. Differences between the conglomerates’ performances are explained by considering the internal and external influence factors developed in the theoretical part of the dissertation. The subsequent meta-analysis of the case studies provides evidence that the extent of vertical integration is positively correlated with firm performance. A correlation between the extent of vertical integration and share price performance, however, is not found. The empirical results further provide evidence that the successful implementation of a vertical integration strategy might
be correlated with the choice of organizational form and suggests further research to allow a definite conclusion in this matter.
Die vorliegende Studie behandelt die strategischen Risiken und Vorzüge vertikaler Integration führender internationaler Medienkonzern und beurteilt ihre Auswirkungen auf die Unternehmensprofitabilität. Die Entwicklung der sechs weltweit größten Medienkonzern wird unter besonderer Berücksichtigung der von diesen angewandten Strategien vertikaler Integration untersucht.


bestimmten Grad mit der Unternehmenskultur und -form zusammenhängt, und weisen auf die Notwendigkeit weiterführender Untersuchungen hin, um in dieser Hinsicht zu abschliessenden Ergebnissen zu kommen.
1. INTRODUCTION

1.1. Research Background

Vertical integration is not a new phenomenon in the media industry. From the beginning of the 1920s until the outset of the 1950s, the Hollywood studio system was characterized by the in-house nature of all facets of production, distribution and exhibition. This in turn meant an extremely high level of vertical integration and thus of ownership concentration, which included control over content creators as well as the means of production and distribution (Balio, 1990; Sklar, 1994). With 95 per cent of screen time controlled by the major Hollywood content studios, smaller independent producers and exhibitors were effectively shut out of the market. This soon sparked anti-trust investigations which resulted in the U.S. Supreme Court putting an end to vertical integration in the media industry in 1948, divorcing exhibition from production and distribution as well as outlawing vertical foreclosure practices.

In contrast to this first wave of vertical integration, which focused on control over creativity as well as distribution, the vertical integration practices between 1980 and 2000 have been primarily driven by the need to secure multiple revenue windows for increasingly expensive film and television content, and to realize economies of scale and scope by bundling content production and distribution operations.

Since the turn of the millenium, the media industry has again been going through an intense phase of transformation, with digitization of production processes, technological convergence, and deregulation of the media business environment as the three defining trends. Digitization benefits the multiple usage of content and the enlargement of product formats (Picard, 2004). The technological convergence and subsequent emergence of multimedia markets have led to a proliferation of opportunities for content utilization (Lawson-Borders, 2003). The third trend, the deregulation of business environments, promotes the increasing globalization and commodization of media input and output markets.

Based on these developments, many media companies have merged to become multimedia conglomerates in their efforts to seek competitive advantages and thus higher profitability. The above-mentioned proliferation of content utilization opportunities allows the expansion of for example, a newspaper article into a magazine article; which could become the basis for a book, then, perhaps, a television series, and finally, a movie. This conceptual advantage,
known as synergy, has induced the conglomerization through vertical integration of many media enterprises. In addition, deregulation has allowed the media industry to develop from primarily national markets to one global commercial-media market (McChesney, 1999). The expansion of transnational media conglomerates like Time Warner into many European markets and of Australia’s News Corporation into the U.S. also reflects the development of an integrated global media marketplace.

In order to exploit the maximum number of revenue streams on a maximum number of inputs, the global media conglomerates have been formed by following a strategy of vertically integrating as many segments of the media value chain as possible, in order to exert the maximum possible control over all transformations that affect the media industry and its value chain.

In consequence, the global media market is at present dominated by just seven mega-conglomerates: Time Warner, Disney, Viacom, Vivendi-Universal, News Corporation, Bertelsmann, and Sony Corporation (Compaine, 2004). Between them, these companies own all major U.S. film studios, control about 80 percent of the global music market, dominate satellite broadcasting worldwide, control a significant percentage of book publishing and commercial magazine publishing, own all or part of most commercial cable television channels worldwide and operate a large portion of European terrestrial television. Several, such as Vivendi-Universal, Sony Corporation and Time Warner, also have major interests in consumer electronics, telecommunications and Internet service provision.

1.2. Problem Statement

The background to the proposed dissertation topic is the struggle of current academic literature to explain if and why vertical integration remains the dominant corporate strategy for the major media conglomerates. Vertical integration in general has been extensively studied by academic scholars and remains an issue of heated debates on the respective risks and benefits of this strategy both for the companies as well as the consumers.

The trend towards media conglomerization has also been discussed by scholars and industry insiders alike and has led to repeated debates about the advantages and disadvantages of such developments. Proponents have argued that the new technologies and consequent expansion of media distribution platforms create the economies of scale and scope that are necessary to compete in the global marketplace (Shearer, 2000), whereas opponents have called the
acceleration of consolidation a threat to democracy because of the homogenization of all media (Parker, 2000; Wellstone, 2000).

Considering the significant role media corporations play in the delivery of culture, news and information, and the fact that corporate structure, strategy, management and firm behaviour ultimately impact and change the nature of the content delivered to an audience (Hollifield, 2001), a better understanding of the patterns and determinants of media conglomerates' strategies is paramount to improve the understanding of media practitioners and academia alike of the developments that have led to the development of today’s media conglomerates.

Today’s global media conglomerates display an unprecedented size over audiences. It is therefore not surprising that the debate whether the consolidation of ownership is good or bad has been the focus of media studies since the emergence of transnational media corporations (Demers, 2002; McChesney, 1997; Smith, 1991). Traditionally, economists, regulators, and academic media scholars focused on exploring the negative impacts of ownership concentration through vertical integration. However, from the perspective of operating media corporations, vertical integration seems to be the strategy of choice to achieve outstanding synergies that allow them to realize higher profitability margins than smaller-size, non-vertically integrated media firms. Thus, the need to measure the financial performance of media firms’ vertical integration is unavoidable. So far, the existing empirical research on whether vertical integration improves corporate performance remains inconclusive since no clear positive correlation between the firms’ size or their presence in vertically related media industry businesses and their economic performance has been found up to now (Kolo & Vogt, 2003; Peltier, 2004). The economic relevance for the media industry and its incumbents, coupled with the theoretical contribution to the body of corporate management knowledge make this a pressing research issue.

Drawing on both deductive and inductive techniques, the aim of this study is threefold:

1. To apply the main strands of vertical integration theories to the specific characteristics of the media industry and the major global media conglomerates, in order to derive a valid set of variables that influence the vertical integration decision of media enterprises in general, and the major media conglomerates in particular.

2. To examine and compare the vertical integration strategies and corporate developments of the leading media conglomerates in the U.S. and Europe from their
foundation up to 2005, using a set of influencing variables derived from the theoretical concepts examined before. The study aims to establish whether and to what extent the structure of large media firms has changed, and whether these changes were due to vertical integration activities. If general trends among the media conglomerates within or across industry segments can be established, the “timing” of vertical integration (its onset, development, and possible slow-down or end) is also of interest. Moreover, the study aims to establish commonalities and differences in the timing, extent, and character of general vertical integration activities among media conglomerates in the US and Europe.

3. _To provide an interpretation of the differences in vertical integration activities and company performance, specifically whether a higher degree of vertical integration leads to improved performance_. The aim of this part of the study is to establish whether the decision to follow a strategy of vertical integration has led to an improvement in firm performance, measured by operational performance parameters as well as through shareholder value creation, as represented by share price performance. The impact of organizational form on the success of a strategy of vertical integration is also analyzed.

1.3. **Purpose of the Study**

The study is aimed at two audiences – academia as well as the management executives of media corporations. The goal of applied strategic management research is to identify a research gap, which makes a contribution to the strategic management theory-building and equally provides answers to current real-world management issues. The former point has been challenged above such that the author seeks to fill an evident research gap through a thorough evaluation of the validity of the existing theories of vertical integration for the media industry, leading to the formulation of a catalogue of variables that influence the vertical integration decision in international media conglomerates, followed by an analysis of possible performance-enhancing aspects of a vertical integration strategy in international media conglomerates. Concerning the latter point, since the media industry is facing great upheaval through technological advances in the digital realm and the convergence of media, information technology, and communications markets, the need for managers to gain deeper
insights into the strategic rationales behind one of the media industry’s dominant corporate strategies, forms a fascinating basis for this study.

Accordingly, this study should therefore be read both with an academic and a executive manager’s eye: One the one hand, the academic reader may want to focus on the literature review, the research model and applied methodology, the compilation of the set of variables that determine the vertical integration decision for media industry conglomerates, as well as the analysis of a possible positive link between vertical integration and operational and financial market performance for the chosen conglomerates. The academic reader may pay less attention to the first empirical part, which presents a detailed description of each chosen media conglomerate’s corporate history with an in-depth analysis of each conglomerate’s respective vertical integration strategy. On the other hand, the executive media manager may especially focus on the above described empirical part with a view on how improve his or her media corporation’s performance by improving an existing or embarking on a vertical integration strategy. Of specific interest for media practitioners’ should also be the last chapter of the study, which gives recommendations on how to best respond to the new demands that come with the changes that have and still are affecting the media industry value chain.

1.4. Scope and Limitations of the Study

The scope of this study is, firstly, to develop from the existing literature a catalogue of variables that influence the decision to vertical integrate in the media industry. Secondly, this study provides an in-depth description and analysis of the vertical integration strategies of six of the seven major global media conglomerates – Time Warner, News Corporation, Viacom, Disney, Sony Corporation, and Bertelsmann AG – between 1995 and 2005. Thirdly, this study analyzes whether differences in the adopted vertical integration strategies have led to positive or negative differences in performance, with performance being defined by certain key financial ratios as well as the conglomerates’ respective share price developments in the time frame 1995 to 2005. Both empirical areas, i.e. the analysis of the respective vertical integration strategies and the performance implications of the strategy, are considered distinct and hence require a separate empirical analysis and approach.

The study is of a highly exploratory nature and intends to make explicit trends in the under-researched field of corporate strategies of media conglomerates. The detail of the presented
case studies is of an unprecedented nature, and the study therefore promotes an extensive
descriptive and analytical presentation and discussion of results. Results from the
performance analysis crucially need to be put adjacent to the descriptive findings, as the
latter’s findings and trends cannot be validated without appropriate financial performance
analysis.

Consequently, the limitations of this study’s approach are the following: Due to the chosen
approach to analyze the vertical integration in major media conglomerates from a both
qualitative as well as quantitative angle, the overall number of case studies is limited to six
cases, which does not allow for statistical significance levels, and thus limits the
generalizability of the findings. Further research is also needed in order to formulate a truly
generic model which supports media companies to make equitable decisions regarding the
benefits and risks associated with an envisaged vertical integration strategy. More detailed
research is equally necessary on whether the positive effect of vertical integration on
performance has an optimum, and beyond which the positive effect of vertical integration
declines due to increased managerial complexity and cost of coordination. Furthermore, the
supposed link between successful vertical integration and choice of organizational form
needs to be researched with a greater sample size in order to allow definite conclusions.

1.5. Organization of Research

The main purpose of the study is to give an overview of the vertical integration strategies and
their effects on the financial performance of the profiled media conglomerates. At the heart of
the dissertation are, therefore, chapters VI and VII in which the empirical findings on the
vertical integration strategies of the major international media conglomerates are presented
and analyzed, and where their impact on company performance is examined.

Before that, chapter II starts with an examination of the economic characteristics of media
firms and the market structures, followed by a comprehensive analysis of macroeconomic
and microeconomic factors that have been and currently are influencing the development of
international media conglomerates. Next, the existing theoretical and empirical literature on
vertical integration is reviewed. The way in which business historians since Chandler have
described the overall development of large companies is set out, and Williamson’s
transaction cost economic approach to the crucial dimensions of corporate structure is
developed. Further defining vertical integration theories are presented and their relevance for the media industry is tested. The chapter continues with the summary and concluding analysis of the influencing factors that generally induce companies to adopt vertical integration as their corporate strategy. Next, the research hypotheses are developed. The chapter concludes with an analysis of the general vertical integration rationales and the presentation of specific vertical integration efficiency justifications - as postulated by the two most defining theoretical contribution to vertical integration theory - for each segment of the media value chain.

Chapter III presents the research design for the proposed empirical analyses. The chosen research methodology is critically discussed in order to ensure the highest possible validity for the empirical results of this study. Quality measures for the research design are introduced, and data collection and analysis methods for the case studies are explained.

Chapter IV constitutes the first empirical part of this study and presents the six selected case studies of international media conglomerates. The case studies are comprised of the following companies: Viacom, Time Warner, Disney, News Corporation, Sony Corporation, and Bertelsmann AG. Strategic business combination histories and vertical growth developments for each profiled company are extensively described and analyzed, followed by analysis of the M&A transactions that have shaped the structure of the media conglomerates, where each transaction will be classified as either vertical, horizontal or unrelated. The results of this analysis will determine whether vertical integration is, in fact, the strategy of choice for international media conglomerates, or whether other forms of integration prevail or have at least equal weight. The vertical integration strategies of the media conglomerates will be analyzed using the relevant theoretical vertical integration models that were presented in chapter IV.

In chapter V, a meta-analysis of the extent and direction of the selected companies’ vertical integration strategies is presented, which subsequently allows the compilation of a vertical integration ranking for the selected media conglomerates. This is followed by an extensive analysis of the financial performance of each firm. The results are then compared and possible explanations for differences in performance are presented. In order to provide a coherent picture of the financial situation and capital resources availability for each conglomerate, the individual share price performance is examined, in order to determine whether the adopted vertical integration strategy has had a positive, negative, or no effect on share prices. The inter-case analysis is further advanced by comparing the organizational
structure of the selected firms with their performance, in order to determine whether organizational structure and corporate culture have helped or hindered the successful implementation of a vertical integration strategy.

Chapter VI summarizes the findings of the empirical parts, and presents strategic recommendations on how the studied media conglomerates should respond to further future changes in the media value chain. The chapter concludes by suggesting areas of further research.
2. LITERATURE REVIEW

2.1. The Empirical Context of the Media Industry

The media industry is a strong candidate to study the benefits of vertical integration and specialization as well as the evolution of vertical scope for three main reasons – (1) the fact that the industry presents a case of ongoing competition between vertically specialized and vertically integrated firms as demonstrated by the continuing appearance of young and innovative firms especially in the new media sectors, which constitute vertically specialized enterprises, as well as the long established media behemoths which command dominant overall market positions through an integrated presence in most or all of the media value chain segments; (2) the rapid and seemingly extremely successful development of huge global media conglomerates through vertical integration since the 1980s; and (3) the industry’s centrality and significance within the global information economy.

To provide a framework for the analysis of the media conglomerates’ vertical integration activities, firstly the defining influences on the formation of media conglomerates will be addressed under section 2.2. Since the products of global media conglomerates are quite different from the typical focus of many vertical integration studies, which have so far mainly examined manufacturing, and occasionally, service firms, the specific characteristics of the media industry will be presented in greater detail.

Secondly, the body of literature representing the main concepts of vertical integration will be presented. The two major strands of vertical integration theories are introduced, and the main contributions to each of the two areas are illustrated and analyzed according to their applicability to the media industry in general, and media conglomerates in particular.

Existing empirical evidence for each theory will be introduced and discussed, with a particular focus on research undertaken on vertical integration in media enterprises. Combining both the theoretical foundations of vertical integration as well as the existing empirical research, a set of influencing variables will be derived and each variable discussed for its relevance to the media industry in general, and the international media conglomerates in particular. This set of variables will serve as the basis for the first research question.

Finally, the empirical literature on the link between vertical integration and performance will be examined, introducing the second research question.
2.2. **Influences on the Development of the International Media Conglomerate**

Several of the broad influences that are driving change in the media industry and requiring media firms in general, and the international media conglomerates in particular, to reconsider and adjust their strategies, will now be examined in greater detail. These factors can be summarized in four external and internal influencing variables (see figure below). The conceptualization of the external factors has been adapted from Porter's Five Forces Model (1980), and illustrates influences relating to competitive and comparative advantages and constraints. The conceptualization of the internal factors (firm-specific influences) reflects the resource-based school of strategic thought (Wernerfelt, 1984; Prahalad & Hamel, 1990; Miller & Shamsie, 1996) and illustrates company capabilities, competencies and needs.

![Diagram of Influences on Media Companies](image)

**Figure 1: Influences on Media Companies**

Source: Adapted from Porter’s Five Forces Model (1980)

2.2.1.1. **General Environmental Influences**

Four general environmental factors can be distinguished, which influence the development and strategic behaviour of the international media conglomerates: (1) The development of the global capital markets, (2) technological advances, (3) increasing globalisation, and (4) defining socio-cultural developments. These four factors shall be explained in greater detail in the following paragraphs. An examination of the general macroeconomic environment of
media conglomerates reveals a market that is characterized by high volatility and turbulence (Eisenmann, 2000). The primary cause of this market instability is technological innovation, since change in this area is fast and unpredictable, and new technologies are expanding existing or opening up new markets.

2.2.1.1. Development of Global Capital Markets

The increasing globalization of the financial and capital markets has been a two-edged sword for most media conglomerates. On the one hand, access to the global capital markets has allowed media companies to obtain the financial resources needed for further expansion by listing their shares on the international stock exchanges, and to seek capital outside their home countries. Consequently, the extended choice of capital sources has increased the media conglomerates’ ability to build global operations. In addition, the internationalization of financial institutions has eased most financial transactions processes, thus reducing the complexity and the costs of international trade, and further supporting the expansion of international activities.

On the other hand, a participation in the global capital markets by way of a stock exchange listing, exposes the media conglomerate in question to the scrutiny of financial analysts and rating agencies, and makes it dependent on the often short-sighted shareholder value requirements.

2.2.1.1.2. Technological Innovation

The evolution of computing and communications technologies has had a profound influence on the media industry, firstly by improving efficiency of workflows through new software applications and improved communication, and secondly, by profoundly transforming the traditional media value chain through the advent of digitalization and the Internet.

2.2.1.1.2.1. Convergence

According to industry scholars, the drivers of industry convergence can be classified into three groups: (1) Deregulation, (2) demand-related drivers, and (3) technological drivers. The interactions between these three groups are exemplified in the figure below.
In general, since the 1990s, the media and communications markets in the U.S. and Europe have witnessed significant liberalization and deregulation. The effects of deregulation on the global media markets will be analyzed in greater detail in the section on media-specific policy influences.

Regarding the demand-related drivers, a growing personalization of media products and services can be observed, which has led to an increased demand for integrated information and communication services. Such tendencies lead to an overlap of the media and communications markets, and thus to industry convergence (Wirtz, 2001).

Technological convergence refers to developments affecting the technological basis of communications at the level of networks, applications, and services. It can more clearly be defined as the growing symbiosis of the technologies of media, telecommunications and information technology, and is thus increasingly blurring the boundaries between different sorts of media and communication products and markets. More importantly, the new technological developments lead to a convergence of the different segments of the media
industry and a transformation of the traditional media value chain (Wirtz, 2001). Industry convergence has already exerted a profound effect on the corporate strategies of media firms. Wirtz (2001) states that a self-reinforcing diffusion process can be observed, in which industry convergence, together with first mover behaviour from pioneer companies, has initiated a significant intensification of competition. The first movers place formerly passive market actors under considerable competitive pressure, and the reactions of the established media conglomerates have been characterized by a frenzy of vertical mergers and acquisitions to obtain a presence in the newly created segments of the media value chain.

The three main drivers of technological convergence are digitization, increased processor speed, and the migration to higher transmission capacity (Bauer, 2005). At the level of networks, migration from individual specialized platforms to a general-purpose platform may unfold in two prototypical ways (as well as hybrids of those ways): network upgrades and new deployments. Examples of the first approach are enhancements of a one-way cable delivery network to two-way interactive capability; or the upgrade of narrowband to broadband networks. Examples of the second approach are the deployment of fibre networks or of wireless broadband networks. Which path will be pursued depends on the revenue opportunities generated by new platforms and the relative costs of upgrades as compared to the costs of new deployments.

In addition to these technological aspects, economic forces, such as the need to price discriminate to recover the high fixed investment costs will work toward more differentiated media products and distribution platforms. From a technological perspective, the forces of convergence will thus be counteracted by certain opposite forces, resulting in further differentiation of products and services.

Concerning the distribution-related part of the media value chain, the effects of technological convergence will be the most profound: As the capacity of networks is expanding, and an increasing number of platforms are principally able to provide digital services, large segments of the market for entertainment content transmission may start to turn into markets with low profit margins. Higher value-added, and hence profit opportunities will most likely become associated with distinctive applications and services. A good example to illustrate this point is the pressure that access-independent VoIP services like Skype or Google Talk are exerting on the traditional telephony business model. Combinations of high sunk costs and low profit opportunities are, however, inherently unstable and will necessitate adjustments from the industry incumbents. Two principal strategies are available: Firstly, a
differentiation of offered products and services away from the low-margin areas of the market, or, secondly, partial or full vertical integration between distribution and content providers to ensure increased operating efficiency through the realization of economies of scale and scope.

Convergence also affects endogenous and exogenous market entry barriers. Exogenous entry barriers are those that are outside of the firms’ control, and convergence may increase some exogenous barriers while reducing others. For example, if technical convergence results in higher economies of scale and scope, it will also increase entry barriers as fewer facilities-based access providers may be able to survive in the market.

However, if the extent of such economies relative to the market remains limited, convergence may reduce entry barriers for applications and service providers who can choose between competing network platforms.

2.2.1.2.2. Digitization

The ability to convert text and graphics digitally means that digitized content can be repackaged into various audio and video formats, and then distributed to and shared with others, leading to an important extension of the revenues for one single source of content. In audiovisual production, the lower capital costs of digital equipment have also reduced technology-based entry barriers. As stated above, digital technology is one of the main drivers of convergence since information can be more readily stored, packaged and re-disseminated in different formats. Because of the potential for economies of scale and scope, the greater the number of products and services that can be delivered to consumers via the same communications infrastructure, the better the economies of each service will be. Digital cable and satellite television services now offer up to 200 channels where only a few analogue channels would fit before. Digital technology has already produced several completely new entertainment markets like video games and DVDs.

In addition, digitization enables the personalization of media services and products, and will thus support the increasing fragmentation of the former mass audiences, since consumers can now realize their individual preferences (Burt and London, 2004). In consequence, the control that formerly rested with the communicators shifts towards the consumers.

For most traditional media companies this represents a major adaptive challenge. Media companies whose primary business models are based on advertising revenues, like television
networks and newspapers, find it increasingly difficult to reach a mass audience. So far, the industry's responses have fallen into three categories: horizontal integration, vertical integration, and the search for new revenue sources. The strategic rationale behind horizontal and vertical integration is that in a fragmenting market, media companies can only reach a mass audience with a broad portfolio of media assets, each targeted at a different group, that can be exploited along the distribution windows.

In summary, media companies are trying to re-aggregate audiences by diversifying across types of media and by taking a portfolio approach to content.

2.2.1.1.2.3. New Media and Internet

The development of the Internet has so far presented traditional media companies with opportunities as well as threats. On the one hand, the Internet has offered content creators easy distribution access and thus another way to extend their customer base and to connect audiences and advertisers.

On the other hand, research conducted in the U.S. by Jupiter (2001), shows that 44 per cent of online users have decreased their television viewing time. Moreover, television is the most affected medium far above magazines (25 per cent), newspapers (24 per cent), and radio (12 per cent). There seems to be direct competition in terms of viewing moment as Internet peak time is also prime television time which has led to a pronounced shift of advertising budgets from television to online advertising. The impact of the Internet on media consumption will continue to increase as web sites will develop increasingly equivalent or better quality services than traditional media and as overall penetration of broadband Internet grows.

2.2.1.1.3. Globalization

In contrast to the nationally restrictive policies of the 1980s, policy-makers in the U.S. and Europe have since the 1990s sought to develop initiatives that support the development of a global information society. National markets are increasingly being opened up by globalization, and especially U.S. media firms are turning to the global marketplace in order to generate revenues outside their relatively saturated home markets. The increases in market complexity due to organizational, production and distribution requirements for global activities have led to the emergence of large, dominant transnational media corporations (Gershon, 1997). The United States have so far been the primary exporter of media content,
but the rise of non-U.S. media conglomerates such as News Corporation\(^1\), Vivendi Universal, Sony, and Bertelsmann shows those companies also capitalize on the growth potential available outside their national markets (Goldsmith, 2000).

2.2.1.1.4. Socio-Cultural Developments

A growing urbanization of population in both developed and developing countries allows the increasingly efficient establishment of infrastructures to provide media entertainment and telecommunications services, which are critical to most media businesses. Urbanization also creates conditions that support many media because they overcome economic constraints related to distribution distances and population density (Picard, 2002).

Increases in disposable income and leisure time created by improvements to the living standards are also particularly significant for media firms since their content products and distribution services command significant temporal and monetary expenditures by consumers (Picard, 2002).

In summary, the current socio-cultural trends positively affect the media industry as demand increases through urbanization and improved media expenditure capabilities of consumers.

2.2.1.2. Media-Specific Policy Influences

Many media firms, especially broadcasters, have tended to operate in markets where levels of competition have been strongly influenced by state regulation. Legislation by governments of the countries where a media company has established operations can have fundamental limitations to ownership of media on the one hand, or facilitate a monopolistic market structure on the other hand.

Since the early 1990s, however, media industries across the globe have benefited from a combination of deregulatory actions as well as a liberalization of former policies. In the U.S., the Federal Communications Commission (FCC) increased ownership limits and rules regarding programme requirements were either relaxed or completely removed. The 1996

\(^1\) News Corporation primary listing was transferred from Australia to the U.S. in 2004, thus turning it into a U.S. company.
Telecommunications Act sought to eliminate competitive barriers in all broadcast, cable and telecommunications industries. Companies operating in one industry segment could now also be active in another, and in broadcasting, a steady proliferation of delivery outlets has removed spectrum scarcity and opened up new markets to distribution platform providers (Brown, 1999). The lifting of these regulatory inhibitions has led to increased consolidation across U.S. media industries. In the U.S. radio industry alone, some 75 different radio stations were merged or acquired into one of two companies: Clear Channel Communications or Infinity Radio (Viacom). The same is true for the television industry, where the U.S. media conglomerates embarked on a television station acquisition spree after the 1996 Telecommunications Act (Albarran, 2004).

The pace of liberalization has varied in European nations, but its transforming effect has also led to explosive growth in the number of domestic commercial broadcasters (Council of Europe, 1998).

2.2.1.3. Market-Specific Influences

2.2.1.3.1. Increasing Competition and Market Consolidation

Competition in all media markets has intensified considerably. An increase in the types of media and communications systems together with increased bandwidths and spectrum has enlarged the number of direct competitors and increased the number of available substitutable and partly substitutable content products.

Since consumer spending on information and entertainment has remained relatively stable, the increased competition has resulted in declining profits per title, channel, or product, and declining profits for firms in most established media industries. The natural response to intensifying competition has been increased consolidation and concentration across all media sectors (Jupiter Research, 2001).

In general, concentration in an industry is measured by determining the percentage of total revenue in an industry segment going to the top four and top eight companies. These numbers are referred to as the concentration ratio, or CR, of an industry. CR4 refers to the ratio of revenue going to the top four companies, and CR8 calculates the same ratio for the top 8 companies. An industry is said to be highly concentrated when the CR4 > 0.5 or when CR8 > 0.75 (Picard, 2005).
The following table presents an analysis of the 2003 concentration ratios of media industry segments:

<table>
<thead>
<tr>
<th></th>
<th>CR4</th>
<th>CR8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Filmed Entertainment</td>
<td>0.78</td>
<td>1.00</td>
</tr>
<tr>
<td>Television Networks</td>
<td>0.84</td>
<td>0.98</td>
</tr>
<tr>
<td>Television Stations</td>
<td>0.31</td>
<td>0.51</td>
</tr>
<tr>
<td>Cable Systems</td>
<td>0.61</td>
<td>0.87</td>
</tr>
<tr>
<td>Newspapers</td>
<td>0.48</td>
<td>0.69</td>
</tr>
<tr>
<td>Consumer Magazines</td>
<td>0.77</td>
<td>0.91</td>
</tr>
<tr>
<td>Consumer Books</td>
<td>0.77</td>
<td>0.94</td>
</tr>
<tr>
<td>Radio Stations</td>
<td>0.77</td>
<td>0.88</td>
</tr>
<tr>
<td>Recorded Music</td>
<td>0.98</td>
<td>1.00</td>
</tr>
<tr>
<td>Internet</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Table 1: 2003 Media Industry Segments’ Concentration Ratios  
Source: Albarran (2003)

Regardless of the methods used, all studies of concentration show an increasing consolidation across all media markets, with many media sectors reaching a highly concentrated status with the sector being dominated by a handful of oligopolists. Representative studies of media concentration across industries include Albarran (2003), Albarran and Dimmick (1996), Bagdikian (2005), and Compaine (1985b), along with specific studies of industry concentration in newspapers (Lacy, 1984, 1985; McCombs, 1988; Picard, 1982, 1988a; Rosse, 1980), broadcast television (Bates, 1993; Litman, 1979; Owen, Beebe, and Manning, 1974), cable television (Chan-Olmsted & Litman, 1988), motion pictures (Gomery, 1993), and trade books (Greco, 1993).

Picard’s study on the daily newspaper industry revealed, for example, that local markets were highly concentrated and that even the most competitive markets were well above the levels at which monopolistic behaviour becomes problematic (Picard, 1988a). Several other studies could also prove that economic pressures in local markets, combined with poor public policies for newspapers, have promoted market concentration and monopoly (Picard, Winter, McCombs, and Lacy, 1988). More recent studies into press ownership and competition also support the earlier concentration trends (see Chyi & Sylvie, 2001; Lacy, Shaver, & St. Cyr, 1996; Lacy & Simon, 1997).

The television programming and syndication markets also exhibit high concentration ratios (Owen, Beebe, and Manning, 1974). Chan-Olmsted and Litman (1988) have shown that the cable network market was still relatively un-concentrated in the late 1980s, but that horizontal and vertical integration already gave great power to a few firms. Other evidence indicates that...
the book publishing and film distribution markets are also highly concentrated media industry segments.

The highly concentrated nature of the media industry is in large part due to two factors: Firstly, the relaxation of ownership regulations in the United States, and to a lesser extent, in Europe. The FCC's 1996 Telecommunications Act allowed companies to dominate a larger market share of an industry segment and also allowed ownership in two neighbouring segments like content production and distribution. The cost of entry into media industry segments is the second important factor. Variations in the cost of setting up a business in a specific media industry segment will determine whether the concentration ratio of the segment will be high or low. Cost-intensive media such as theatrical content production and the establishment of content distribution platforms tend to be more concentrated than lower cost media, such as various forms of publishing and radio (Picard, 2005).

It should be noted, however, that the level of ownership concentration can inversely change as well. For example, in the 1970s, the three major television networks in the U.S. collectively had a 90 per cent television audience share. Since the early 2000s, the audience share of the now four major television networks has fallen to 50 per cent for prime time slots (Compaine, 2004). Networks still dominate, but cable television has become a major competitor for broadcast television, even though no single cable channel can generate even the lowest rating of one of the four major television networks (Picard, 2005).

The pace of industry consolidation or concentration continues to increase since 2000, as several major deals have further reshaped the media landscape: General Electric/NBC's acquisition of Vivendi Universal's entertainment assets, Liberty Media's buyout of QVC, Comcast's acquisition of AT&T Broadband, the merging of Bertelsmann AG and Sony Corporations' music businesses, and the DirecTV acquisition by News Corporation are just some of the many examples. Furthermore, an increasing focus on new media industry segments away from the traditional media markets can be observed. Examples are the acquisitions of Internet and new media assets like MySpace.com by the traditional media enterprises, and the acquisition of new media start-ups like YouTube and Skype by "modern" media companies like Google.

In sum, increasing consolidation is no surprising development when one considers the competitive and economic benefits that the assembly of a large media conglomerate conveys, including global scale for distributing content and selling advertising; negotiating leverage as
a result of multiple properties and platforms; and less exposure to cyclical economic downturns because of multiple revenue streams.

2.2.1.3.2. Increasing Fragmentation of Media Markets

As becomes clear from the above described developments like convergence and digitization, media conglomerates have to deal with a rapidly shifting industry environment and a number of external forces that threaten to make their former business models obsolete. An additional effect of those new technologies is the erosion of traditional mass media audiences.

Since advertising revenues still constitute the main source of income for most media enterprises in Europe and the U.S.\(^2\). The trend towards audience fragmentation has forced advertisers to rethink the allocation of their advertising budgets.

Accordingly, media companies increasingly attempt to gain a better understanding of how the intended target audience can be reached. Two main trends seem to emerge: Personalized and interactive advertising, both of which shift advertising budgets even more in the direction of specialist niche channels or online advertising. Compared to other media types, online advertising offers the opportunity to integrate three steps of the sales cycle (information, transaction and follow-up), whereas traditional media are focused on mass marketing and information. The Internet has furthermore allowed the development of new advertising techniques or has advanced traditional techniques such as sponsoring, bartering, and product placement (BoozAllenHamilton, 2006).

The threat of fragmentation is, of course, most significant for the major media conglomerates, whose access to mass audiences has so far constituted one of their major competitive advantages. As a response, these companies have mostly resorted to a strategy of vertical integration, coupled with a congruent horizontal extension of their activities: Under this

\(^2\) The key long-term driver for advertising expenditures is Gross Domestic Product (GDP). A strong correlation can be observed between GDP and advertising expenditures, and it is generally accepted that advertising expenditure anticipates GDP growth by three to six months since advertising budgets are allocated with this lead time before the actual advertising exploitation (Zenith Media, 2001). Short or medium-term economic factors such as employment and interest rates also have a somewhat less pronounced influence on advertising expenditures, as they are indicators of the current economic climate in a country. Another important factor determining advertising spending is the maturity of an industry. A mature advertising market is generally characterized by a stable relationship between GDP and advertising expenditure. This is the case for most large European countries and for the U.S.
strategy, media content and distribution assets are linked along the media value chain, while both content and distribution segments are strengthened and laterally extended through horizontal acquisitions. By stretching across products and distribution channels, the probability of reaching an audience broad enough to satisfy advertisers increases significantly.

An alternative strategic approach is the creation of alternative revenue sources that have as their main characteristic their independence of traditional advertising revenues. Examples are the subscription model advocated by music retailers such as Napster, or the pay-per-download system pioneered by Apple. Digital radio stations such as Sirius and XM, and digital video recorder services such as TiVo, have created successful subscription-based businesses with customers paying a flat monthly fee for hundreds of advertising-free radio and television channels.

Content producers are also starting to explore programming opportunities offered by digital video recorders (DVRs) and video-on-demand; other attempts at new media business models include services such as Movielink (a joint venture between MGM, Paramount, Sony Pictures, Universal and Warner Brothers) and MovieBeam (owned by Disney), which place a fully managed store of digital content in the consumer's home.

2.2.1.4. Firm-Specific Influences

For many media enterprises, declining profits because of the above-mentioned increasing competition and the volatility of advertising revenues are becoming the norm. The situation for firms is compounded because most firms are offering media products and services in mature or relatively mature markets in which growth potential is or goes towards zero. Established media conglomerates are also faced with significant competitiveness changes due to rising costs (especially of content), decreasing or stagnant productivity, declining customer satisfaction, and lack of innovation. Concerns about the sustainability of many media companies are being raised. The effects of disruptive technologies and the appearance of attractive and advantageous substitutes, combined with decreasing competitiveness and profitability raise doubts about the survival of a majority of traditional or “old media” conglomerates in the coming decades.

Currently, the large media conglomerates are still enjoying competitive and economic advantages, including global scale for content distribution and the sale of advertising time, and, in addition, substantial negotiating leverage as a result of those multiple media content
and distribution assets. They are also less exposed to cyclical economic downturns because of multiple revenue streams. Nonetheless, it is obvious that managing such large, complex and diversified enterprises creates problems as well as benefits. Especially in times of rapid technological change, the large and widely diversified media companies likely suffer from a prolonged reaction time due to the complexity of their operations.

2.3. Theoretical Frameworks of Vertical Integration

2.3.1. Introduction and Definition of Vertical Integration

According to neoclassical economic theory, in a world characterized by perfectly competitive and informationally efficient input and output product markets, transaction costs should be non-existent and no sustainable advantages can therefore be generated from being vertically integrated. Transaction costs are the costs associated with each transaction that a firm makes (Picard, 2002, p. 66). All firms, integrated or not, earn at best long-term returns that approximate their respective costs of capital. Any management action that by chance caused a positive deviation from the expected level of return is soon be eroded by competition's counterattack (Coase, 1988).

However, the neoclassical assumptions of perfect competition and complete market transparency are impossible to uphold in the real world, and so vertical integration has been a recurring and often dominant strategy for enterprises in many different industries.

The causes of vertical integration and its consequences on market outcomes and consumer welfare have been extensively researched and discussed by academic and industry scholars. According to these theories, vertical integration can on the one hand promote efficiency by eliminating successive monopoly mark-ups, internalizing service, and mitigating contractual problems between firms (Williamson, 1971; Grossman and Hart, 1986).

On the other hand, it can facilitate the strategic practice of market foreclosure, whereby an integrated firm denies rivals access to markets in order to gain greater market power. The first effect results in lower prices, higher sales, and greater consumer welfare, while the second raises the prices of final goods, thereby harming consumers (Chipty, 2001).

Definitions of vertical integration have been formulated by almost every scholar in this field of study. All these definitions denote the same process, they just phrase it differently.
Riordan, for example, very generally states that “vertical integration is the organization of successive production processes within a single firm, a firm being an entity that produces goods and services” (Riordan, 1990, p. 2).

Eckard (1984, p. 105) defined vertical integration as "a range of activities involved in producing and selling products which take place within the firm rather than within supplying firms". Temin (1988, p. 892) went slightly further by stating that "vertical integration is the elimination of contractual and market exchanges, and the substitution of internal exchanges within the boundary of the firm".

And Harrigan (1986, p. 536) defined vertical integration as "a pattern of diversification that combines lines of business in a way that allows a company to use the outputs of one line of business as inputs for another line of business".

According to the economists Scherer & Ross (1990, p.93), "vertical integration in the static sense describes the extent to which firms cover the entire spectrum of production and distribution stages".

Vertical integration can occur in two directions: upstream and downstream. Upstream, or backward vertical integration, involves ownership and production of the raw materials that might otherwise be supplied from independent, external producers. A firm would thus integrate upstream in order to ensure that the supply of its raw materials is always available. Downstream, or forward vertical integration, involves controlling the final or finishing steps of semi-fabricated products and the wholesaling and retailing operations that deliver goods to consumers (Scherer & Ross, 1990). Downstream integration is expected to improve performance through achieving greater influence over the nature and level of demand.

Vertical integration may also be full or partial:

- **Full integration** exists between two or more stages of production when all of the first stage’s production is transferred to the subsequent stages with no sales or purchases from third parties.
- **Partial integration** exists when stages of production are not internally self-sufficient, or when only partial ownership of the integrated stages is assumed.

In the context of the media industry, upstream integration will involve a content distribution firm (theatrical, television, cable, satellite, video distributors, music and print distribution, and Internet and other new media access providers) buying the relevant content producer,
whereas downstream integration is analogous to primarily content producing firms acquiring all, one or several distribution platforms in order to gain control of the distribution of their content and acquire greater knowledge of their consumers.

### 2.4. Vertical Integration Theories

Theories of vertical integration generally analyze the ways that companies deal with different forms of market imperfections. In the vertical integration literature, three main approaches can generally be distinguished: The incomplete contracting approach, the industrial organisation theorists' perspective as put forward by Porter (1980) with its resource-based view of the firm, and the exclusionary market power approach. These three approaches will be introduced in a general manner in the next paragraph, while the individual academic theories that constitute each approach will be presented and analyzed in greater detail throughout the rest of this chapter.

![Figure 3: Overview Vertical Integration Theories](source: Own Illustration)

The incomplete contracting approach to vertical integration takes the view that different units of the firm are run by separate managers who are self-interested and cannot be made to act in the best interest of the firm because of the incompleteness of contracts (Williamson, 1975, 1979, 1985; Klein, Crawford and Alchian, 1978; Grossman and Hart, 1986; Hart and Moore,
The contractual hazards adversely affect ex ante investment incentives and ex post performance efficiency. The managers foresee that part of the surplus they generate with their investment will be expropriated by the buyer in the bargaining process while they still pay the full cost of investment. Contractual incompleteness and its interaction with transactional attributes like asset specificity, complexity, and uncertainty therefore influences firms' decisions about governance through market-based bilateral contracts versus governance through vertical integration.

The incomplete contracting approach can be subdivided into two interrelated literatures: Firstly, the Transaction Cost Economics (TCE) theory that is generally identified with Oliver Williamson (1975, 1983, 1985). Secondly, the property rights theory that has been put forward by Oliver Hart and his co-authors (Grossman & Hart, 1986; Hart 1995; Hart & Moore, 1990).

The industrial organization or strategic management perspective, as put forward by Porter (1980) and others, argues that vertical integration can create competitive advantages in imperfect markets. Porter defined vertical integration as follows: "Vertical integration is the combination of technologically distinct production, distribution, selling and/or other economic processes within the confines of a single firm" (Porter, 1987, p. 300). In discussing different strategic motives for vertical integration, Porter (1980) argues that the strategic purpose of vertical integration is to utilize different forms of economies, i.e. cost savings, like economies of combined operations, economics of internal control and coordination, economies of information, and economies of stable relationships. Porter argues, in the same way as Pfeffer & Salancik (1978), that vertical integration is an important instrument for reducing uncertainty and securing supply for critical input.

The resource-based view of the firm has received much attention for its explanation of the existence of sustained competitive advantage (Penrose, 1959; Wernerfelt, 1984; Barney, 1991; Peteraf, 1993). The resource-based view of the firm confirms the view that the decision to vertically integrate is based on creating or sustaining competitive advantage (Wernerfelt, 1984, Ramanujam and Varadarajan, 1989, Miller and Shamsie, 1996).

The third and final branch of literature is known as the exclusionary market power approach and offers an analysis of the phenomenon of vertical foreclosure. The aim of this approach is to explain how vertical integration affects industry cost structure and competition in the downstream market. Vertical integration is used as a device to change the industry cost
structure to the benefit of the firm making the integration decision. The theory states that integration removes all conflicts of interest inside the firms, which enables them to focus on the strategic interaction with other market participants (Vickers, 1985; Bonnano and Vickers, 1988; Salinger, 1988; Hart and Tirole, 1990; Ordover, Salonen and Salop, 1990; and Gal-Or, 1992).

For each of the three approaches described above, the theoretical contributions can be further divided into static and dynamic models. The latter are generally of a more recent nature – with the exception of Stigler’s life-cycle theory of vertical integration – and analyze vertical integration in an evolutionary context.

2.4.1. Static Models of Vertical Integration

2.4.1.1. Transaction Cost Economics

Before the introduction of Transactions Cost Economics, explanations of vertical integration were mainly focused on technological factors. Indivisibilities between two successive production stages were held to render vertical integration necessary (as is the case when intermediate products cannot be transported to a remote stage of the production process) or, at least, more cost efficient than the production of the respective goods in two separate companies; for a critique of this explanation see Holmstrom and Tirole (1989).

The classical exposition of the transaction cost economic argument is contained in Coase (1937) where he considers the question why transactions are shifted out of the market into the institutional framework of production within firms, thereby supplanting the market’s price mechanism. Coase defines transaction costs as the costs of using the price mechanism, which he sees in the costs of information (in his language, the costs of discovering what the relevant prices are), and the costs of writing (i.e. negotiating and concluding) contracts. In this way, Coase breaks with the neoclassical assumption of the availability of complete information at no cost, and introduces the notion of information asymmetries between the different parties. Secondly, implicit in Coase’s argument that the writing of contracts will be costly is the idea - albeit not clearly spelled out in the 1937 article - that contracting may suffer from subjective or objective limits on information or from self-interest seeking by the parties to an exchange. If transaction costs were non-existent, the predictions of neoclassical theory would hold, and all contracts would maximize wealth regardless of the initial assignment of property rights.
(Coase, 1960, pp. 15-19). In a world of non-zero transaction costs, however, the integration of activities into firms can be more efficient than the use of costly transaction mechanisms in the market place. What checks the integration of activities into firms, then, is the cost of organizing different activities within hierarchies. Coase (1937, p. 395) argues that “a firm will tend to expand until the costs of organizing an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organizing in another firm”.

Following Coase, Williamson (1991) argues that the choice between different modes of governing contractual relationships follows cost-minimizing criteria (see also Whittington, 1993). Less cost effective governance modes would be eroded over time by the pressure of competition (Williamson, 1993). He distinguishes between three principal governance modes: markets, hierarchies (firms), and hybrid forms of organization between these two, such as networks, joint ventures and strategic alliances.

At the centre of the transaction cost economic approach is the notion that transactions, both within and among hierarchies, are costly to organize. This notion builds on three classes of assumptions which are discussed in turn.

1. Behavioural Assumptions

a) **Bounded rationality** refers to the notion that human behavior is “intendedly rational, but only limited so” (Simon, 1976, p. xxviii). Bounded rationality marks a clear divergence from the neoclassical profit-maximization assumption: While economic actors intend to maximize profits - i.e. they have an “econомizing orientation” (Williamson, 1985, p. 45) -, they are not always capable of doing so. Bounded rationality contributes to the difficulty of writing unambiguous contracts, due to which complex contractual arrangements are open to costly renegotiation and haggling.

b) The notion of **opportunism** refers to the strategic, self-interest seeking of actors with “guile” (Williamson, 1991, pp. 7f.). While not all individuals may behave opportunistically in all instances, parties to a contract have to take into account the possibility that the other parties may misrepresent their intentions or even lie in an outright way, and that they may not honor their agreements. Ex ante and ex post opportunism leads to the possibility of adverse selection and moral hazard, but also to outright cheating and stealing. The costs of
information gathering about the true intentions of the parties to a contract, as well as of monitoring their performance during contract execution stage, are major elements of transaction costs. Opportunistic behavior makes it particularly difficult to contract upon knowledge-intensive goods (e.g. patents) which suffer from “information impactedness”, i.e. whose value cannot be disclosed without disclosing the information itself (Arrow, 1970, p. 152). The danger is that the other party would opportunistically exploit the information gained upon disclosure without paying.

2. Environmental Factors

While bounded rationality refers to cognitive, i.e. internal limits in dealing with information, complexity and uncertainty pose external limits on the ability of human actors to determine the full range of contingencies and the appropriate responses at any stage of the contracting process. While under uncertainty the full range of contingencies and options can simply not be generated, under complexity this range could be produced in principle, but doing so is prohibitively difficult (Williamson, 1975). The argument also implies that information may be distributed asymmetrically across parties. While asymmetric distribution of information occurs frequently between the parties to an exchange in the market, it is also of major importance for the emergence of principal-agent conflicts within hierarchies (Arrow, 1986, pp. 1183-1195). This indicates that all of the conditions that render market transactions hazardous and costly also raise the costs of the internal organization of economic activities in firms or in intermediate (“hybrid”) forms of organization.

3. Characteristics of Contractual Relationships

a) **Asset specificity** refers to the extent to which contractual relationships require transaction-specific investment to be made, ranging from non-specific to idiosyncratic investments (Williamson, 1979). Of particular importance in the employment relationship is the acquisition of firm-specific skills (Monteverde & Teece, 1982; Masten, Meehan & Snyder, 1989). In addition to such human asset specificity, Williamson (1985) distinguishes three other types of asset specificity:

- **site specificity**: proximity between different production processes economises on inventory and transportation costs;
• **physical asset specificity:** due to their physical design properties, certain goods have their full value only within a particular relationship;

• **dedicated assets:** general-purpose investments made explicitly in order to sell large quantities of output to a specific customer.

The particular problem associated with asset specificity – most importantly human asset and site specificity - is that under such conditions the partners to a contract are effectively locked into their contractual relationship. Specific assets have their full value only within the contractual relationship into which the investment was made, so that a breakdown of the relationship will entail a partial or complete loss for at least one of the parties concerned. The party that bears the risk of being opportunistically exploited by the other party will ask for additional contractual safeguards, but these will be difficult and costly to devise, given the impossibility of full contingent-claims contracts in the face of uncertainty and bounded rationality.

b) **Small-numbers conditions** exist where the number of bidders on either side of a bargain is very limited. This restricts the ability of the other party to the deal to select the lowest cost supplier. The problem becomes severe when during the contract execution stage the number of bidders reduces even further, as the bidder who obtained the initial contract establishes a strategic advantage that is difficult to replicate for potential bidders in future deals. This is frequently the case where the current contract partner acquires information specific to the exchange relationship. Williamson (1985, pp. 240ff.) calls the change in the character of the “neutral” bargaining relationship at the outset to a relationship of greater unilateral or mutual dependency during contract execution the “fundamental transformation”. Small-numbers conditions render opportunistic behavior possible. If there were large numbers of bidders, opportunistic behavior would not take place, because the opportunistic bidder would be excluded at the next contract renewal (Williamson, 1975). However, long-term or frequently renewed contracts are in many cases desirable, in particular to render relationship-specific investments possible, but also to save the search costs resulting from incomplete information. Therefore, governance structures that check opportunism and allow for long-term contractual relationships are desirable.
Literature Review

Transactions can also be characterized by the frequency with which they take place, and by their duration. While the latter condition has already been discussed implicitly in the last paragraph, with respect to the former Williamson (1979) distinguishes between one-time, occasional and recurrent contract renewal. One-time contracts will usually not require any other governance mode than the market. Recurrent contracts, however, may require a relational governance mode (Kay 1993; Williamson 1979), as the identities of the parties matter to the contract. Generally, if parties transact frequently with each other, learning and reputation effects will decrease transaction costs; but the developing routine may also lead to incautious behaviour that can be exploited opportunistically, thus raising transaction costs. Partners to long-term contracts will aim at ensuring that the contracts are ‘watertight’ (i.e. that they take into account as many contingencies as possible), which implies high ex ante transaction costs. On the other hand, these costs may be regarded as investments which, with a certain likelihood, pay off in the form of lower ex post transaction costs for contract amendments and the like.

Regarded as a characteristic of contractual relationships, uncertainty and bounded rationality translate into the difficulty and costliness of monitoring and measuring the performance of contract partners. This means that contractual arrangements concerning the human resources necessary to a firm will be formulated so as to reduce such costs. Remuneration systems should thus be designed around performance measures which are most easily and cheaply ascertained (Lazear 1995). Anderson and Schnittlein (1984) find support for the derived hypothesis that firms are likely to integrate those particular categories of personnel whose performance is most difficult to measure.

Transaction costs can be conveniently divided into ex ante and ex post transaction costs, depending on whether they arise during the contract preparation stage or after contract completion (Kreps 1990). Another way of categorizing transaction costs is to distinguish between external and internal transaction costs. The former refers to the costs of contracting between independent parties, while the latter is defined as the transaction costs associated with organizing economic activity within vertically integrated business units. These costs may include the costs of supervisory activity, of benefits paid as motivating devices on top of
the normal salaries, and other types of agency and influence costs (Milgrom & Roberts, 1990). Williamson argues that internalized transactions suffer from bureaucratic costs not present when the transaction is carried out in the market. Demsetz (1988) points out, however, that the seller then manages the transaction which has been outsourced by the buyer and thus sets the price so that his management cost will be included.

The main explanatory factor in the transaction-cost economic theory of vertical integration is the asset specificity of investments into successive stages of production under conditions of complexity, uncertainty and bounded rationality. Where transaction-specific investments are needed, the partners to a contract have to deal with the problem of lock-in due to the “fundamental transformation” from large-numbers bargaining conditions ex ante to a relationship of mutual dependency ex post. The underlying difficulty consists of the complexity and costliness of writing contracts under conditions of uncertainty, complexity and bounded rationality. Ex-post adaptations to a contract may not only be costly – and the costs cannot be estimated ex ante –, they may even prove impossible to execute to the satisfaction of both parties. Transaction Cost Economics argues that the risks associated with asset specificity may render the integration of successive stages of production more transaction cost efficient than their non-unified ownership. The relative advantage of unified ownership increases with the degree of asset specificity, if complexity, uncertainty and bounded rationality are taken as given. It is in particular site specificity and human asset specificity that call for vertical integration. Dedicated assets usually do not require common ownership, while physical asset specificity requires common ownership only if the two production stages are immobile (in which case the problem can be expressed in terms of site specificity).

2.4.1.1.1. Applicability of Transaction Cost Economics to the Media Industry

The Transaction Cost Economics approach provides the main justification for the common adoption of vertical integration strategies in larger media enterprises. In order to show how the transaction cost economics approach can be applied to the media industry, an analysis of the nature of transactions between content creators and content distributors will be presented hereafter.

Content producers generally license the rights to their content libraries to distributors. The licensing process is characterized by decreasing levels of uncertainty, depending on the stage
of the windowing process in which the rights are licensed to a distributor. For example, once a movie has shown to be a theatrical success, the success uncertainty should diminish sharply over the DVD/video and broadcasting windows. This implies high transaction costs - due to the costliness of writing contracts under uncertainty - for the first stage of the windowing process, i.e. theatrical exhibition, and proportionally lower transaction costs for all successive windows, since uncertainty will be proportionally decreasing as well.

Rights licensing transactions are also characterized by high asset specificity. The distributors need to make transaction-specific investments in the form of the provision of the distribution infrastructure for the content to which they have acquired the rights. If these investments are high, content producers can act opportunistically and appropriate the quasi-rent associated with the distributors' investments. According to transaction cost economics, the incentive for distributors to vertically integrate backwards should in this case be significant. Industry analysis shows that networks have indeed increasingly integrated upstream into content production since the repeal of the financial interest and syndication rules by the FCC (Vogel, 1998; Litman, 1998).

In summary, in the media industry, all content rights are naturally characterized by high asset specificity. It could be argued that vertical integration of rights holders into distribution has only happened for want of effective copyright regimes. Functioning copyright protection would eliminate the problem of incomplete contracts and the subsequent hazards to the rights owners. Allowing content originators to both sell their works and retain legal control over reproduction and other uses for a limited time will lead to lower transaction costs (Cheverie, 2002).

Another relevant example of the application of Transaction Cost Economics is the prevalence of vertical integration between music content producers and music distribution companies. The establishment of distribution networks, marketing and promotion efforts, and royalty collection mechanisms for musical content requires large upfront investments, which then have to be amortized over as large a customer base as possible.

Empirical research against the importance of transaction costs for the implementation of a vertical integration strategy has been presented by Collete & Chan (2001). They found that distributors who are vertically integrated with content producers still tend to buy a relevant percentage of their content from other content producers through contractual relationships (Collette & Chan, 2001). Interestingly enough, they obtained the same results for content
producers that have forward-integrated into distribution: the majority of content is not sold to
the conglomerate to which they belong, but to "foreign" networks or aggregators (Collette &
Chan, 2001). The generalizability of the results is questionable, though, due to the limited
scope of the study.

In response to the argument, instead of only relying on the organizational form that would be
most efficient according to Transaction Cost Economics, content producers have - even
before the advent of digital technology and the Internet - maintained a dual form of
distribution using both vertical integration and contractual relationships. This dual
distribution form is both as a safeguard for non-redeployable assets and a mechanism
providing adaptation capabilities to cope with uncertainty (Dutta, Bergen, Heide & John,
1995). The demand uncertainty for a specific content is indeed an important factor for the
distributors. Although distributors can partly influence the success of content through their
promotional activities, they are nonetheless unable to predict any audience response with
certainty. In order to decrease the risks associated with new content, they rely on heuristics
such as previously successful producers, writers and actors. If these assets are already under
contract of an external distributor or content producer, the integrated distributor will
nonetheless be forced to buy its content in the market. On the sale side, content producers that
sell only to their integrated distributors do not take advantage of multiple bidders in the
marketplace that might generate higher prices for superior content products (Collette, 1998).

2.4.1.2. Property Rights Theory

The framework of the modern property rights theory as developed by Hart (1995), Hart &
Grossman (1989), and Hart and Moore (1990) states that the inability to write complete
contracts which govern a firm’s relationships with outside market actors increases the
motivation to vertically integrate.

The property rights model can thus be seen as an extension of the asset specificity problem of
Transaction Cost Economics\(^3\). Transaction costs theory emphasizes the economic costs of
writing contracts and the consequent contractual incompleteness, but pays less attention to

\(^3\) See Hart (1995) and Williamson (2000) for a detailed discussion of the differences between transaction cost
economics and incomplete contract theory.
the idea that institutional arrangements can be designed to allocate control rights among agents. Property rights theory focuses on how control rights to specific assets are allocated in contractual relationships.

An optimal contract will stipulate each person’s obligations in every conceivable eventuality and impose large economic penalties if either party of the contract fails to live up to these obligations. Hart (1995) noted that in business reality, contracts were not comprehensive and were almost constantly revised and renegotiated. According to Transaction Cost Economics, renegotiation is a consequence of environmental uncertainty and bounded rationality and thus unavoidable. The renegotiation process imposes several transaction costs. Some of these costs are ex post costs incurred at the renegotiation itself, and others are ex ante costs incurred in anticipation of renegotiation. Hart (1995) argues that the contracting parties will only be willing to incur renegotiation costs if the contract requires an ex ante relationship-specific investment that creates economic value only in the case of a long-term contractual relationship. Given each contractual party’s fear that the other party will act opportunistically at the renegotiation stage, asset-specific investments may not be undertaken. Such decisions sacrifice some of the efficiency benefits of specialization.

Grossman, Hart and Moore have developed a model that focuses exclusively on this efficient boundaries question. They hypothesize that ownership of an asset confers the residual rights of control over that asset, i.e. the decision rights over all uses that are not specified in the contract or that are not enforceable by a court. The owner of the asset thus gains bargaining power from asset ownership that enables him to appropriate a majority of the surplus resulting from the project. When allocated efficiently, the incentives provided by ownership will induce the owning party to make decisions that maximize - or come close to maximizing - the returns from the project.

This conclusion is quite different from that of traditional studies of interactions between principals and agents (e.g. Holmström, 1979), which generally conclude that the incentives offered to the contracting parties (cash flow rights) are critical, but not the allocation of ownership rights.

Vertical integration now increases the acquiring firm’s incentive to make relationship-specific investments, since it receives the residual control rights and thus a larger share of the created surplus. The cost of integration might entail somewhat diminished incentives of the
acquired firm because it will consequently receive a smaller fraction of the surplus created by its investment.

Hart and Moore also model the incentive problems associated with complementary physical assets (Hart & Moore, 1990; Hart 1991). Two assets are said to be strictly complementary if both are unproductive unless they are used together (Hart & Moore 1990, p. 1135). Once again, an interdependent relationship is assumed. It follows directly that single ownership of the two complementary assets is the efficient contractual arrangement (Hart & Moore, 1990). In this situation integration yields only benefits but no costs since the assets are unproductive and yield no marginal return absent an agreement between the two owners. Therefore, the investment incentives of both parties can only increase through integration, but not diminish.

2.4.1.2.1. Applicability of the Property Rights Theory to the Media Industry

Property rights theory offers a different explanation of vertical integration in the media industry. Under this view, all movements of vertical integration are first and foremost adjustments of the appropriate boundaries of the firm. In the media industry, those boundaries are constantly being reset by a rapidly changing technological environment. Today, a movie does not only entertain customers in a film-theatre. Nowadays it is launched as a brand name under which a multitude of entertainment articles are sold (toys, books, videos, CDs, clothes, food etc.) on all available distribution platforms. Because launching a strong brand name is very costly and the duration of a brand in the entertainment industry is short, the industry faces a time-cost trade-off that forces the industry to exploit brands in a concerted manner. The critical asset now is the possibility to create a brand name of the content asset, and its revenue generation abilities depend on (most often promotional) investments made by each participant of the value chain. If the aim of the content producer is revenue maximization, as can reasonably be assumed, ownership of all residual rights assures the appropriation of all possible revenue streams since distortions regarding the investment incentives of the other parties can be eliminated (Rajan & Zingales 2000).
Empirical work to date has not focused on trying to distinguish between Transaction Cost Economics and property rights theories of vertical integration and there has been little effort to test property rights theories directly (Whinston, 2003).

Most of the academic studies undertaken on vertical integration are based on Williamson’s Transaction Cost Economics Theory. This empirical work has focused on decisions to vertically integrate, the design of non-standard contractual arrangements and the performance of both vertical integration and non-standard contractual arrangements over time as supply and demand conditions change. This work has included both detailed case studies of particular firms as well as econometric analyses based on large numbers of observations on the governance arrangements chosen for transactions with different attributes.

Papers by Joskow (2003) and Klein (2004) are devoted to reviewing the empirical literature on the effect of transaction costs on vertical integration decisions. They highlight the similarity in empirical research strategies in this area: most of the work involves testing the likelihood of observing a transaction or lack of one as a function of the properties of the production process and the environment. In these studies, typical explanatory variables include proxies for asset specificity, uncertainty, complexity, and frequency of transfers. Most of these studies have been performed within a single industry because the specific explanatory variable must be tailored to capture the characteristics of particular exchange relationships. These studies tend to follow a similar empirical methodology. They generally focus on a particular good or service that is used as an input to produce or distribute a specific class of products: automobile components (Klein, Crawford, and Alchian, 1978; Klein, 2000, 2002; Monteverde and Teece, 1982; Walker and Weber, 1984; Langlois and Robertson, 1989), coal (Joskow, 1985, 1987, 1988b, 1990; Kerkvliet, 1991), aerospace systems (Masten, 1984), aluminium (Stukey, 1983), forestry (Globerman & Schwindt, 1986), carbonated beverages (Muris, Scheffman and Spiller, 1992), pulp and paper (Ohanian, 1994), property-liability insurance (Regan, 1997). Other studies focus on a set of products that can be distributed through a similar set of alternative distribution modes (Anderson and Schmittlein, 1984; Affuso, 2002).

Another extensive inter-industry study was undertaken by Harrigan (1985, 1986), where the make-or-buy decisions of 192 firms from sixteen industries were examined for the years
1960-1981. Her findings contributed explanatory evidence that suggests that firms with market power “need not own a vertically related unit in order to enjoy the advantages vertical control provides” (1985, p. 421).

The empirical analysis examines whether the incidence of vertical integration or substitute non-standard vertical contractual arrangements observed in practice can be explained by variations in the transactional characteristics of the goods and services whose governance structures are being investigated, in particular by the importance of asset specificity, holding other transactional attributes constant. The overall conclusion of this large number of empirical studies is that the importance of specific investments and other attributes that affect transaction costs are both statistically and economically important causal factors influencing the decision to vertically integrate.

These studies have produced strong support for the theorized relationships between the presence or absence of vertical integration and the environmental factors being analyzed.

2.4.1.3. Vertical Integration as a Mechanism to Prevent Exclusionary Market Power

Another framework that economists have used to account for vertical integration is the exclusionary market power theory (Salop & Scheffman, 1987; Ordover, Saloner, Salop, 1990; Salop, 1993). Exclusionary market power is the ability to raise or maintain prices above the competitive level by conduct that raises costs or excludes competitors and thereby induces these rivals to restrict their output (Salop, 1993). Salop & Scheffman (1983), Aghion & Bolton (1987) and Ordover, Saloner and Salop (1990) show how vertical integration creates vertical foreclosure, the exclusion that results when either non-integrated downstream rivals are foreclosed from the supplies controlled by the integrated firm, or non-integrated upstream supplies are foreclosed from selling to the integrated downstream firm. In sum, foreclosure can be defined as restricted access to input or output markets which leads to a limitation of inter-company competition.

In order for vertical foreclosure to occur, two conditions have to be met: markets need to be monopolistic or oligopolistic, and exhibit high barriers to entry. Vertical foreclosure can only occur when there is no potential competition in the markets controlled by the integrated firms (Baumol, Panzar & Willig, 1982).
The classic case of foreclosure arises when there is a monopoly over the supply of some essential facility or "bottleneck resource" that competing firms need access to in order to supply the downstream market. Then the dominant firm can raise rivals' costs by charging dependent buyers high prices for the input or access to the input. A company in these circumstances is commonly referred to as a gate-keeper. A gate-keeper will be able to engage in exclusionary practices against its competitors and/or excessive pricing vis-à-vis its customers. The extreme example is where a company, as a result of vertical or horizontal integration, succeeds in completely barring the access to a given market to its competitors.

Under the following conditions, foreclosure occurs in oligopolistic markets. Ordover, Salop and Saloner (1990) analyze a model with a duopoly of two identical firms that engage in perfect competition in the upstream market and with another duopoly in the downstream market. Without vertical integration the upstream firms sell their input to the downstream firms at a price equal to their marginal cost. The downstream firms take this input price into account and maximize profits given the demand elasticities they face for their products. This means that if one firm raises its price then the competing firm will also find it profitable to raise its price. Each firm's price in turn depends on the price it pays for inputs. If one downstream firm now vertically integrates with one upstream supplier, and decides not to sell its input to the other downstream firm anymore, the remaining supplier becomes the monopoly supplier for the remaining downstream firm and will accordingly charge a monopoly price for its input. The non-integrated downstream firm will respond by raising its prices which will lead to the other integrated downstream firm to raise its prices in response. Downstream prices thus rise and so do the profits of the vertically integrated firm as its input prices have not changed.

In addition, firms with monopolistic or oligopolistic market power may have the ability to leverage their dominant position into further upstream and downstream markets. The most common strategy of leveraging is tying or bundling. In that case, a monopolist can use his market power in the tying market to extract additional surplus from the tied market even when the latter is competitive. As an example a firm will be considered that has monopolistic market power in market A, and wants to sell product B in the competitive B market. The firm now bundles product A and B and prices them so that the incremental price increase of the bundle AB over A is less than the cost of B. As a consequence, equally efficient competitors selling only product B are foreclosed. The bundling or tying of products and services thus fulfills important strategic functions. It allows producers to shield themselves, at least to a
certain degree, against market entry by competitors in one market segment. If the incumbent is able to bundle products and/or services in a way that the potential entrant in a single segment cannot supply, it may be able to offer the contested product or service at a very low price within the bundle. This drastically reduces the market entry opportunities of potential new entrants that only compete in one market segment. More generally, bundling will create entry barriers for companies that are present in fewer market segments than the incumbent (Nalebuff, 2004), and will thus, ceteris paribus, reduce the intensity of competition.

The logic is that bundling goods directs the buyer’s attention away from the value of individual items, which constitutes information that is extremely expensive to obtain, and instead focuses attention on the average value of the entire bundle which is information that can be obtained more cheaply. Bundling can thus reduce transaction costs by decreasing the transacting parties’ incentives to expend additional effort attempting to define the true value of each item in the bundle, since, on average, the overpriced and underpriced goods in the bundle tend to balance each other out.

2.4.1.3.1. Empirical Research on the Exclusionary Market Power Approach

Most of the empirical literature that is concerned with the analysis of the market power explanations of vertical integration focuses on whether vertical integration leads to higher or lower prices, on whether there is evidence of exclusion of competing suppliers from the market, and on whether there is evidence of changes in consumer welfare. The empirical work effectively reduces these theories into “efficiency” theories of vertical integration that are good for consumers and anticompetitive “foreclosure” theories which are harmful for consumers.

Vita (2000) and Gilbert and Hastings (2001) examine the effects of government regulations that restrict vertical integration between upstream gasoline refiners and downstream gasoline retailers. Both studies find that the restrictions on vertical integration lead to higher retail prices. Rosengren and Meehan (1994) use an event study approach that examines the effects of equity share prices of non-integrated rivals at the time vertical mergers are announced for a sample of vertical mergers. If the vertical mergers reflect an effort to foreclose the competition, then they expect to find positive abnormal returns for the shares of rival non-integrated firms. They find no evidende to support the foreclosure theory.
Experimental economics techniques have also been used to test foreclosure theories of vertical integration. Martin, Norman and Snyder (2001) find evidence that vertical integration increases the ability of the upstream firm to withhold output and increase prices. However, Mason and Philips (2000) find that vertical integration leads to an expansion of output and increased consumer welfare in a similar experimental setting.

Regarding the media industry, studies examining vertical integration have so far been concerned mainly with the cable television industry. Waterman and Weis (1996) examine the effects of vertical integration between programming and distribution in the cable television industry, and find extensive evidence of exclusionary behaviour by vertically integrated firms. They find little evidence for any downstream price effects but do find that sales are higher for affiliated programming services carried by vertically integrated firms than for non-integrated distributors. Waterman and Wise conclude that the results are consistent with either a foreclosure theory or an efficiency theory of vertical integration.

These findings are corroborated by Chipty’s (2001) study. He states that vertically integrated cable distributors are more likely to exclude rival cable programming networks and favour affiliated networks over non-integrated distributors.

2.4.1.3.2. Applicability of the Exclusionary Market Power Approach to the Media Industry

In order to determine the applicability of the exclusionary market power approach to the media industry, the relationships between content producers and distributors will serve again as a general example.

Media products are costly to produce and are largely indivisible by nature. This means that the producer must incur the full costs of production before being able to predict the potential market for the product with any certainty. Consequently, profit margins for even the largest and economically efficient content producers can be volatile, and the industry average rates of return on investment (ROIC) are low compared to the ROIC of most content distribution operations. Despite this unfavourable risk-return profile, content producers have been regarded by media and entertainment companies as valuable strategic assets because secured access to their current content and the content libraries can give vertically integrated
companies an advantage in launching or defending virtually all downstream distribution platforms.

In the case where one or a few distributors now decide to vertically integrate backward into content production, foreclosure of other producers can happen if the distributors occupy a oligopolistic or monopolistic market position and if barriers to entry limit the entrance of new distributors.

According to vertical foreclosure theory, content production companies then generally have three options for responding to the threat of distribution foreclosure. They can

1. vertically integrate forward into distribution to ensure access and create a gatekeeper position of their own,
2. acquire more content, preferably of a strong branded or otherwise compelling nature to raise the opportunity costs for the distributor threatening to deny access,
3. diversify into downstream businesses which are customers of one or more of the distributor's units and which have a strong bargaining position vis-à-vis these units to create a countervailing threat.

The practice of bundling or tying described in the preceding section is also a commonly used strategy in the media industry. These practices are common in both the content and the distribution segments of the media value chain. Examples are the content bundling practices of the major studios, or bundled Internet, telephone, and pay-television access.

Bakos and Brynjolfsson (1999) found that bundling very large numbers of unrelated information goods can be highly profitable, and it is possible to achieve increased sales volumes, greater economic efficiency and greater profits per good from a bundle than can be achieved by selling the goods separately.

In general, the practice of content bundling or “block booking” prevents distributors from licensing individual content products and instead requires them to purchase pre-arranged content packages. Content bundling serves two distinct purposes. First, it reduces the costs of distributing first-run movies. The practice stems in large part from the difficulty in determining the true value of a movie at the time it is initially licensed. The complexities of scheduling distribution generally require that licensing agreements are signed before the content is produced, and, more importantly, before the content’s first run has revealed its actual value. Block booking is thus an effective means to prevent distributors from
opportunistically attempting to renegotiate their content deals once they have obtained information about the actual value of the film (i.e. the box office results, or television audience ratings, etc.). Accordingly, when block booking contracts become subject to renegotiation or get too expensive to enforce, content producers may find it preferable to vertically integrate into distribution (Kenney & Klein, 1983).

In the case of service or access providers, bundling allows them to reduce the variability in the willingness to pay for individual services, leading to higher total revenues for the service provider (Shapiro & Varian, 1999). If consumers have complicated preference structures, more differentiated mixed bundling strategies can be adopted with revenue-enhancing effects. For consumers, bundling may reduce the overall outlay for services, and may create further benefits due to the reduced transaction costs of the one-stop shopping model. Ideally, bundling has beneficial effects for both the supplier and the buyer.

Bundling has also allowed service providers to shield themselves against market entry by niche competitors. In a broadband environment, companies like Skype could enter the market with relatively low customer acquisition costs and minimal facility investment. In contrast, if an incumbent is able to offer triple play or even quadruple play bundles at equally competitive prices, it should be able to lure most of the new entrant’s customers away (Bianco, 2004). However, in order for the incumbent to offer triple or quadruple play services, extensive vertical integration of content, broadcasting, telecommunications, and Internet access services is a prerequisite.

2.4.1.4. The Resource-Based View of the Firm and its Application to Vertical Integration

The resource-based view of the firm provides an analysis of vertical integration that deviates from the market imperfections and oligopoly assumptions of the Transactions Cost Economics approaches (Perry, 1989; Joskow, 2005).

In general, the resource-and capability-based view of the firm has its roots in Penrose (1959) and more recently Wernerfelt (1984) and Barney (1991). It emphasizes the firm’s resources as the fundamental determinants of competitive advantage and performance.

The theories presented so far have focused primarily on individual transactions as a unit of analysis where the particular transaction costs are examined that may push a firm towards vertical integration as opposed to procurement through the market. However, the effectiveness of any change in strategy is dependent on both the environmental and
organizational changes that accompany it (Rajagopalan & Spreitzer, 1997). Managerial capabilities such as an evaluation of potential costs and benefits of a vertical integration strategy, also constitute an integral determinant of vertical integration success. From this perspective, the performance consequences of vertical integration can be described as a function of both firm-specific competencies and environmental constraints (Peyrefitte & Golden, 2002).

Barney and Peteraf have developed a model of the sources of competitive advantage, which rests on two assumptions (Barney, 1991; Peteraf and Barney, 2003). Firstly, the model assumes that firms within an industry (or within a strategic group) may be heterogeneous with respect to the bundle of resources that they control. Secondly, it assumes that resource heterogeneity may persist over time because the resources used to implement firms’ strategies are not perfectly mobile across firms (i.e., some of the resources cannot be traded in factor markets and are difficult to accumulate and imitate). Heterogeneity in productive capabilities is an often observed phenomenon because the ability to carry out a complex activity is typically developed in an organization through a long, path-dependent learning process, which is in turn shaped by various contingencies and thus produces a unique "way of doing things" (Levinthal, 1997). Thus, even in environments were primary resources are quite homogenous, different organizations are likely to display different efficiencies as a result of different capabilities and learning processes (Lieberman & Dhawan, 2001). Resource heterogeneity (or uniqueness) is therefore considered a necessary condition for creating sustainable competitive advantage. According to Barney (1991), a firm resource must, in addition, be valuable, rare, and imperfectly imitable and substitutable in order to become a source of sustained competitive advantage. Peteraf (1993) summarizes the four conditions underlying sustained competitive advantage in the following conclusive manner: superior resources (heterogeneity within an industry), ex post limits to competition, imperfect resource mobility and ex ante limits to competition.

Firms, in deciding whether to integrate or not, compare their own capabilities with those of other firms – as signaled by the price and quality terms on which those other firms are prepared to deal. This line of analysis shows the fundamental difference between the resource-based view and Transaction Cost Economics, which is more concerned with the conditions of the exchange and neglects the conditions of production. This means that, for market exchanges to occur, the distribution of productive capabilities in an industry must be asymmetric, making it advantageous for firms that show less efficient capabilities in a
specific segment to trade with firms that have efficiently conquered the respective segment. In other words, the more dissimilar the industry segments actually are, and the less strength from one segment can be translated into strength in another segment, the smaller the likelihood of vertical integration.

Even if industry segments are quite homogenous, the core capabilities of the firm may be compromised in the vertical integration process since they have to be adapted to the requirements of the new segment. It is unlikely that the management of a non-integrated firm can utilize its existing capabilities to manage the integrated activities (Peyrefitte & Golden, 2002). This implies that, according to the resource-based view of the firm, one of the most important determinants of vertical integration success are the learning capabilities of the management team and the ability to accurately access the net benefits and costs of the envisaged vertical integration strategy.

In recent years a convergence between Transaction Cost Economics and the resource-based view of the firm could be observed, and several authors have argued that capabilities as well as transaction costs must be considered in explaining vertical scope (Argyres, 1996; Poppo & Zenger, 1998; Schilling & Steensma, 2002; Madhok, 2002; Leiblein & Miller, 2003; Jacobides & Hitt, 2005). Williamson himself has recognized that the transaction cost and internal firm perspectives "deal with overlapping phenomena, often in complementary ways" (Williamson, 1999, p. 1098). He has also confirmed that a firm's history and capability endowments matter to boundary choices. Madhok (2002) has summed up the convergence of the two theories and postulates that an individual firm's choice of integration depends not only on the characteristics of the transactional conditions, but also on its strategic objectives, the attributes of its own capabilities, and the governance structure it operates in.

Several scholars of technological innovation have taken the convergence of capabilities and transaction costs even further, and have produced dynamic models that explain how regularities in the patterns of technological evolution interact with transaction costs and capabilities to shape industry value chains (Chessborough & Teece, 1997; Raynor and Christensen, 2003; Jacobides & Winter, 2004).

Figure 6 illustrates the dynamic interactions between capabilities, transaction costs, and vertical integration in an industry.
Jacobides and Winter (2004) argue that this co-evolvement of capabilities, transaction costs, and vertical integration is most pronounced in industries that are characterized by frequent technological innovations. Starting again with Williamson (1981) they argue that integration is beneficial whenever asset-specific investments are necessary and that this tends to happen when new technologies appear that rely on new knowledge bases. The increased costs that come with the application of the new technology might be translated into higher transaction costs by non-integrated firms in the industry, because integrated firms might be better positioned to leverage their existing knowledge and avoid the increase in transaction costs. Another problem may be the suitability of the existing products for the new role – adaptation and improvement may be required. The difficulty of getting appropriate inputs for the new technology from existing suppliers then provides another powerful reason for vertical integration.

Another advantage of vertical integration in this case may be that new technologies and related management capabilities for an emerging new sector can be imported from an existing integrated sector (Chesborough & Teece, 1996).

Raynor and Christensen (2003) have also argued that technologically motivated vertical integration may lead to superior innovative abilities. They present the telecommunications industry as a case to illustrate their argument: "In particular, the ability to develop and deploy
new technology services depends on the control a firm exercises over the value chain (…) interdependent technological architectures are best developed by firms with integrated value chains" (Raynor & Christensen, 2003, p.4).

In conclusion, the resource-based view of the firm predicts that firms will vertically integrate in situations where integration allows the firm to either leverage its own unique capabilities into another market segment or where new unique capabilities can be secured through the acquisition of a firm in another market segment. In general, vertical integration will also occur when it is more efficient to access or leverage knowledge- or property-based capabilities through integration than through market contracts (Grant, 1996).

2.4.1.4.1. Empirical Research on the Resource-Based View of Vertical Integration

While transactional drivers have been the focus of the majority of the empirical work on vertical integration, recent work has shifted away from validating any single theory or running “horse races” between theories towards understanding how the theoretical factors interact to shape the evolution of an industry. While Transaction Cost Economics and the resource-based view were for a long time viewed as alternative explanations of vertical integration, more recently they have come to be considered as being complementary. Jacobides and Winter (2004) argue that capabilities and transaction costs co-evolve and work to push an industry towards more or less vertical integration over time. They support their argument with evidence from the U.S. mortgage banking industry and the Swiss watch manufacturing industry. In consequence, the theory of the firm literature is moving towards a more holistic analysis of vertical integration, considering the dynamic causes and consequences of vertical integration.

There is by now substantial empirical support for the proposition that considerations of transaction governance trade off against capability or resource-based considerations when firms choose component suppliers (Walker and Weber, 1984; Argyres, 1996; Poppo and Zenger, 1998; Schilling and Stensmaa, 2001; Afua, 2001; Jacobides and Hitt, 2004; Hoetker, 2004). These contributions consider the complementary roles of transactional and capability considerations in the micro-analysis of firm decisions.
2.4.1.4.2. Applicability of the Resource-Based View of Vertical Integration to the Media Industry

Examining the behavior of the media firms through the resource-based view provides valuable insights about vertical integration. The resource-based view entails an analysis whether and to what extent media firms control the key resources of either property or knowledge in their respective market segments.

In terms of property resources, the key resources for the media organizations can be divided into intangible and tangible property resources.

Intangible property resources are content rights or at least long-term content licensing and distribution rights. Another important intangible property resource is constituted by long-standing relationships with suppliers, distributors, and customers. In the case of the media industry, the importance of long-standing relationships with advertisers is of specific importance and can significantly reduce market uncertainty and secure the stability of revenue flows.

Tangible property resources encompass all resources that are necessary to produce content and distribute it to the consumer, i.e. from printing presses over the actual cable systems in the ground to hardware retail outlets, to name just a few examples.

The second kind of key resources are knowledge-based resources. The most critical knowledge-based resource is a detailed understanding of the media firm’s audiences through audience research and control of subscription lists and distribution information. This resource is one of the most important instruments in building sustainable competitive advantage since it allows media managers a timely reaction to the needs and wants of their audiences. Dimmick supports this notion by stating that the gratifications the audience receives from a specific media product are among the key resources controlled by a media firm (Dimmick, 2003, p. 56).

Knowledge about financial resources and strategic approaches to financial management also constitute a powerful knowledge-based resource, and this resource becomes even more valuable with the increasing importance of securing a company’s access to the global capital markets described in section 3.4.1.1.1.

Finally, a media company’s product might be deemed both its central knowledge and its central property resource. Media content is necessarily the product of the individuals who create it and, consequently, it is presumed to be at least somewhat non-imitatable and non-
substitutable. Vertical and horizontal integration allow media firms relatively easy access to the above described key resources. For example, vertical downstream integration of many content producers into content distribution has provided the content creators with a valuable direct link to their consumers or audience, allowing the generation of proprietary audience data, with improved demand management capabilities as a strategically important consequence. The Disney acquisition of the specialist animated content studio Pixar provides an excellent example of a horizontal integration that was undertaken with the aim of strengthening the intangible property resources by acquiring a so far inimitable content product.

2.4.2. Dynamic Models of Vertical Integration

As can be seen from the preceding sections, the theory of the firm literature has developed a rich body of knowledge regarding why a firm might be better off performing a stage of the production process internally. The focus has been on the bilateral relationship between a single producer and a potential supplier, where the role of transactions costs, asset specificity, incomplete contracts, market power, and other individual firm capabilities for the vertical integration decision has been specified.

Yet, influential as this work has been, it only provides a static approach and does not take into consideration how an industry and the interdependences between firms might change over time. For example, the attractiveness of outsourcing to a certain supplier may well depend on how many firms can potentially provide the required inputs, which in turn may depend on whether other firms in the industry have chosen to be vertically integrated or still outsource their supply needs.

In Demsetz’ words, “the decision [to produce] hinges on the internal costs of production that burden the potential purchaser and supplier… The emphasis that has been given to transaction cost… dims our view of the full picture by implicitly assuming that all firms can produce goods or services equally well.” (Demsetz, 1988, p. 147).

2.4.2.1. Stigler's Dynamic Model of Vertical Integration

Stigler (1951) proposed one of the first models to explain the evolutionary dynamics of industry structure in general, and vertical integration in particular. His main proposition in
this respect is that the degree of vertical specialization in an industry is determined by the size of the industry and the phase of industry evolution.

Describing firms in terms of a life cycle made up of three stages, he studies what may bring about vertical integration or disintegration in each of the transition periods between those phases. In the initial stage, vertical integration is unavoidable because the firm has to carry out a number of activities that may not be available on the market because the set-up costs incurred to carry out activities that are subject to scale economies may be too high to make the emergence of specialized suppliers profitable. In the following stage, as the market grows, however, such suppliers can be supported on the basis of higher output levels. The outcome of the transition between those two stages is a gradual disintegration of the original firms. In the last transition phase, as the firm shrinks relative to the rest of the economy, vertical integration begins to re-emerge.

Stigler's theory depends primarily on the existence of economies and diseconomies of scale and the assumption that suppliers of new products require specialized inputs. Williamson criticized this approach for not being fully comparative since other firms already in the industry could, absent potential opportunism, serve as sources of supply without incurring set-up costs (Williamson, 1975, pp.16-19). Stigler's approach also ignores transaction costs associated with both internal organization and market contracting.

Stigler’s theory, which spurred some empirical literature on market size and specialization (Joskow, 2003), has proven hard to ratify. Most attempts to support Stigler’s hypothesis have been founded on oligopolistic structures with differences between fixed and variable cost conditions of integrated versus specialized firms. See Elberfeld (2002) or Dufeu (2004) for further illustrations.

In sum, Stigler’ industry life-cycle theory postulates that industry value chain evolution will lead to a subsequent transformation of industry structure. Dominant, integrated firms will be replaced over time by horizontally stratified and increasingly specialized firms (Chesbrough and Teece, 1996; Grove, 1996, Christensen, Verlinden and Westerman, 2002). At the heart of the process seem to be several motivating factors: gains from specialization driven by differences in the evolving knowledge bases along the value chain and latent gains from trade emerging from capability differences between specific firms in the industry (Jacobides, 2005). Costly technology shifts might require open solutions to minimize R&D investment and a
higher degree of vertical specialization, due to cost pressure both in terms of matured technologies and investment cost of new technologies.

2.4.2.1.1. Applicability of Stigler’s Vertical Integration Theory to the Media Industry

The challenge of being able to maintain high performance across a range of activities has been identified as one of the key dilemmas for the vertically integrated media conglomerates – vertical integration can lead to the subsidizing of internal activities with weak performance, reducing the overall effectiveness of the company (Porter, 1996; Evans, 1998). This averaging-out is not a problem so long as it does not threaten competitive advantage along the entire media value chain, and therefore the firm’s ability to support weak performance of, for example, untested business model in newly emerging media markets. But if this is not the case, then the outsourcing of weak performance activities can boost profitability and increase opportunities for growth by allowing the company to focus on activities in which the firm maintains a competitive edge (Evans, 1998). This problem has been identified by Porter who argues that strategy requires firms to deliberately forego potentially attractive opportunities in other parts of the value chain (Porter, 1998).

It follows that in increasingly maturing market segments of the media industry, vertical de-integration of the media conglomerates should be observable, followed by an increasing vertical specialization.

Multidimensional complexity is making it increasingly difficult for media firms to retain all activities in-house and is resulting in the evolution of capability differences between different firms. This, in turn, is increasing the gains from trade across firm boundaries. This is particularly true in the face of shortened product lifecycle times, the increasing need for interoperability of different media and the aggressive entry of new competitors that are leveraging their own core competences in areas such as digital media, telecommunications, and the Internet.

The significant underperformance of the share prices of the media conglomerates under study in this dissertation (see chapter 7 for a detailed share price analysis) may lend some support to Stigler’s theory by indicating that the financial markets believe that overly diversified media conglomerates with non-synergistic asset holdings may have to restructure, divest, and focus on core business (Ferrari et al., 2002).
As a consequence, various media firms have recently been considering, or are engaged in, major divorces or divestitures. In 2005 alone, Viacom, Liberty Media, Sony, and Time Warner, have all announced spin-offs and divestitures of parts of their operations (Lowry & Grover, 2005). However, a closer analysis shows that these spin-offs in most cases entail only a partial release of control by the parent companies, and do not constitute a true exit of certain media value chain segments. In the cases where a 100 per cent divestiture has taken place, as, for example, happened when Time Warner sold its music division, the divestitures were undertaken to either respond to anti-trust obligations, or in order to exit from non-synergistic business segments that had no relations with the rest of the conglomerate’s portfolio.

In sum, no conclusive evidence from the media industry can yet be found to support Stigler’s industry life-cycle theory. Further detailed research in this area might lead to different results, but this lies outside the scope of this study.

2.4.2.2. Harrigan’s Model of Vertical Integration

Harrigan (1981, 1984, 1985, 2001) has developed a comprehensive dynamic model of the structural determinants of vertical integration. Her model takes into account not only the different stages of industry evolution, but also incorporates all available forms of vertical relationships, from non-integration over quasi- and partial to full vertical integration.

Harrigan starts by differentiating vertical integration according to the following four parameters:

(1) The stages of integration, which denotes the number of integrated value chain components.
(2) Breadth of integration, which essentially addresses the horizontal dimension of the vertically integrated activities. Breadth of integration is an important dimension since companies that produce too many diverse components for a product line may loose important scale economies.
(3) The third factor is the degree of integration, which determines the extent of internal transactions and transfer between the individual elements of the company’s value chain. Harrigan states that the degree of internal transfers matters because the minimum efficient size of upstream and downstream participants of the value chain in question are rarely the same. Some part of the value chain is likely to be out of balance due to such differences of scale, so some units will have to either engage in transactions with outsiders or let excess capacity lie idle (Harrigan, 1985, p. 401).
(4) The last parameter is the form of integration, denoting the extent and mode of ownership of the vertical relationship in question.
According to Harrigan, firms will now adapt the dimensions of vertical integration outlined above according to (1) the phase of industry development (sales growth, changes in growth rates), (2) industry volatility (concentration and exit barriers), (3) asymmetries in bargaining position (vis-à-vis suppliers, distributors, customers, or competitors’ integration strategies, and (4) firms’ strategic objectives (market dominance or focus on a specific niche).

Depending on the specific combination of the above variables, firms can adopt one of four generic integration strategies. Each represents differing degrees of internal investments and transfers, and each implies differing degrees of bargaining power with adjacent industries. Each generic strategy also represents different degrees of risk aversion, desires for control, objectives for market share, or long-term profitability.

<table>
<thead>
<tr>
<th>Full Integration</th>
<th>Integration of the activities of the entire value chain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taper Integration</td>
<td>Part of the production or distribution activities are internalized, the rest is outsourced</td>
</tr>
<tr>
<td>Quasi-Integration</td>
<td>Cooperation arrangements replace full ownership of suppliers or distributors</td>
</tr>
<tr>
<td>Non-Integration</td>
<td>No ownership or cooperation in any form with vertical units of the value chain</td>
</tr>
</tbody>
</table>

**Figure 5: Harrigan’s Generic Vertical Integration Strategies**

Source: Harrigan (1985)

Fully integrated firms buy or sell all of their requirements for a particular product or service internally. Sequential units are in most cases fully owned subsidiaries. In Harrigan’s view, full integration is used under conditions of incomplete contracting, i.e. when input prices are so volatile that no long-term contracts can be written. Full integration is also used when firms believe they must protect proprietary processes or assets, or when firms desire to supervise all stages of quality control, or when interconnection gives integration cost advantages (Harrington, 1981, p. 17). Fully integrated firms often follow a market share leader strategy, particularly if the minimum efficient scale is large.

Taper- or partially integrated firms rely on outsiders for a portion of their requirements. Harrigan believes that taper integration is necessary where technologies incur substantially increasing costs beyond some level of production or if additional capacity is available only in great lumps that cannot be used efficiently without stealing sales from competitors and
risking price wars. Taper integration assumes that an outside supply of (or market for) excess resources will be readily available. Thus taper integration can create bargaining power when firms are able to use their knowledge of suppliers’ or distributors’ cost structures in order to extract lower prices from them (Harrigan, 1981, p. 18).

Quasi-integration is a bonding of autonomous units which may take the form of cooperative ventures, minority equity investments, loans to the other entity, or just an understanding of customary relationships. Quasi-integration provides many of the advantages of vertical integration without assuming the risks and rigidity of full ownership. Quasi-integration is useful when risks from new technologies or capital requirements are high, and it offers the competitive-scanning advantages of taper integration for a lower ownership stake. The downside of quasi-integration is that it can lock firms into relatively inflexible contracts with particular suppliers and customers, a factor which proves significant if these partner firms should prove to be strategically sick themselves, by impeding their abilities to shift tactics quickly in a volatile market (Harrigan, 1981, pp. 20-21).

Non-integration is an attractive strategy when firms are reluctant to acquire highly specialized assets. Also, in turbulent market environments, a non-integrated strategy lowers a firm’s overhead and break-even point. If the firm commands a strong bargaining position in the market, non-integration can shift the risk from the firm to its suppliers or distributors. Successful non-integration assumes, however, the availability of numerous subcontractors whose products and services equal or exceed the quality of the firm’s own, but if subcontractors are scarce, outsiders may gain bargaining power over the firm in a way that is disadvantageous to the firm’s strategic flexibility (Harrigan, 1981, p. 21).

Harrigan expects all of the above variables to be important to a firm’s choice of the appropriate vertical integration mode, but states that some factors may be more important to some dimensions than others: A firm’s corporate strategy objectives and its industry’s phase of development will have the most weight in influencing decisions concerning the number of stages to be engaged in (Harrigan, 1985, p. 403). Volatility of competition, and the firm’s bargaining power vis-à-vis suppliers or distributors, or customers, and the firm’s overall strategic objectives, will influence all decisions concerning the form of ownership of vertical stages.

The interplay of all these variables has been summarized by Harrigan in four different strategic frameworks of vertical integration, which vary according to the phase of industry
development. The frameworks give specific vertical integration strategy recommendations by taking the following generalized influencing variables into account: the firm’s strategic objective, its bargaining power, and the competitive conditions of the industry.

The four frameworks are: Nascent industries, emerging industries, established industries, and declining industries. The two frameworks that are relevant for the media industry and the media conglomerates studied in this thesis are presented below. The framework for established industries can be applied to the traditional media value chain market segments, like theatrical and television content production, broadcasting, radio, and all print and music publishing operations, as these industry segments are characterized by long established structures and the beginning saturation of their individual submarkets. In contrast, the emerging industries framework is applicable to the new media sectors of the media value chain, like the Internet and new digital technology market segments, as these are characterized by strong growth and a loosely defined industry structure with not yet rigid boundaries and entry barriers.

![Harrigan's Vertical Integration Framework for Established Industries](image)

**Figure 6:** Harrigan’s Vertical Integration Framework for Established Industries

Source: Harrigan (1983)

In the established industries framework, as an industry matures and sales volumes become stable, a strategy of extensive vertical integration allows a firm to realize possible scale economies. Since firms can better forecast their activity levels, more value-added can be retained inside the firm by using vertical integration. On the other hand, as industry trading relationships become more established, firms that enter at this late stage may be required to
be more integrated than they may wish to overcome foreclosure to raw materials or distribution outlets created by the existing firms’ vertical arrangements.

Harrigan also states that there is a transition points in established industries after which the vertical integration strategy of a company should be reevaluated. Changes in market share become rare and small, and corporate pressures to harvest businesses in established industries increase as industry growth slows. At this point managers should become critical of their integrated positions and assess whether reductions should occur.

Presented below is Harrigan’s model for emerging industries. To see the different recommendations of the two models, a random example will be selected: for a company that focuses on a specific niche segment in a mature established industry with stable competitive environment, but which has low bargaining power, the model recommends a partial integration. In contrast, in the case of an emerging or growth industry, the same company could follow either a strategy of partial integration or a strategy of quasi-integration.

Figure 7: Harrigan’s Strategic Framework of Vertical Integration in Emerging Industries

Source: Harrigan (1983)

The remaining two models for nascent and declining industries will not be presented in greater detail as they are deemed not relevant for the purpose of this thesis.
2.4.2.2.1. Applicability of Harrigan’s Strategic Framework to the Media Industry

The following paragraphs attempt to apply Harrigan’s frameworks of vertical integration to the specific conditions of the media industry. For this purpose, the four general influencing variables of Harrigan’s framework will be analyzed for the media industry.

Competitive conditions: The media industry as a whole is at the same time characterized by a stable and an unstable competitive environment. On the one hand, most segments of the media value chain have for the last decades been subjected to stable oligopolistic market structures. In recent years, competition has intensified considerably, meaning that even fewer players now dominate the global media industry. On the other hand, new competition has sprung up where new markets were opened up through digitalization or other technological developments. Nonetheless, the trend in the new markets is also one of rapid consolidation. Google is a case in point. In addition, the competitive environment of the media industry can also be characterized by an inherent instability if one takes into account the enormous success volatility of media content. Success or failure of a content product in the opening stages of the value chain determines the price and thus the revenues in all subsequent stages of the media value chain. This implies a volatility of revenues that has the potential to alter the competitive structures of the industry or the segment from one content product launch to the next.

Bargaining power: Since the large U.S. and European media conglomerates all command substantial market shares, and most are in addition fully vertically integrated, it follows that they can command high bargaining power vis-à-vis external market participants as well as vis-à-vis their integrated suppliers or distributors. Harrigan’s model incidentally also gives the recommendation for full integration if high bargaining power is to be attained.

Strategic objectives: For the biggest global media conglomerates, market leadership of the global media market has been and still is the main strategic objective. For the remaining industry players the strategic objective can be stated as gaining market share in their respective segments and eventually extending their reach into adjacent segments.

Phase of industry development: Most of the media industry market segments are in mature industries, except for the new media segments which can be characterized as emerging industries.

It becomes clear from this analysis that the major media conglomerates that are the subject of this study, have already followed Harrigan’s recommendation of full or at least partial
vertical integration for the case of a mature industry that is characterized by either stable or unstable competitive conditions, and where the companies in question aim for market leadership.

2.4.2.3. The Strategy-Structure Choice Model of Vertical Integration

The strategy-structure choice model was developed by Jones and Hill (1988) and is based on Chandler's (1962) and Scott's (1973) strategy-structure-performance model and on Williamson's theory of Transaction Cost Economics. In Scott's original model, structure is hypothesized to follow strategy, and superior performance is the result of establishing the correct fit between strategy and structure. In order to incorporate Williamson's theory, Jones and Hill extend the original model by presenting it as a function of two factors: the first factor is comprised of the economic benefits of a transaction cost reduction through vertical integration. The second factor is made up of the additional bureaucratic costs of internalizing transactions and thus represents the economic costs of vertical integration. Different corporate strategies can thus be associated with different levels of economic benefits and bureaucratic costs. The difference between relative costs and benefits then determines the ideal strategy for the company in question (Jones & Hill, 1988).

The authors argue that vertical integration entails additional bureaucratic costs for the following reasons: Firstly, the establishment of production linkages between operating divisions requires investments in bureaucratic controls to manage the interdivisional exchange. This control will most likely take the form of a centralized management style, and the corporate center will take on operating as well as strategic decisions. Secondly, internal transfers make the assessment of divisional performance by means of external market controls more difficult. This increases the potential for agent opportunism. To overcome this moral hazard, the firm needs to buy more information; hence, bureaucratic costs increase further.

Jones & Hill (1988) formalize the relationship between bureaucratic costs and the number of divisions in a firm by arguing that bureaucratic costs will increase at a linear rate with the addition of divisions in the case of vertically integrated firms (for the mathematical analysis see Jones & Hill, 1988, p. 165). The relationship between the economic benefits of internalization, the economic costs of additional bureaucracy, and the number of divisions is then treated from a marginalist perspective and formalized in a simple model, where the
economic benefit of the last unit of internalization is defined as the marginal economic benefit (MEB), and the additional bureaucratic cost incurred as the marginal bureaucratic cost (MBC).

The figure below illustrates the relationship between the two curves in a graphic manner:

![Static Model of Marginal Bureaucratic Costs and Marginal Economic Benefit](image)

**Figure 8:** Static Model of Marginal Bureaucratic Costs and Marginal Economic Benefit

Source: Jones & Hill (1988)

The model above shows the MBC and MEB curves in a static setting. If the firm only internalizes up to point I1 it is losing economic benefits, thus further vertical integration would be profitable. At I3, the bureaucratic costs outweigh the benefits of integration, and therefore disintegration will increase profitability. Hence, the optimum level of internalization is to be found at I2.

When the factors underlying the curves change, the curves will shift, leading to a new equilibrium. Factors which shift the MBC curve downwards are for example organizational innovations such as the multi-divisional structure (Chandler, 1962), and increasing abilities of information technology (Galbraith, 1973), since both lead to lower monitoring costs. Exogenous factors may also shift the MBC curve. Increasing environmental volatility and uncertainty will increase complexity and instability, and therefore bureaucratic costs. In these circumstances, the MBC curve will shift upwards (Jones & Hill, 1988).

Factors that will shift the MEB curve downwards are those that decrease the economic benefits of vertical integration, i.e. increased competition enlarges the consumer’s choice between suppliers and thus reduces transaction difficulties. Increased competition also leads to a more efficient pricing mechanism by making the market more transparent. Both factors make internalization a less desirable option (Jones & Hill, 1988).
In summary, the Jones & Hill model serves as a tool which helps to define the ideal extent of vertical integration for a company irrespective of other external factors like industry structure or other relevant macroeconomic variables. In conclusion, the Jones & Hill model has been presented for its descriptive illustration of how a company can determine its ideal degree of vertical integration. In this function, the model basically transfers Williamson’s static Transaction Cost Economics into a dynamic setting. Therefore a specific testing of the model’s applicability to the media industry is not deemed necessary for the purpose of this dissertation, and the arguments outlined in section 4.2.1.1.1. are assumed to be equally valid for the dynamic setting of the Jones & Hill model.

2.4.2.4. A Dynamic Model of Vertical Integration under the Resource-Based View of the Firm

Jacobides (2005a, 2005b) further develops the resource-based view of the firm framework and its application to vertical integration. He proposes a dynamic framework in which industries cycle through stages of vertical integration and specialization.

Similar to Sigler’s life-cycle theory, Jacobides hypothesizes that capability differences emerge among firms as an industry evolves. These capability differences lead to vertical specialization as firms seek to maximize the value of their relative strengths by focusing on the stages of production where they excel while accessing the superior capabilities of other firms for the other stages of production. However, he goes on to argue that the gains from trade that push an industry towards a vertically stratified structure also lead to specialization in knowledge and potentially excessive compartmentalization (Jacobides, 2005a). This in turn creates an opportunity for vertically integrated firms to fill “the gap between what the vertically specialized system can produce and what the market demands” (Jacobides, 2005b, p. 473). At this stage of a market’s evolution, market forces and institutional factors set “in motion a process of experimentation with integrated service provision, which is strengthened by broader social forces such as the deinstitutionalization of professions, or changes in demand structure. Re-integration is advanced by firms seeking to protect their position, enter new, related markets, or find new ways of leveraging their capabilities: Firms strategize to change their institutional environment, helping to create new all-in-one, integrated markets.

Jacobides’ approach has been included in the literature review because of its potential applicability to the media industry in justifying the necessity and evolution of integrated services provision. However, Jacobides dynamic extension of the resource-based view of
vertical integration will not be presented in greater details as the usefulness of his contribution to the study of vertical integration cannot yet be evaluated and thus lies out of the scope of this dissertation.

2.5. Possible Diseconomies of Vertical Integration

The decision to vertically integrate and the subsequent internalization of production processes means that firms incur costs associated with the organization of production within the firm. Other things given, the greater the number of factors of production, the greater the costs associated with either growing or entering a new segment of the industry. Williamson (1974) recognizes the limits to size imposed by the diseconomies of firm scale.

A very important component of the costs of increased vertical scope is linked to managerial diseconomies. This arises because managerial ability is a scarce resource and because the greater the number of assets under the manager's control the greater the rate at which he must take decisions or the more decision-making he must delegate (Canes, 1976). Related to the problem of managerial diseconomies is that of control. As the firm integrates the complexity and degree of differentiation of its structure increases. As a result the need to monitor different stages of production also increases with the ensuing demands on the top hierarchical management tier. Thus, control is not only a matter of size, but may have a prominent role to play in coordinating new stages because of the non-specialization of production. The acquisition of new knowledge may prove to be expensive and the more so the more asset-specific this knowledge is. Thus, the costs of coordinating stages are inversely related to the similarity of processes and the possibility to share innovations (Armour & Teece, 1980).

Another set of problems that can arise are problems related to the principal-agent theory. Vertical integration creates growing delegation and employee-specific information. Agency theory points out that through vertical integration, transaction costs are transformed from market-based transaction costs into hierarchy-based transaction costs. As a result, agents rather than supplier or buyer opportunism may arise (D'Aveni & Illinitch, 1992). Hill and Hoskisson (1987), Jones and Hill (1988) and Mahoney (1992) have also proposed that vertical integration can increase bureaucratic costs like internal monitoring and coordination.

Another disadvantage of vertical integration is that mobility and exit barriers may increase strategic inflexibility which traps firms into keeping obsolescent technologies and strategies
(Harrigan, 1985b). The same logic may force firms to forgo purchasing at low prices in the open market (Quinn, Doorley & Pacquette, 1990).

Underutilized capacity may increase cost in some stages of production because throughput is unbalanced if technological factors force firms to build plants of differing scales at adjacent stages of production (Harrigan, 1983).

2.6. **Summary and Concluding Analysis of the Motives for Implementing a Vertical Integration Strategy**

The analysis of the existing literature on vertical integration shows clearly that the choice of whether or not to vertically integrate upstream or downstream involves a complex series of economic tradeoffs. The tradeoffs generally pit the costs or benefits of transacting business across firms against the efficiencies or inefficiencies associated with doing business in-house (Randall et al., 2002).

In order to reduce the complexity of the theoretical frameworks, and, more importantly, combine the different existing strands of vertical integration theory, the following section derives a set of generally applicable influencing variables or motives, which increase the likelihood of firms adopting a strategy of vertical integration. From the theoretical and empirical vertical integration studies examined in the preceding chapter, six “traditional” factors can be derived that influence the integration decision: Transaction cost considerations, avoidance of opportunistic behaviour, input/output price advantages, synergy creation, uncertainty and risk reduction, and purely strategic considerations. These can be further supplemented by new, contemporary influencing factors: the aim to increase and benefit from knowledge transfers, to oppose the process of value migration, to improve the ability to deal with an increasing complexity of both products and the marketplace, and the creation of a strong position in new and emerging markets. Each motive will be discussed in detail over the following sections of this chapter.

2.6.1. **Traditional Vertical Integration Factors**

Figure 11 presents an overview of the traditional vertical integration factors that could be deducted from the presented literature review.

<table>
<thead>
<tr>
<th><strong>Transaction Cost Considerations</strong></th>
<th>Minimization of the costs of negotiating, adapting, monitoring, and enforcing buyer/supplier relationships (Coase 1937, Williamson, 1985)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Moral Hazard Considerations</strong></td>
<td>Minimization of opportunistic behaviours (Williamson, 1985)</td>
</tr>
<tr>
<td><strong>Synergy Considerations</strong></td>
<td>Elimination of double marginalization in the case of successive stages of production (Harrigan, 1983)</td>
</tr>
<tr>
<td><strong>Transaction Involvement Considerations</strong></td>
<td>Intercompany transaction costs (Williamson, 1985)</td>
</tr>
<tr>
<td><strong>Customer-Dependent Considerations</strong></td>
<td>Minimization of the costs of negotiating, adapting, monitoring, and enforcing buyer/supplier relationships (Coase 1937, Williamson, 1985)</td>
</tr>
<tr>
<td><strong>Uncertainty and Risk Reduction Considerations</strong></td>
<td>Minimization of opportunistic behaviours (Williamson, 1985)</td>
</tr>
<tr>
<td><strong>Strategic Considerations</strong></td>
<td>Minimization of the costs of negotiating, adapting, monitoring, and enforcing buyer/supplier relationships (Coase 1937, Williamson, 1985)</td>
</tr>
<tr>
<td><strong>Opportunity-Making Considerations</strong></td>
<td>Minimization of opportunistic behaviours (Williamson, 1985)</td>
</tr>
</tbody>
</table>
2.6.1.1. Transaction Cost Considerations

In general, costs may be decreased by avoiding market costs (Jones and Hill, 1988), by eliminating the distortion in input prices caused by imperfect competition in the upstream market (Vernon & Graham, 1971, Westfield, 1981), by reducing transaction costs (Jones and Hill, 1988, Mahoney, 1992, Williamson 1985), by decreasing uncertainty or asymmetric information, resulting in more efficient use of inputs (Green, 1974, Riordan & Sappington, 1987), and by protecting proprietary technology (Jones & Hill, 1988).

The level of transaction costs is related to the degree of uncertainty in the market (Williamson, 1999). The more uncertainty, the higher transaction costs will be, and the more it is likely that firms organize their economic activities internally. Since the size of a firm depends foremost on the question whether it will pay to bring an external market transaction under the organizing authority of a firm (Coase, 1988), lower transaction costs as a result of standardization and the subsequent reduction in uncertainty will decrease the motivation for organizing transactions within a firm.

A high degree of internal transfers can confer economies of integration by reducing transaction costs, including the costs of finding, selling, negotiating, contracting, monitoring and resolving disputes with other firms in open market transactions (Coase, 1937). Williamson (1971, 1975) details three main channels through which vertical integration reduces transaction costs. First, corporate managers can use vertical integration to harmonize
incentives, replacing individual profit maximization with joint profit maximization for all stages. Second, vertical integration offers a variety of control instruments to decrease the transaction costs associated with opportunistic behaviour. Third, vertical integration improves information exchanges between successive stages of production. As a consequence, transaction costs such as selling and advertising expenses can be significantly reduced if information is transferred through internal hierarchies.

Reduced transaction costs are especially significant when there is antagonistic bargaining, as occurs in bilateral monopolies or oligopolies, when future uncertainties make long-term contracts expensive, and when short-term contracting is inefficient because equipment is long-lived or first-mover advantages exist.

It should also be noted, that transaction cost motives for vertical integration have been somewhat weakened through the advent of the Internet. It has become much cheaper to search for, compare and switch suppliers or distributors (Sinha 2000; Butler et al. 1997). Several scholars predict that as transaction costs are reduced firms should become smaller and less vertically integrated (e.g. Malone & Crowston 1994, Bryan & Fraser 1999). According to Evans and Wurster (2000), the Internet could become the primary driver of a trend towards de-integration since it offers new possibilities for commercializing the information component of an industry, and, correspondingly, has the potential to disrupt existing value chains. So far, however, it seems that although the advent of the Internet has altered the established media value chain by adding new distribution outlets, leading to the emergence of new, focused entrants in a number of industries, the incumbent firms have so far better exploited the opportunities offered by the Internet for further expanding their scope, which frequently allowed them to tighten their grip on their respective industries. In conclusion, the Internet, like many preceding technologies, has led to an industry-specific restructuring of the costs and benefits of vertical integration: some industries de-integrate while others (re-) integrate.

2.6.1.2. Reduction of Opportunistic Behaviour

Vertical integration can also reduce the transaction costs associated with opportunistic behavior.

Three types of opportunistic behavior that firms may seek to avoid can generally be identified:

1. Hold Up
Klein, Crawford, and Alchian identified a type of opportunistic behavior that can arise whenever a firm makes an asset-specific investment. When the cost of such an asset exceeds the value of its next best use, the investment is said to create “appropriable quasi-rents,” because they allow others to hold up the investing party in an attempt to extract a greater proportion of the joint benefits (Klein, Crawford & Alchian, 1978).

Firms confronting the risk of such opportunistic behavior essentially have two options. First, they can attempt to anticipate the problems and incorporate solutions to them into the contractual relationship. Negotiating and enforcing such contracts can be quite costly, and the costs of protecting one’s interests via contractual contingencies rise dramatically as the size of the relationship-specific investment increases and as information becomes increasingly asymmetric and hard to verify. These problems are exacerbated still further if the risks associated with the project are high and the number of alternative business partners is relatively small (Williamson, 1985). Prior empirical studies find that in such situations firms will vertically integrate to avoid "small numbers" bargaining (Williamson, 1985; Levy, 1985). Small numbers bargaining situations are in turn often characterized by the degree of concentration or consolidation in an industry or supplier base. Therefore the probability of vertical integration should increase sharply in order to ensure adequate supply of a product at reasonable prices when the industry is highly concentrated.

In addition, the impossibility of anticipating every possible contingency inevitably means that all contracts are in some way analytically incomplete. To cover the losses associated with reduced payments on some of their sales, this hold-up problem causes suppliers of inputs to raise prices, which in turn raises the costs of production of input buyers. These higher input prices lie at the heart of the incentive to vertically integrate: by owning the producers of inputs, the (downstream) buyer of inputs pays only the marginal cost of producing the inputs and so avoids the premium charged by independent input suppliers to cover expected losses created by the hold-up problem. As a further positive result, total welfare (for the consumer and the producer) is maximized (Williamson, 1985; Joskow, 1985). Finally, once vertical integration begins in an industry it creates a dynamic that reinforces the incentive for further vertical integration: as more and more input suppliers and buyers vertically integrate, the set of available input buyers whom the remaining independent input suppliers can
sell to shrinks, exacerbating the hold-up problem and reinforcing the incentive to vertically integrate.

2. Free Riding

Free riding represents another type of opportunistic behavior that can cause transaction costs to rise. As Telser’s (1960) demonstrates, transaction costs tend to rise any time a firm is not able to capture all of the benefits created by its own conduct, because the existence of such positive externalities gives other firms the incentive to attempt to free ride on the benefits created by other firms. Telser argues that distributors will have the incentive to shirk in providing such services in the hopes that other distributors will bear the costs of providing such services. If all distributors respond to these incentives in the same way, the total amount of pre-sale services will fall below efficient levels.

A producer facing the possibility of such free riding has two alternatives. A firm that is faced with the possibility of free-riding behaviour can contractually specify the level of pre-sale services that each distributor is required to offer. Such contracts, however, can be quite expensive to negotiate and enforce, and are inevitably incomplete. If the transaction costs become sufficiently large, a firm might instead choose to vertically integrate into distribution.

3. Adverse Selection

The third example of opportunistic behavior is known in the literature as “adverse selection”. It typically arises when products are homogeneous, but display small variations in product quality and when market transparency is low, meaning that the buyer cannot easily determine the true value of the goods (Akerlof, 1970). Buyers facing such a situation have the incentive to “oversearch” in an attempt to find the one homogeneous good that is relatively underpriced. These difficulties in determining product quality can thus lead to a wasteful expenditure of resources (Kenney & Klein, 1983).

The parties can avoid these costs, however, either by vertically integrating or by agreeing to a vertical contractual constraint, such as a long-term exclusive dealing arrangement, that functionally serves the same purposes. In addition, the producer can mitigate the problem of oversearching by selling his goods in bundles (Kenney & Klein, 1983).
2.6.1.3. Synergy Creation

On the one hand, one of the principal arguments against vertical integration is that combining fundamentally different segments of the value chain within the firm reduces efficiency and increases bureaucratic costs. On the other hand, the counterargument presented by Arrow (1976) is that extensive internal vertical transfers allow the creation of various synergies between the individual stages of the firm’s internal value chain.

Synergies can be defined as “the sum of percentage of resources that are shared with sister business units upstream and downstream” (Harrigan, 1985, p. 411). Different types of synergies can be created between different business units of a firm:

First, synergies can be realized by a coordination of administrative tasks that are common to several internal departments. Such tasks include production and inventory scheduling that can substantially reduce a firm’s cost by reducing unused capacity and inventory carrying costs (Harrigan, 1983b). Transportation costs may be reduced by using the same location for producing and processing the inputs.

Forward integration also allows for synergies to be created between the advertising and marketing efforts of different stages (Porter, 1980). In a similar vein, direct feedback from marketing may be valuable for the product development department.

Second, synergies can be gained from the exploitation of technological interdependencies. These arise when a combination of two successive stages of production permits the application of similar technologies and R&D sharing.

Third, powerful synergies can also be realized by suppliers that, through vertical integration, can exercise direct control over the customer interface. This enables the firms to supply their customers without the costly services of an intermediary, and in addition allows them to obtain more timely and accurate information about customer demand (Holmstroem et al. 2000).

2.6.1.4. Reduction of Uncertainty and Risk

Researchers agree that uncertainty is a significant determinant of vertical integration (Balakrishnan & Wernerfelt, 1986; Harrigan, 1986; Miles & Snow, 1986). Economists have suggested that vertical integration reduces environmental uncertainty and the associated risks (Blair and Kaserman, 1983). Coase (1937) was the first to argue that the creation of a firm is
essentially a response to environmental uncertainty and risk. Activities, from purchasing through manufacturing, are combined, because, in part, this allows for some insulation from environmental risk.

Discussions on uncertainty in vertical integration literature address several types and forms of uncertainty ranging from demand uncertainty to technological uncertainty (Mahoney, 1992). In the case of extremely high industry uncertainty, extensive vertical integration can negatively affect flexibility, and, if this is the case, companies should concentrate on their core activities where they can achieve high flexibility and rapid adaptation (Miles & Snow, 1986).

Generally, supply and demand volatility can be defined as the two major factors of environmental uncertainty for any firm. The exclusionary market power theory of vertical integration, for example, has as the main motive the successful prevention of supply foreclosure.

Carlton (1979) and others have formalized the view that demand variability is a further reason for integration, but have not verified this empirically. Lieberman (1991) develops several hypotheses regarding demand fluctuations. His results offer substantial support for the transactions cost approach, and some limited support for Carlton’s hypothesis. Levy (1984), employing industry level data, reports that demand growth and concentration are positively related to vertical integration. Anderson and Schmittlein (1984), and Walker and Weber (1987) also report a positive correlation between demand uncertainty and vertical integration. Harrigan (1986), however, reports a negative correlation. Nonetheless, the overall consent is that higher demand volatility leads to higher supply chain costs due to the increasing mismatch between supply and demand and subsequent risk of unsold supply.

Since uncertainty is also high in nascent industries, and following Stigler’s (1951) life-cycle argument, an adoption of vertical integration can reasonably be expected by firms that want to build a strong position in the respective new market or industry. Another possible way of decreasing the degree of uncertainty in a nascent market is by developing industry-wide standards (Funk & Methe, 2001). This option is, however, only realizable if the firm commands a certain market power which enables it to establish its proprietary technology as the dominant standard. Vertical integration, as argued in the exclusionary market power theory under section 4.2.1.3., can be an effective means to push standardization by creating the necessary market and bargaining power vis-à-vis the distributors and consumers.
2.6.1.5. Strategic Rationales of Vertical Integration

The strategic motivations for utilizing vertical integration can be summarized into two main drivers: (1) to remain competitive amidst changing regulatory and technological trends, and (2) to create and exploit quasi-monopolistic market power through vertical foreclosure. With regard to the media industry, most vertical mergers fall in this latter category, as a means to create barriers to new competition or to exclude rival firms from the market by reducing their access to supplies or distribution outlets (Ordover & Saloner, 1989, Salop & Scheffman, 1983).

Guaranteed Content Access:

The dramatic growth in distributive media has increased speculative behaviour concerning the gains from the control of content. Upstream vertical integration, in this scenario, provides a guard against future price rises (Carlton, 1979), and a means to secure unconditional access to quality content. This was the case for Sony's decision to acquire Columbia Tristar Pictures, one of the major U.S. content production studios.

Guaranteed Distribution Access:

By choosing downstream vertical integration content producers can also ensure their access to distribution platform for their content products. Thus, content can be leveraged over an increased number of distribution channels. This type of vertical integration not only provides the opportunity to amortize costs over a broader channel base and thus additional product release windows, but also provides critical mass for the purpose of building brands for the content producers (Ozanich & Wirth, 2004). This rationale also explains the increasing activity of traditional media companies in Internet- and e-commerce-related acquisitions.

Vertical integration motives based on strategic rationales have been rendered slightly less important by globalization and technological change. For instance, barriers to entry have been eroded by events such as converging industries and the availability of global investment capital. Likewise, with the liberalization of trade and investment around the world, attempts to foreclose supply and distribution channels have been shown to be futile in many industries (Bryan & Fraser 1999).
2.6.2. Contemporary Vertical Integration Influencing Factors

<table>
<thead>
<tr>
<th>Innovation</th>
<th>Vertical integration increases opportunities for integrated product innovation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Knowledge Transfer</td>
<td>Generating direct information exchanges and knowledge transfers between all stages of the vertically integrated firm and the consumer interface</td>
</tr>
<tr>
<td>Value Migration</td>
<td>Increase in downstream vertical integration to capture the higher margins of the service segments of the value chain</td>
</tr>
<tr>
<td>Increasing Product Complexity</td>
<td>Strong positive association between vertical integration and the ability to manage increasing complexity of new product development</td>
</tr>
</tbody>
</table>

Figure 10: Overview Contemporary Vertical Integration Influencing Factors
Source: Own Illustration

2.6.2.1. Innovation

Vertical integration increases the opportunities for integrated product innovation. Vertically integrated companies have control over the quality and the timing of the supply of all components of their value chain, and can integrate different production stages or processes in order to experiment with multi-feature or interoperable products. Recent developments in the telecommunications industry illustrate the validity of the innovation motive: “Vertical integration in the downstream layers of the industry seems to strengthen coordination between firms in order to develop new applications related to high speed Internet and 3G mobile phones” (Krafft, 2003, p. 647).

2.6.2.2. Knowledge Transfer

Many of the recent vertical integration decisions may also be due to an increased desire of firms to generate more detailed knowledge about the industry in general, and the customers in particular.

Downstream integration facilitates access to both information and knowledge about customers. Whereas the acquisition of declarative information such as the level of demand, can be accomplished by publicly available data collection, the creation of genuine knowledge requires a direct knowledge transfer from and exchange with the consumers. While many of the benefits of upstream vertical integration can apparently be replicated with independent, closely aligned suppliers, knowledge transfer can only be realized in full by owning the
customer interface. Knowledge transfers cannot be entrusted to channel partners since the sharing of knowledge of a more tacit nature requires a common “language” and common organizational knowledge management processes (Kogut & Zander 1992, 1993).

2.6.2.3. Value Migration

In many industries, value added has migrated downstream for a host of reasons. First, in many manufacturing industries, due to high penetration rates and longer product life spans, the "installed base" (i.e. the number of products in use) relative to the number of products sold in any year has become very large. As a result, a considerable portion of value added has shifted away from manufacturing toward maintaining and servicing existing products. This trend has been reinforced with the rise in technical complexity and performance of many manufactured goods, which leads to exponential growth in their service requirements (Wise & Baumgartner, 1999).

As a result, in numerous industries manufacturers are vertically integrating downstream into the servicing segments in search of value added.

2.6.2.4. Increasing Product Complexity

The theory of transaction cost economics argues that as the complexity of a transaction increases the costs of information gathering and monitoring also increase. This adds incentives for the transacting parties to vertically integrate (Coase, 1937; Mahoney, 1992). In this context, Novak and Eppinger (2001) also report a strong positive correlation between vertical integration and complexity in the new product development.

Regarding the content production segment of the media industry, the complexity of content creation has increased substantially over the last decades, considering the explosion of theatrical film production costs. Digitization and related new technologies have so far only partially been used with the aim of cost reduction but rather for the creation of even more sophisticated special effects.

In the distribution segment of the media industry, the defining development towards increased product complexity has been technological and industry convergence. Many firms are compelled by their customers or audiences to provide them with "integrated solutions" that offer a multitude of services in one product, or generally interactive and interoperable
products. These demands can only be optimally met through an integration of the various product and service constituents with centralized R&D departments that develop products spanning several industry segments. In contrast to the vertical integration “push” in pursuit of migrating value and the ability to deal with increasing product and market complexity, the demand for integrated-solutions represents a vertical integration “pull” by the customers.

2.6.3. Conclusion: Vertical Integration as a Natural Strategic Response to the Given Media Market Structure

In general, differing degrees of success in the media conglomerates are the result of differences in the organization and operation of large firms. Some use centralized management, whereas others use decentralized management; some require standardization among their media products, some permit individuality. Some firms operate as single entities, others operate with divisions and subsidiaries; some are operated with a strategic vision, others are not. These types of factors create differences in behaviour and the ability of media conglomerates to grow and survive. Although there are differences among the major firms, there are also strong parallels between the activities and the history of the major media conglomerates, as exemplified by the fact that all of the major global media conglomerates exhibit as their defining characteristic a vertically integrated corporate structure. According to Hughes (2000, p. 27), “the strategic ambition of most of these players is to create vertically integrated businesses that control the gateways across television, phone and wireless networks, offering customers a single bill and a single brand”.

The duality of revenue generation postulates a distinct structure of the media industry combined with particular characteristics of its economic behaviour (Picard, 2001). The characteristics of media products mentioned in the preceding sections lead to a market environment in which related product and geographic diversification as well as vertical integration of resources and distribution are likely to be the preferred strategies. For example, as the intangible, content-based media product may be stored and presented in various formats (print, electronic or digital media), related product diversification that extends a conglomerate's product lines into related content formats (e.g., owning a newspaper and an online content site) would likely benefit the firm by enabling content repurposing, marketing knowledge, and sharing of production facilities, leading to additional revenues and thus superior performance. Media conglomerates will seek out distribution platforms that complement their content products and vice versa, which emphasizes the importance of
securing access to inputs and outputs that a firm does not already possess yet which are critical for improving its competitive position (Barney, 1991; Das & Teng, 1998).

In summary, the symbiotic relationship between media content and distribution platforms presents a classic case for vertical integration. The fact that an existing product may be redistributed to and re-used in different outlets via a windowing process reinforces the advantage of expanding into multiple related distribution sectors in various international markets to increase the revenue streams for content products. This trend towards vertical integration can particularly be observed in the media industry segments that are characterized by high initial investment requirements coupled with high overall environmental uncertainty (Sanchez-Tabernero & Carvajal, 2002). Caves (2000) also argued that the endemic risk and uncertainty about creative production and the demand for its final products can best be managed through the internalization of multiple contracts within a single institutional entity. Davis and Scase (2000) draw attention to the rise of bureaucracy both in both the commercial and publicly-supported creative industries sectors as a means of controlling and coordinating the creative process.

The public good nature of media products furthermore encourages the geographic expansion of content products via integrated distribution platforms on a global scale, as the incremental or marginal costs of distribution are minimal.

Convergence and globalization have further strengthened the trends towards industry consolidation and vertical and horizontal cross-media ownership, as exemplified by the growth of integrated conglomerates whose activities span most geographic as well as product segments of the industry. Enlarged enterprises are better able to reap the economies of scale and scope which are naturally present in the industry and which, due to globalization and convergence, have become even more pronounced (Hoskins et al, 1997). Conventional wisdom implies that the bigger the size of a company and its market share, the more successful the company is (Makadok, 1999; O’Regan, 2002). In order to develop a sustainable competitive advantage, unique resources and capabilities must be acquired, built, combined, maintained, and utilized superiorly (Teece et al., 1997). Through the improved utilization of those resources and capabilities, size effects can be exploited. These effects consist mainly of economies of scale and scope (Baumol et al., 1990; Scherer & Ross, 1990; Teece, 1980, 1982).
Economies of scale exist in any industry where marginal costs are lower than average costs. Whenever the cost of providing an extra unit of a good falls as the scale of output expands, economies of scale will be created (Doyle, 2002). Many industries experience economies of scale, especially those engaged in manufacturing where larger production runs and automated assembly line techniques lead to ever lower average production costs. However, economies of scale are especially significant in the media industry because of the public good attributes of the media products. For media firms, marginal costs are the costs of supplying a product or service to one extra consumer. Average costs are the total costs involved in providing the product or service, divided by its audience. Consequently, as the audience increases, the average costs to the firm of supplying that product will be lowered (Doyle, 2002). If average production costs go down as the scale of consumption of the firm’s output increases, then economies of scale and higher profits will be enjoyed. Long-run average costs will be minimized when the firm has reached a so-called “minimum efficient scale”. Given the size of a market, there is only room for a select number of firms at the minimum efficient scale. This results in a general trend towards consolidation in the industry as companies move to take advantage of opportunities to generate economies of scale and re-use content, and to offer more attractive packages to larger advertising customers.

Economies of scope signify cost savings from the joint production of related or unrelated products. Economies of scope are generally defined as the economies available to firms “large enough to engage efficiently in multi-product production and associated large-scale distribution, advertising and purchasing operations” (Lipsey and Chrystal, 1995, p. 880). They arise when overhead, marketing, R&D, sales or other costs can be shared for two or more related products, or when any other efficiency gains can be reaped from the joint production and sale of related or unrelated products. Economies of scope can also be created by re-using specialist inputs gathered for one product in another product (Doyle, 2002).

Economies of scope are common in the media industry since the nature of media content allows the reformatting and repackaging of one product for several markets. Whenever economies of scope are present, vertical integration will be an economically efficient strategy because “the total cost of the diversified firm is bound to be lower than for a group of single-product firms producing the same output” (Moschandreas, 1994, p. 155). A large number of recent mergers, acquisitions, and alliances can be translated into an attempt to use the same product in a number of different ways: pure entertainment and telecommunication, or entertainment and information, or information and telecommunication. From an economic
In summary, the common factor behind the vertical integration efforts is the uniform desire to optimize the characteristics and limitations of the given market structure in order to reduce the inherent business risk for the company by a) expanding the number of actual and potential revenue streams, and b) by securing access to either the products or the distribution outlets that generate these revenue streams, and c) by overcoming regulatory barriers (Chan-Olmsted & Chang, 2003).

2.7. Vertical Integration Rationales Along the Media Value Chain

Three broad stages have traditionally been identified in the vertical media industry supply chain. The first stage encompasses the business of creating media content, in the next stage the media content is assembled into a marketable product, and the third stage deals with the distribution of the finished product to consumers. The overall goal for the producers is to maximize their revenues by selling their content product as many times as is feasible to the widest possible audience and at the highest possible price.

All of the stages in the media value chain are interdependent. Media content has no value unless it is distributed to an audience, and distribution infrastructures and outlets have no value without content to disseminate. No single stage is more important than another since all are interrelated.

The interdependent relationship of different phases in the value chain has important implications for what sort of competitive and corporate strategies media firms will choose to pursue since the performance of every firm involved in the supply chain will be threatened if a bottleneck develops, i.e. if one player manages to monopolize any single stage in the chain.

As described in chapter III, a profound transformation of the media industry has taken place since the late 1990s. The key drivers of this transformation have been convergence through technological advances and the rise of the Internet, both of which have fostered the creation of new distribution platforms. These developments have, in turn, led to an important extension of the traditional media value chain, which now encompasses telecommunication, information technology, and electronic commerce in addition to the three traditional stages mentioned above. The figure below illustrates this extension in a graphic manner.
The following sections will provide a detailed analysis of each segment of the reconfigured value chain. The risks and benefits of a presence in one or several increasingly integrated segments of the value chain will also be discussed.

The content producers stand at the beginning of the media value chain and assume responsibility for the production of any kind of audio-visual content by combining artistic, financial and commercial know-how. They can produce their own creative content or be solely responsible for the creation of formats developed by others. Examples of content producers are the production companies of the major Hollywood studios, and in Europe Endemol, Freemantle Media, and Studio Canal, to name just the biggest three.

The second stage of the value chain is dominated by the rights holders and rights dealers. The former are the primary sources of content rights. Numerous intellectual rights owners exist, but they usually have agreements with a few corporations that manage and commercially use the rights. These corporations are the rights holders. Examples of rights holders are the major media conglomerates, but there are also some television, cable and satellite broadcasting companies that hold rights.
Rights dealers, in contrast, are companies that trade content rights. They usually play the role of an intermediary to facilitate the distribution of independent productions through the aggregation of film and television content from many producers in an extensive rights catalogue. Another role is to alleviate the transaction costs associated with rights' search and selection. The U.S. based UIP is a good example.

The content aggregation segment is formed by the content aggregators who acquire content from the rights holders or dealers and subsequently package the acquired products into channels and sell advertising airtime to support those programmes. In addition to acquiring content, an increasing number of content aggregators will also produce their own content in-house. Typical content aggregators are the public and commercial television broadcasters, the cable and satellite broadcasting networks (as opposed to the cable systems of control the access to cable), and pay television networks.

The remaining three segments of the value chain group all distribution activities. Firstly, networks transmit the aggregated content across their infrastructure and are responsible for the development, the maintenance and the operations of their transmission infrastructure. Typical examples of networks are cable system companies, telecommunications companies, satellite carriers and terrestrial television networks.

The access providers operate the physical media platforms and manage end-user equipment (decoders and set-top boxes). They are responsible for the billing process, usage tracking and the customer relationship. Access providers are often called gateways as they provide customers with the actual access to their services. Examples of access providers are the telecommunications conglomerates, which increasingly offer integrated triple or quadruple service bundles\(^4\) to their customers.

The last segment of the value chain houses the navigation systems or interface providers who are responsible for the manufacturing, selling and marketing of the end-user equipment. The hardware produced ranges from television sets, set-top boxes to mobile phones and personal computers.

\(^4\) A triple play offer includes telephone, high-speed Internet access, and television services. A quadruple play offer includes a mobile phone services in addition to the components of the triple play offer.
The media industry structure and the relations between the individual segments can best be analyzed using a systems thinking approach, which facilitates the illustration of causal relationships between the individual players that constitute the industry segment. The next sections will provide a detailed examination of the three main segments of the media value chain using this approach, followed by a description of the current trends that affect the sector in question.

2.7.1. Vertical Integration Rationale for Content Producers

2.7.1.1. Vertical Integration between Theatrical Content Producers and Theatrical Distribution

In order to define and explain the extent of vertical integration between content producers and theatrical exhibitors, as a starting point the general market mechanism and the distribution relationships between the two concerned actors will be analyzed.

To investigate the motivations that induce content producers and theatrical exhibitors to choose vertical integration over other possible strategies, the price setting mechanism between the two segments needs to be analyzed. Assuming the neoclassical equilibrium with free entry, one should expect movie producers to earn zero profits. Hence, the sum of the prices theatrical exhibitors pay for content should be equal to the content production cost.

In the real world, however, the theatrical content production and distribution market consists of interconnected bilateral monopolies. In each geographical market, a movie theater is a local monopolist, and for each movie, the producer is a monopolist. Thus in determining the price that a movie theater pays to gain the right to show a movie, the theater and producer both act as bilateral monopolists, with initially equal bargaining positions. This situation changes, however, when two theatrical exhibitors form a coalition across two local markets, thereby increasing their bargaining power. Accordingly, the content producer’s position is weakened, and the integrated theaters can likely command an increase of their residual rights or affect market prices to their advantage (Chae & Heidhues, 1999).

In addition, the theatrical content distribution segment is affected by bounded rationality, which gives rise to the problems of moral hazard and opportunistic behaviour. Asymmetrical information problems apply either to information deficits with regard to film value and
quality (concerning the exhibitors) or to information deficits with regard to the decision-making processes of cinema attendance (concerning the content providers).

In summary, in order to limit the risk of opportunistic behaviour of the theatrical exhibitors resulting from asymmetric information and unequal bargaining power, content producers forward vertically integrate into theatrical exhibition. In recent years, however, a full forward vertical integration has become increasingly unattractive due to the diminishing content revenue percentage generated from theatrical exhibition (compare section 5.2.2.). Instead, content producers have increasingly replaced full vertical integration with the following vertical constraints: (1) First run films will be distributed to cinemas that either operate in key markets or offer greater financial guarantees, since box office results (which in turn determine the value of television and video rights and foreign sales) are often based on only several key markets (OECD, 2000). (2) Content producers rely on the practice of zoning, which consists of setting geographic boundaries within which a given cinema will have exclusive distribution rights. This practice ensures that the cinema exhibitor will have an adequate incentive to provide promotion for the film, but on the other hand it also ensures that the cinema operator will obtain the largest possible audience for his film by preventing nearby cinemas to compete for viewers. (3) Content producers also practice bundling or “block booking” (compare section 4.2.1.3.1.), whereby authorization to show a film is granted on condition that the operator takes a package of films from the producer. This practice, which prohibits bidding for individual films cinema by cinema, makes it impossible for small competitors to profitably obtain first runs and gives a definite advantage to those cinemas that are vertically integrated with one of the major content producers.

Vertical foreclosure. These vertical constraints, like a full forward vertical integration, function as bottlenecks in the theatrical distribution segment. Through the content they obtain from their integrated content producers, the major theatrical exhibitors may squeeze out small content producers. In other respects, entry barriers in film exhibition may be considered relatively insignificant. It does not appear unduly difficult in most markets to build and operate cinema complexes, which are comparable to any other large retail establishment. The gatekeeper characteristic is clearly the ability to acquire the rights to exhibit popular and thus commercially valuable first run films.

In summary, high asset specificity through the control of key locations make theaters a hard-to-copy resource (Black & Boal, 1994; Miller & Shamsie, 1996). The advantage of vertical integration into theatrical exhibition is that ownership of a theatrical exhibition network gives
the content producers a first reliable outlet for their content. In addition, since the theatrical distribution sector faces multiple cost characteristics (Dally, 2002), vertical integration allows the realization of economies of scope and scale in the areas of distribution and marketing, by establishing dense distribution networks and by bundling the marketing efforts of producers and exhibitors. Theaters controlled by the studios in the 1980s averaged annual revenues that were 15 times those of the independents (Balio, 1985, p. 255).

2.7.1.2. Vertical Integration between Music Content Producers and Music Distributors

The distribution of music has traditionally been associated with large, up-front investments in order to (1) create a global distribution network, and (2) the ability to fund large-scale promotional and marketing campaigns. Since advances in recording technology enabled the mass production of a musical work in the form of a sound recording, realizing efficient modes of production became the key element of success in the music industry. These financial requirements could only be met by a few players: the well-established major record companies. The high up-front investments have also successfully obstructed the entry of new potential competitors in these areas (Peterson & Berger 1975). The competing independent record companies were often forced to seek alliances with the major record companies, as they proved unable to invade these highly profitable stages (Lopes 1992, Hesmondhalgh 1996, Dowd 2000).

The impact of digitization of the industry processes has been pronounced and so far seems to result in a loss of indispensability for the record labels. Digitization and the Internet have opened up alternative distribution and promotion channels, making the traditional music distribution channels almost obsolete, and as a direct consequence, the relative importance of the investments and the bargaining payoffs have changed in favour of the music content producers. The decreased bargaining power of the music distributors, i.e. the record labels, has most importantly affected the allocation of ownership of the musical copyrights. The optimal ownership structure is in the process of shifting from label ownership to artist ownership. The established record labels can only avoid this shift in ownership rights allocation by an internalization of the new distribution and promotion channels through vertical integration.

Since the music rights rest with the artists, but are controlled by the music distribution companies, the music industry is also prone to problems of opportunistic behaviour. The
firms that control the music distribution have incentives to sell the music that can bring them the highest revenues, and may distort the market by extensive and disproportional promotions in favor of a small number of works. This may skew consumers’ preference and lead to distorted demand (Zhang, 2002).

As in other media industry segments, the practice of bundling is used extensively. In the traditional music distribution market, music works are sold mostly bundled together: a tape or a CD has several songs from either the same or different artists. The most obvious reason is that this saves costs of production and distribution. Two other well-studied reasons are: 1) reduction of dispersion of willingness to pay (Bakos and Brynjolfsson, 1999, 2000, 2001), and 2) increased barriers to entry (Whinston, 1990; Nalebuff, 1999, 2000; Bakos and Brynjolfsson, 2000).

Digitization, however, will change the traditional practice of bundling, since technology enables a song to be downloaded individually and charged individually (Bakos and Brynjolfsson, 2001). However, new ways of online bundling could be introduced, such as the following: 1) bundling the works from a certain artist, 2) bundling works from same genre, 3) unlimited access to a certain pool of music works, or 4) the temporal bundling of music works.

2.7.2. Vertical Integration Rationale for Content Aggregators

2.7.2.1. Vertical Integration between Television Broadcasters and Television Broadcast Stations

As stated in chapter III, the combination of large, up-front fixed costs associated with creating the first copy of television broadcast content and the minimal costs associated with distributing programs to additional viewers give television programming many of the attributes of a pure public good (Owen & Wildman, 1992) When faced with such a declining cost structure, economic efficiency increases with every additional viewer reached. Broadcast programming thus exhibits a natural tendency to seek as broad an audience as possible. The existence of high initial fixed costs leaves the broadcast content aggregators, i.e. the broadcast networks, vulnerable to opportunistic behavior, especially when the content distributors, i.e. the television broadcast stations play a gateway role thus extracting a large share of the economic rent generated by film and television content. Content producers and
content aggregators, i.e. broadcast networks can eliminate these problems by using vertical integration to guarantee that they will have access to either audiences or content.

The logical way for a broadcaster to secure guaranteed wide-scale access to distribution would be for it to vertically integrate into the downstream stage or to negotiate contracts with its broadcast stations guaranteeing it the ability to reach a large enough audience to lower its costs.

Vertical integration also allows the broadcasters to counteract opportunistic behaviour like hold up, free riding, and the problem of adverse selection.

**Hold Up.** The sunk cost investment needed to create or acquire original television content exposes broadcasters to the possibility of being held up. Broadcasters will only invest in content that will enable them to recover both the fixed content acquisition costs as well as the marginal costs of distribution. Once the first-copy costs are sunk, however, it is possible for broadcast stations to hold out in an attempt to avoid having to contribute to fixed costs. The classic way to deter hold up behavior is either to vertically integrate into broadcast distribution or to devise long-term contractual relations that align the interests of both parties.

**Free Riding.** The broadcast network-broadcast stations relationship is also potentially fraught with free rider problems. The value of content is determined by the broadcast network’s ability to reach the largest audience possible. Network profitability thus depends upon the willingness of the individual broadcast stations to transmit the aggregated content provided by the network, since doing so allows the first-copy costs to be spread across the largest possible audience. Because of this, the value of the network to the local broadcast affiliates depends upon the behavior of other affiliates, since the refusal by any affiliate to carry a program offered by the network causes the fixed costs to be spread over a smaller number of viewers. Each broadcast station’s programming decisions can thus impose significant negative externalities on other stations, as greater defections lead to inefficient program distribution and lower overall investments in broadcast content.

The ideal situation for a network affiliate, however, is to refuse to carry the least profitable programming provided by the network and to contribute as little as possible to the fixed content costs. In effect, every television channel has the incentive to attempt to free ride on the willingness of other broadcast stations to bear the costs associated with creating and maintaining the network. This will lead to an inefficient level of content distribution, which will in turn create inefficiently low levels of investment in new content. Networks can protect
themselves against such free riding either by vertically integrating into the broadcasting distribution stage or by entering into affiliation agreements that limit a broadcast station’s ability to refuse to carry network programming (Owen & Wildman, 1992).

Adverse Selection. The fact that the popularity of a particular television program is difficult to determine ex ante also leaves networks vulnerable to adverse selection (Kenney & Klein, 1983).

As discussed earlier, adverse selection arises when the quality of a product varies and is hard to determine in advance. Customers looking to purchase such products tend to oversearch to find the highest quality goods and gain an information advantage over each other. The networks can avoid adverse selection problems either by vertically integrating, by entering into exclusive dealing arrangements (Owen & Wildman, 1992), or by bundling programs together in a way that forces the local broadcast stations to focus on the average quality of the programs.

Vertical Foreclosure. It can be argued that the development or acquisition of broadcast networks by the major content producers, i.e. the studios, was a mechanism to prevent foreclosure and the subsequent creation of distribution gateways by the existing television networks. As these had vertically integrated backward into production as a way to control the syndication rights of their content, three major players (ABC, CBS, NBC) had been created that controlled both production and distribution of television content, and represented the only distribution channels available for broadcast television. In order to avoid that these integrated companies profited from their market power, studios decided to enter the distribution market themselves as soon as network ownership was deregulated. The advent of cable and the launch of new stations (allowed by the FCC) then facilitated the launch of the FOX network in the 1980s, the acquisition of the ABC network by Disney, and the launch of Warner Brothers and Paramount networks in the mid-90s.

According to a market power explanation Paramount and WB feared that the four already existing broadcast networks could privilege their proprietary content and exclude them from the market or impose on them less favourable conditions. As a reaction, regardless of the huge costs and limited coverage, they entered the network broadcasting market.

However, recent history has shown that both Paramount and Warner are able to sell their products to backward vertically integrated networks such as ABC, CBS, NBC, and FOX. Moreover, because of both the limited coverage of the new networks and the amount of time
necessary to develop an audience for a new channel, Paramount and Warner Brothers have
great difficulties to generate the ratings and profits on their networks that they would get if
they sold their content to the established networks. Although the market power rationale
seems to have played an important role in the forward vertical integration of studios into
television, the observation that backward vertically integrated networks still rely on content
from external producers partly undermines this explanation.

2.7.2.2. Vertical Integration of Cable Content Aggregators and Cable System Operators

The cable content aggregators are upstream firms which own the cable content networks. The
cable system operators are downstream firms that distribute the aggregated content via their
cable systems to consumers. In the last decade, the cable television industry has experienced
considerable downstream integration between cable content aggregators and cable system
operators. The motives for vertical integration in this industry are quite similar to those for
vertical integration in broadcast television. Just as was the case in broadcasting, the large, up-
front costs associated with creating each program make it especially important that cable
programmers be able to obtain guaranteed distribution to as broad an audience as possible
before making their initial investments in the programming.

The efficient functioning of the cable industry thus depends on the ability of cable content
producers to ensure that they will have access to a sufficient number of cable operators who
control the access to audiences. Again, content aggregators could use long-term contractual
arrangements with cable operators. The necessarily large number of negotiations with the
individual cable operators and the unavoidable incompleteness of the contracts, however,
lead to high transaction costs. If these transaction costs are significant enough, cable content
providers may find it more efficient to instead use vertical integration to guarantee the access
that they need in order to make efficient program investments (Owen & Wildman, 1992).

Another factor affecting the degree of vertical integration in the cable industry was the
introduction of Direct Broadcast Satellite (DBS). Before the advent of Direct Broadcast
Satellite in 1996, the main competitors of cable system operators were terrestrial television,
video, and theatrical content distributors. With DBS, which was digital from the start and had
the advantage of substantially greater channel capacity, cable operators now faced an
intensified competitive environment which forced them to upgrade their networks in order to
be able to offer the same services as DBS. This meant large up-front investments had to be
made, favouring vertically integrated firms as they could draw on a wider array of financial resources.

The existence of large sunk costs and externalities again creates the danger that cable content aggregators and cable operators will act opportunistically in an attempt to capture a greater percentage of the available profits. Vertical integration and vertical contractual restraints can allow cable content producers and cable operators to avoid incurring the transaction costs associated with protecting themselves against this possibility.

**Hold Up.** Cable content aggregators will not invest in content unless it is likely that they will be able to recover both the fixed costs associated with creating the programming as well as the marginal costs of distribution. Once the first-copy costs are sunk, however, it is possible for the cable operators to hold out ex-post in an attempt to drive price down to marginal cost. While it is theoretically possible to use contractual devices to guard against such opportunistic behavior, such contracts may be costly to negotiate and, in any event, will not be able to anticipate every possible contingency. Thus, if the level of risk and the costs of negotiation are relatively high, it may be more efficient for firms to use vertical integration to protect themselves against such sunk cost opportunism (Waterman & Weiss, 1996).

**Free Riding.** Cable operators have the incentive to attempt to free ride on other cable operators’ contribution to the first-copy costs of production. Ideally, a cable operator would prefer to rely on other cable operators to cover the up-front costs associated with creating the content and would simply pay the marginal costs associated with distributing the program. By vertically integrating cable operators and cable content providers or aggregators, the cable operator’s incentives to shirk are reduced.

Second, even cable operators who do not shirk on price may attempt to free ride on the promotional efforts of other cable operators. Promotional efforts have the effect of enlarging the possible audience, which in turn allows the fixed costs to be spread over a larger viewer base. The ideal position for a cable operator is for other cable operators to undertake the promotional efforts necessary to build the audience for a particular network to its optimal level, while that operator reaps the benefit of the efforts of other operators while simultaneously avoiding paying the costs of promotion. In other words, it attempts to free ride on the promotional efforts of other operators. This problem is exacerbated by the fact that due to the high number of individual cable operators the transaction costs of monitoring and enforcing cooperation agreements would be impossibly high.
Thus, even a cable operator who foregoes the opportunity to free ride in terms of contribution to fixed costs may attempt to free ride in terms of promotion.

Again, vertical integration can eliminate the incentives for shirking, since doing so internalizes both the gains and losses from shirking within the same firm.

**Vertical Foreclosure.** In her informative study of the cable industry, Chipty (2001) finds that vertically integrated cable distributors are more likely to exclude rival cable content networks and favour their own integrated content networks. Cable content aggregators usually do not have other means for distributing networks to consumers than via cable system operators, and each cable system faces little or no direct competition at the local level.

Waterman and Weiss (1996) examine the same issues for premium cable networks and find extensive evidence of exclusionary behavior on the part of vertically integrated firms. They find little evidence of any downstream price effects but do find that sales (i.e., penetration) are higher for vertically integrated programming services than for non-integrated programming services. Industry participants have also confirmed that foreclosure through vertical integration was essential in creating audiences for cable channels such as CNN, C-Span, the Discovery Channel, BET, and TNT (Waterman, 1995).

### 2.7.3. Vertical Integration Rationale for Internet Access Providers

#### 2.7.3.1. Backward Vertical Integration of Internet Access Providers into Content Production

The primary purpose of an Internet access provider or an Internet portal is the aggregation of useful and interesting content for its subscribers. The aggregated content can either be acquired from independent content producers, or produced by the portal itself. To achieve success, however, a portal must offer a wide array of content that takes advantage of a high-speed broadband connection in order to attract customers who then typically demonstrate a significant degree of loyalty to one portal (Rubinstein & Singer, 2000). Given this linkage

---

5 Upstream foreclosure is also an issue in this industry. Cable distributors other than cable operators (such as satellite television) claim that vertical integration between cable programming firms and cable operators makes it difficult for them to carry integrated networks.
between access to broadband content and the success of a broadband portal, any impediment to entry in the content market will also inhibit entry into the portal market.

To the extent that the costs of producing content for the Internet mirror those of producing content for cable television, any economies of scale translate from one medium to another. Most of the production costs of broadband Internet content, like cable television content, come in the form of high up-front investments, while the marginal costs of reaching additional subscribers are negligible (Owen & Wildman, 1992). This makes the efficient scale in the production and aggregation of broadband content quite large, and provides natural barriers to entry in the broadband portal market.

In addition to the costs of producing new content, developers of broadband portals require a large number of servers, additional bandwidth, and sophisticated compression software to encode video and audio files for speedier transmission over the Internet. Further, entrants in this market face the uncertainty associated with new and untested business models.

**Vertical Foreclosure.** Through foreclosure by the cable providers who still control the direct access to customers, non-integrated broadband portals have difficulties in building a large enough subscriber base in order to reach the scale that is necessary for investments in content production. In addition, successful foreclosure can be achieved by the unwillingness or inability of customers to switch to non-foreclosed competitors. Given the existence of economies of scale in the broadband portal market, it is conceivable that a broadband portal would “exit from the market if the foreclosure drives it below minimum viable scale (MVS).” (Riordan & Salop, 1995). Even where the foreclosed input supplier does not fall below MVS, its ability or incentives to compete may be reduced if its marginal costs rise: “In particular, a reduced customer base may reduce the incentives of the foreclosed firm to invest in cost reduction, product quality, or other non-price product dimensions.” (Riordan & Salop, 1995)

---

6 A small number of well-financed nonintegrated broadband content providers, such as Yahoo!, have made large investments to compete for broadband customers. In July 1999, Yahoo! purchased Broadcast.com, a pioneer in the aggregation of streaming audio and video clips, for $5.7 billion (Roth, 2000.) In March 2000, Yahoo! launched FinanceVision, a site that offers live business news to customers at work (Business Wire, 2000). Yahoo!’s broadband sites will be funded by thirty second “multi-media” spots. The number of customers who view the advertisements and hence generate Yahoo’s most important revenue stream, critically depends on each provider’s willingness to refrain from content discrimination.
Church & Gandal (2000) have investigated foreclosure while treating the downstream product as a system composed of hardware (supplied by the downstream provider) and its complementary software, i.e. content (supplied by the upstream content provider). In the Church-Gandal framework, the value of the system increases as the variety of the available software grows. Foreclosure then involves the decision to make the software incompatible with rival hardware technologies. The authors demonstrate that foreclosure by a single firm, when the other firm does not retaliate in kind, can occur if either: (1) the hardware products are highly differentiated and the marginal value of software variety is small; or (2) the hardware products are not highly differentiated.

A vertically-integrated broadband content and portal access provider would have an incentive to pursue two foreclosure strategies: (1) engage in access discrimination by withholding its service over rival access providers or by placing its prime content solely within a “walled garden”; or (2) engage in content discrimination by denying, limiting, or degrading customers’ access to unaffiliated content. According to Church & Gandal (2000, p. 63), the decision to foreclose is straightforward: “The profitability of foreclosure depends on the trade off between lost upstream profits (from not supplying the competing system) and increased downstream profits (from the increase in demand and potentially the increase in the downstream price)”.

At the height of the new economy bubble several media groups merged with Internet companies to control the value chain from content production to the final distribution to the consumers. Reviewing these concentrations, the European Commission was concerned that the vertically integrated groups would leverage their market power on the content side to foreclose entry on the emerging Internet distribution markets, and then mutually reinforce their positions on these two types of markets. Therefore, it required the merged entities to either divest some of their content operations or ensure third party access to their content.

The AOL/Time Warner merger in 2000 serves as a good example. AOL was the leading Internet access provider in the U.S. and the only provider with a presence in most EU member states (through a joint venture with Bertelsmann). Time Warner, on the other hand, was one of the world's largest media companies with interests in television networks, publishing, music, filmed entertainment and cable networks. The Commission found that the concentration would create a dominance on the new markets for online music distribution (including digital downloads and streaming) and music player software and that the parties would be able to impose their proprietary technology because of the possibility to leverage
their dominant position in the music publishing rights and their Internet know how\(^7\). In order to deal with these concerns, the Commission imposed that AOL dissolve the joint venture with Bertelsmann, one of the leading content rights owners (Abbamonte & Rassano, 2001).

2.7.3.2. Forward Vertical Integration of Internet Access Providers into Product Services

Internet access providers will have a powerful incentive to integrate forward into product services in order to differentiate their products and price discriminate (Srinagesh & Gong, 1996). The need to recover the sunk and fixed costs of constructing Internet access facilities pushes providers to integrate forward to permit product differentiation and price discrimination to offer value-added services. Because the marginal costs of providing access to another subscriber are close to zero, economic efficiency increases with every additional viewer reached. In order to price discriminate, facilities-based providers will have a strong incentive to offer bundled services\(^8\).

An important driver for forward integration may be associated with the need to provide integrated, quality-of-service differentiated services. This may provide a powerful incentive for an Internet access provider to integrate into Internet product services in order to ensure reliability, customer security, and to support quality-of-service guarantees for Internet services.

Another distributional innovation with the potential to rearrange the existing vertical structures has just entered the media marketplace: video-on-demand. Digital cable and the Internet transmit movies directly to consumers from the film distributor, bypassing middlemen such as pay television movie channels and video-rental stores. As a response, five of the major studios have already formed a joint venture that offers the online movie service Movielink, renting out the content of their libraries online. The joint venture can also be viewed as the industry’s legal economic response to their biggest threat, the availability of free, unauthorized films over file sharing peer-to-peer networks on the Internet.

---


\(^8\) i.e., one-stop shopping and services that bundle transport with value-added features such as enhanced billing, new features, etc. Creative bundling will facilitate a wider range of targeted discount programs that can be used to more narrowly target customer groups. Moreover, one-stop shopping offers opportunities to offer forward-discounts that reduce customer's incentives to switch to a competing carrier.
2.8. Vertical Integration and Its Effect on Firm Performance

The vertical integration theories presented in this chapter demonstrate that – in theory – a strategy of vertical integration can produce manifold advantages for firms choosing to pursue this strategy. These theoretical advantages should produce an empirically testable positive effect on firm performance.

The following paragraphs will analyze the empirical research that has so far been devoted to this topic. An extensive amount of empirical literature (for a summary see Whinston (2001)) has been devoted to the examination of the causes of vertical integration in order to validate or reject the various theoretical vertical integration frameworks. For example, researchers have examined whether firms that must make asset-specific investments are more likely to integrate (Joskow, 1985; Baker and Hubbard, 2003) as suggested by Transaction Cost Economics. There is, however, less empirical research on the actual microeconomic effects of vertical integration, i.e. on how integration affects firm performance. The complexity of a vertical integration strategy, its competitive advantages and disadvantages, and its internal benefits and costs make forecasting its economic outcomes very difficult (Harrigan, 1985, Perry, 1989). Empirical research on the effect of vertical integration has not yet resulted in a clear-cut picture and most of the empirical studies undertaken so far have concentrated on a comparison of the performance of integrated and non-integrated firms (Mullainathan and Scharfstein, 2001; Berger, et al., 2004). In one of the earliest studies, Rumelt (1974) found that related diversification, which denotes both horizontal and vertical integration, was associated with superior performance as compared to unrelated diversification. Carter (1977) supported Rumelt’s findings by presenting evidence that vertically integrated firms outperformed their non-integrated counterparts. Later work, however, suggested that the superior performance of related diversifiers in Rumelt’s sample was due to the impact of industry structure on profit rates (Christensen and Montgomery, 1981; Bettis, 1981; Rumelt, 1982). In later studies, Rumelt (1986) and Hoskisson (1987) also found a negative correlation between vertical integration and performance, which was confirmed by D’Aveni and Ravenscraft’s 1994 study where the decision to vertically integrate did not result in predictable economic performance improvements. Reed and Fronmueller (1990), however, concluded on performance neutrality in their study.

Further research on other industries suggests that very few companies have so far succeeded in capitalizing on the opportunities for synergy and many found that the transaction costs generated from increased vertical integration were larger than the financial benefits captured...

In contrast, if one looks at the existing research related directly to the media industry, a more positive picture emerges. Vertically motivated media industry mergers and acquisitions have generally created value for the acquirer. Transactions that have involved vertical backward or upstream integration have interestingly been more successful than forward integrative deals. This means that distributors acquiring content have been more successful at creating value than content players attempting to move into distribution (Ferrari et al., 2003). Chan-Olmsted and Jung (2005) find in their study of the top 26 media firms that related diversification improves financial performance, while unrelated diversification decreases performance.

In contrast, Kolo and Vogt (2003) state that no clear indication can be made about the degree to which the size and corresponding degree of vertical integration improves the financial performance of media corporations.

Several researchers have also suggested that the relationship between vertical integration and performance must be of a non-linear nature, meaning that is is only beneficial under certain conditions. They hypothesize that performance increases as a firm shifts from single business strategies to vertical integration or related diversification, but that performance decreases as extent of vertical integration reaches a saturating point, due to the increasing cost and diseconomies of managing too many products (Chan-Olmsted & Chang, 2003, Geringer, Tallman & Olsen, 2000; Palich, Cardinal & Miller, 2000, Sambharya, 1995; Tallman & Li, 1996). Grant, Jammine & Thomas (1988) recognize the growing strain on top management and also delineate other costs such as coordination costs and diseconomies related to organizational inefficiencies.

For a comprehensive summary on the existing empirical research on vertical integration and performance see Exhibit 1 in the appendix.

2.9. Hypotheses

The main conclusion that arises from the preceding theoretical considerations is that so far no simple and consistent relationship between vertical integration and performance has been proven nor has a general framework been developed which could serve as a tool to determine
the ex ante success of any given vertical integration decision. Not surprisingly, the empirical evidence of the impact of vertical integration on performance is inconclusive, too. Empirical studies are highly fragmented and have concentrated on various levels and subsets, e.g. in selected countries or within specific businesses with a clear focus on the manufacturing sectors.

Nevertheless, the vertical integration rationales presented under section 2.7. show that within as well as between the media value chain segments vertical integration offers numerous strategic as well as theoretically performance-enhancing advantages.

Since the empirical results on why companies undertake vertical integration still remain inconclusive, and show a significant research gap concerning the occurrence of vertical integration in the media industry, this study aims to expand this underresearched area by identifying and explaining the drivers of vertical integration in the media industry. Since only the major media conglomerates exhibit vertically integrated structure over at least several or all of the media value segments, these companies are chosen as units of analysis, in order to be able to command the timeframe and the size necessary to study the various forms of vertical integration and, eventually, determine the overall risks and benefits of such a strategy.

In addition, by studying the six major media conglomerates, this study breaks with the tradition of comparing integrated to non-integrated firms, and will thus allow for an analysis of vertical scope in its purest form and in unprecedented depth.

Hence, the following first hypothesis is proposed:

H1: Vertical integration has been the dominant corporate strategy for the major media conglomerates.

H1.1. The six major media conglomerates have, between 1995 and 2005, evolved into their present form by mainly following a strategy of vertical integration.

H1.2. The six major media conglomerates vertical integration strategies are closely related in their extent and mode.

Furthermore, the empirical results regarding a linkage between vertical integration and corporate performance have been even more conflicting, and clearly benefit from further clarifying research, especially in the field of the media and communications industries. The general argument in the industrial organization literature linking vertical integration to improved performance revolves around the notion of market power and historically media firms have exercised such power through the vertical integration of different products in their
value chains. Second, vertical integration of various media sectors generates the economies of scope and synergy unavailable to tangible, manufacturing products. A single idea, first executed in a theatrical film, may then be exploited in the form of a DVD, a television film or series, a book, magazine articles, a video game, Internet offerings, a music soundtrack, and more. Finally, most of the empirical work investigating the linkage between vertical integration and performance has focused on manufacturing firms, as detailed under section 2.7. The differences in the nature of products might mean that the vertical integration of products along the individual industry value chains would have different impacts on firm performance.

Hence, this dissertation seeks to provide insight into whether the chosen vertical integration strategies of the profiled companies have created strategic and financial advantages, achieved technical progress in the transmission of media content, and produced value for their shareholders.

H2: Differences in the media conglomerates’ segmental and inter-segmental vertical integration strategies have an impact on the performance of those companies.

H2.1. Vertical integration has an impact on the media conglomerates’ financial performance.

H2.2. Vertical integration has an impact on the media conglomerates’ share price performance.

H2.3. The choice of organizational form has an impact on the success of a strategy of vertical integration.
3. METHODOLOGY AND RESEARCH DESIGN

3.1. Research Goal of the Study

The research goal of the proposed study is to provide practitioners in the media industry and academia with a better understanding of the evolution of the corporate structure of today’s media conglomerates. The primary objective of this dissertation is therefore to critically observe, from a strategic management perspective, the overall corporate strategies with a specific regard to vertical integration activities of selected international media conglomerates. In reviewing the corporate histories of those firms, the dissertation will describe how comparable strategic choices have affected the growth decisions of these firms while they adapted to evolving content and distribution media.

The present study relies on the assumption that a significant portion of future media content distribution will be determined by developments of industry convergence in general, and digitization and broadband communications access as particular trends. Additionally, the impact of regulatory changes brought about through changes in technology and consumer demand will be covered.

3.2. Research Model

3.2.1. Development of the Research Model

The research model has been constructed in order to answer the two research hypotheses and their respective sub-hypotheses outlined in the literature review.

Because of the limited number of participants to be analyzed, the complex circumstances of the global media marketplace, and the importance of gaining in-depth comparisons of corporate performance and business segment activities, a multi-case-study approach is adopted for this study. Lockett and Thompson (2001) pointed out the difficulty of empirical testing in strategy studies because of the causal ambiguity and firm-specific opportunity sets. To increase the validity and reliability of the presented research, quantitative and qualitative measures will be combined (Henderson & Cockburn, 1994). The empirical focus of this
dissertation will therefore be equally divided between a qualitative analysis of the case study data and a quantitative data collection for theory testing purposes (De Vaus, 2001).

Time Warner, The Walt Disney Company, Bertelsmann AG, News Corporation, Viacom, and Sony Corporation were selected as cases for this study. They represent the top six global media conglomerates based on their overall revenues in 2005\textsuperscript{9}. Vivendi Universal has been excluded due to its limited comparability as it entered the global media market only in 1998. In addition, the capital resources provided by its environmental services business segments further distort comparability.

Data for the conglomerates’ financial performance, geographical reach, product diversification, and other resources, were collected through archival sources such as company annual reports, and various financial resources such as Compustat, Datastream, Capital IQ, Hoovers, Moody’s, and the SDC Platinum Mergers and Acquisition Database.

3.2.2. The Research Model

The figure below provides a graphic illustration of the proposed research model for this dissertation. The causalities between the individual research levels of the research model shall be outlined in the following paragraphs.

\textsuperscript{9} For Viacom, 2004 figures are used throughout this study, as the 2005 figures are not representative of the conglomerate Viacom, as the company was split into two separate entities at the end of 2005.
The starting and central point of the research model is formed by the hypotheses H1 to H2 as outlined in section 2.8.

The nature of the research hypotheses simultaneously determines the choice of cases and the layout of the case study protocol. The latter is therefore designed in a manner which ensures that the direction and extent of analysis covers all areas of information that are needed to construct the empirical framework necessary for answering the research hypotheses. The case study protocol lists all empirical research that is to be undertaken, and the mode (i.e. qualitative or quantitative, unstructured or structured empirical enquiries) in which the empirical research should be conducted.

The next step in the research model serves to answer hypothesis H1, and comprises a multi-level intra-case analysis: For all selected case studies the exogenous or systematic factors as well as the indigenous or non-systematic vertical integration drivers will be analyzed. The former can be divided into two groups: industry characteristics, and market characteristics. The market characteristics of the specific media industry sub-markets will be analyzed in direct relation to the activities of the selected media conglomerates in the respective industry segment. The second pillar of analysis is formed by the indigenous or non-systematic vertical integration drivers. This layer comprises the following variables: Corporate history, corporate strategy, organizational form, and management style or corporate culture. These variables
Methodology and Research Design

will be analyzed in great detail for all selected media conglomerates. The results of the variable analysis will be evaluated in a review and critical discussion of the overall vertical integration strategy of each profiled company, and will be further corroborated by establishing the individual dominant mode and the extent of vertical integration. To this end, the M&A history of each media conglomerate is compiled, with the defining M&A transactions over US$100 million being taken into consideration. All transactions are then analyzed according to their type of integration, i.e. vertical, horizontal, or unrelated, in order to determine whether vertical integration-motivated transactions have indeed dominated the selected conglomerates’ acquisition history or whether the opposite is true.

The next step is the creation of a vertical integration ranking, where the SIC codes of the individual media conglomerates are examined with regard to the number of related two-digit sub-sectors. This analysis is further extended by the provision of a profile of all vertically-related activities of the conglomerates along the media value chain.

The following level of the research model is constituted by a detailed evaluation of the selected financial performance variables for each company. In addition, the share price performances will also be examined in order to guarantee a comprehensive performance picture, and to determine whether a link can be established between vertical integration and share price performance.

The research model concludes with a comparative inter-case analysis where all findings are summarized and final conclusions with respect to the initial research questions are drawn.

3.3. Research Design

3.3.1. Research Methodology Discussion

It is generally acknowledged that the nature of scientific research is too diverse to justify a single best scientific method (National Academy of Science, 1989). The nature of scientific research itself is subject to diverging categorizations and definitions. Black (1999) distinguishes between empirical and non-empirical approaches as the basis for understanding and decision-making in social sciences. He stresses the value of systematic observations to reach more valid explanations and theoretically supported decision-making. The general categorization for scientific research methodologies has been the distinction between
quantitative and qualitative research. However, Miles and Huberman (1994) stress the importance of a linkage of both approaches in order to achieve more valid overall results, thus following the objective of contributing to theory.

Accordingly, this dissertation will use a combination of quantitative and qualitative research approaches in order to be able to study the extent and mode of the vertical integration strategies of today's largest global media conglomerates in sufficient depth. The choice of method is critical since it directly impacts the approaches and techniques chosen for the collection and analysis of empirical data (Denzin and Lincoln, 1994).

The next subsections will explain the research approach choices for the specific research objective of this study in greater detail. First, a range of other potentially feasible methodologies is discussed in terms of suitability to the research objective, in order to show why the chosen approach is best suited for the purpose of this dissertation. Concerning the case studies approach selected for this dissertation, several alternative case study methodologies will also be discussed.

3.3.2. Rationale for Adopting a Case Study Approach

Porter has stated that the need for more and better empirical testing is a recurring issue when dealing with the subject of strategy making. He claims that the nature of strategy requires a deep examination of case studies and concludes that the greater use of case studies will be necessary for real progress in the field of strategic management research (Porter, 1991, p. 99).

Most researchers agree that the type of research question is the first and most important condition for choosing a research strategy. The case study method is most appropriate where "how" or "why" research questions are asked (Yin, 1981, 1994). These types of questions are likely to lead to the use of case studies, since "such questions deal with operational links needed to be traced over time, rather than mere frequencies or incidence" (Yin, 1994, p. 18). Yin (1981) categorizes case studies as either descriptive, explanatory or exploratory. A descriptive case study documents a particular action or series of action. Trying to explain or analyze the strategy that resulted in the particular business action classifies a study as an analytical/explanatory study. Going a step further and undertaking a case study to understand the thinking or vision behind the strategy constitutes an exploratory study.
Several researchers have also stressed the importance of longitudinal research for the purpose of analyzing corporate strategy (Helfat, 2000; Burgelman, 2002). The case study's ability to incorporate operational links over time makes it more advantageous than for example a survey, which traditionally focuses on events at a given point of time (Yin, 1994). For the reasons laid out above, for this dissertation the case study method with its longitudinal aspect was found to be best suited to research why international media companies have or have not adopted a strategy of vertical integration, how this strategy has been implemented, and whether or not it has helped to ameliorate performance.

The case study approach also has a distinct advantage over other research methods when the researcher has "little or no control" over the research object (Yin, 1994, p. 20). The researcher's inability to manipulate the research object distinguishes the case study method from other strategies such as experiments and action research, which demand control or interference by the researcher (Reason & Rowan, 1981; Torbert, 1971). The case study is uniquely qualified for examining contemporary events when the relevant behaviours cannot be manipulated, but instead are observed and the results analyzed (Yin, 1994). A contemporary phenomenon can thus be examined within its real-life context, especially when the boundaries between phenomenon and context are not clearly evident and when multiple sources of evidence are being used in investigating the phenomenon (Yin, 1994, p. 23). The explicit emphasis on, and incorporation of, the context distinguishes the case study method from the experiment and the survey. The latter seeks to liberate a phenomenon from its context in order to limit the number of variables to be analyzed (Denzin & Lincoln, 1994; Yin, 1994). Yet the context, i.e. the microeconomic and macroeconomic variables\(^\text{10}\) that influence a company in the strategy process, are central to the purpose of this study. A key advantage of the case study method is therefore the explicit consideration of contextual factors and a multitude of variables to which other methods would largely be insensitive. The case study method, because of its holistic and multi-faceted approach, is therefore considered particularly appropriate for researching complex phenomena like the reasons for adopting a vertical integration strategy in an industry characterized by high uncertainty and constant technological transformation.

\(^{10}\) Relevant microeconomic factors include for example ownership structure, company vision, management style, etc., while macroeconomic factors encompass the general economic climate and the occurrence of new technological developments.
3.3.3. Rationale for Adopting the Multiple-Case Study Approach

Multiple-case study designs have the advantage of producing more compelling evidence and making the overall results of the study more robust (Herriott & Firestone, 1983). With regard to multiple-case studies Yin stresses the importance of applying the research methodology of replication logic. The replication logic in multiple-case studies is analogous to that used in multiple experiments (Hersen & Barlow, 1976; Yin, 1994). If similar results are obtained from all case studies, replication is said to have taken place. Each case must therefore be carefully selected so that it either predicts similar results (literal replication) or produces contrasting results but for predictable reasons (theoretical replication). Yin states that a case number of six to ten, where all turn out as predicted, produces compelling evidence for the initial set of research questions (Yin, 1994, p. 46). If the cases produce contradictory results, the theoretical propositions should be modified and retested with a new set of cases (Yin, 1994, p. 46). For a replication logic case study design the theoretical framework of case analysis is therefore the most important basis, as it later becomes the vehicle for generalizations of new cases.

Concerning this study, due to the fact that the number of international media conglomerates is limited to seven companies 11, of which six will constitute the multiple-case study design, the retesting with a new set of cases in the event of contradictory results becomes all but impossible. The generalizability of results can therefore not be guaranteed for the case studies presented in this dissertation. However, to enhance generalizability, the same set of cases could be reexamined after a certain number of years in order to see whether the companies in question have since changed their vertical integration strategies.

After considering whether to adopt the single case study or the multiple-case study approach, the individual case studies can also be classified into two main types of case studies, depending on whether a single unit of analysis or multiple units of analysis are involved (Yin, 1994). A case study is called holistic if only the global nature of a project or an organization is investigated, and called embedded if the case study involves several units of analysis (Yin, 1994, p. 46ff.). Within the single case subunits of analysis are introduced to make the design more complex or embedded. The advantage of this approach is that the subunits add

---

11 TimeWarner, Disney, News Corporation, Viacom, Sony Corporation, Bertelsmann AG and Vivendi Universal.
significant opportunities for extensive analysis, enhancing the insights into the single case. A
danger that should be avoided by the researcher is to give too much attention to the subunits,
thereby ignoring the larger, holistic aspects of the case (Yin, 1994, p. 44).

In conclusion, an embedded multiple-case study design is the most appropriate research
choice for this dissertation. A multiple case-study design proves most appropriate in order to
guarantee at least a certain generalizability of the results, and by adopting an embedded case
study approach, the sub-units corporate strategy with a specific focus on vertical integration
strategy and the resulting corporate performance can be adequately analyzed while also
taking the historic and current development of the conglomerates and the media industry in
general into account.

3.3.4. Case Study Data Collection

The case studies draw on information from the following three types of sources:

1. Written documents: Information was collected from the business press, analysts’
   reports, corporate histories, electronic sources (Datastream, CompuStat, Capital IQ,
   SDC Platinum Database, and the Internet), annual reports, and other publicly
   available material.

2. Interviews with company representatives: A series of unstructured interviews was
   conducted with senior managers of the companies represented in the case studies who
   had taken an active role in their companies’ strategy processes. Before the interviews,
   a note was sent to the interview partners to set out the main topics of interest. The
   interview participants were first asked to give an overview of the corporate strategy
   process that had been taking place at their company since the beginning of the 1990s.
   These brief presentations, plus the fact that plenty of information on the companies’
   acquisitions, divestments, and the like is publicly available, provided much of the
   factual information on changes in the boundaries of the media conglomerates. More
detailed information from the interview participants was requested on:

   • Changes in the internal organization of the firms presented in the case studies (e.g.
     changes in the role of the head office; centralization / decentralization of decision-
     making processes, etc.).
• Rationales for the restructuring of the boundaries of the case study firms through vertical integration (e.g. potential synergies among the various businesses; contribution of the head office in exploiting potential synergies from vertical linkages, etc.);

• Key factors that were perceived to have either caused / facilitated or hindered / decelerated the vertical integration processes of the case study companies.

The interview partners provided valuable information on these issues. For anonymity reasons and since the interviews were all unstructured, most of the information gathered from those interviews has been incorporated unattributed in the empirical sections (chapter VI and VII) of this dissertation.

3. Other sources: Firstly, interviews were conducted with several outside consultants and analysts with respect to all six companies, so as to ascertain independent opinions of the media conglomerates’ development. Secondly, regarding all information on Bertelsmann AG, it should be noted that the author of this dissertation is working in the business development department of the company, and can thus draw on her own professional experiences to illustrate the case study.

3.3.5. Case Study Data Analysis

For the purpose of this dissertation, the case study data analysis will be strictly guided by the research hypotheses. According to Yin, for the data analysis the researcher should adopt a general analytic strategy, and, within the realm of this wider strategy, a specific analytic technique should be chosen (Yin, 1994, p. 109). The selection of the general analytic strategy depends on the type of case study. For explanatory case studies, such as the ones presented hereafter, reliance on theoretical propositions or research hypotheses is recommended. Thus attention can be focused on certain variables while ignoring other data (Yin, 1994).

For this dissertation, within the general analytic strategy, the specific analytic technique that is recommended and will be used is explanation building. The purpose of explanation building is to compare an empirically-based pattern with a predicted one. Based on this comparison, explanations can then be formulated to illustrate why patterns coincide or not. Explanations can be formed by first rendering an accurate description of the facts of the case study, by subsequently considering alternative explanations of these facts, and by finally drawing a conclusion based on the explanation that seems most congruent with the facts (Yin,
1981). An important characteristic of this approach is that the final explanation has been the result of a series of iterations. In the present study, the case evidence is examined according to the two pillars outlined in the research model, i.e. the exogenous and indigenous influence factors, and the individual case results are then compared with the set of influencing variables derived from the theoretical body of knowledge presented in Chapter II. Finally, the findings are compared in a meta-analysis across all case studies and a conclusion on the overall efficiency of vertical integration for the media conglomerates will be drawn in the final chapter of this dissertation.

3.3.5.1. Constructing a Vertical Integration Ranking

In order to measure the extent of vertical integration of a media conglomerate, the number of business units and distinct sectors as indicated by the SIC codes that each conglomerate is involved in will be examined.

SIC codes are assigned according to each type of product which is mainly produced in one industry (Central Statistical Office 1979, pp. 17ff.). The SIC system is a numerical classification scheme used to describe the activities of companies. It "starts with a small number of broad groups of activities which are then subdivided into progressively narrower groups so that the classification can be used with varying amounts of detail for different purposes" (Central Statistical Office 1979, p. 2). Beyond this, the assignment of the codes takes into account the following criteria: The nature of the process of the work done, the main raw material used, the type or intended use of goods produced or handled, or the type of service rendered.

Therefore, it can be argued that SIC codes within a particular digit-level (i.e. with the same preceding digits) describe activities that are more closely related than activities identified by codes that differ in a higher level of the 4-digit-system, so that the former represent a lower degree of vertical integration than the latter.

The SIC system thus allows to compile a ranking of the media conglomerates’ extent of vertical integration as illustrated by their average number of related operations as represented by the two-digit SIC sub-sectors.
3.3.5.2. Analysis of the Relationship between Vertical Integration and Firm Performance

The relationship between vertical integration and performance can be illustrated in a integrated vertical integration-performance model, which has been adapted to vertical integration from the diversification-performance model developed by Datta et al. (1991). The figure below is general in the sense that it is not restricted to the media industry, and integrated because it takes into account different types of independent, moderating, and dependent variables.

![Diagram of Vertical Integration and Performance](image)

**Figure 13: Vertical Integration and Performance – Theoretical Framework**

Source: Adapted from Datta et al. (1991)

This general integrated model acknowledges the multidimensionality of vertical integration. Regarding the independent variables, the degree or extent of vertical integration gives an indication of how vertically integrated a firm is. The type or direction of vertical integration takes into account the strategic intent of the vertically integrating firm and focuses on whether the vertical integration is effected between the firm and upstream suppliers or downstream customers. In addition, the type of vertical integration is classified as either full, partial or quasi-vertical integration, depending on what ownership structure is selected for the integration of the new business. In combination, both the degree and type of vertical integration can be used to define the operational and financial synergy potential associated with a vertical integration strategy. In addition to the degree and type of vertical integration, the mode of vertical integration is also included as an independent variable. The mode of vertical integration refers to the instrumentation used for vertical integration, i.e. organically or acquisition-induced vertical expansion.
In the next step, the model illustrates that the relation between vertical integration and performance is intermediated by two moderator variables. Industry structure not only influences strategy, but is also a significant determinant of firm profitability. However, researchers do not agree to what extent industry structure determines profitability. According to Schmalensee (1985) and Wernerfelt and Montgomery (1988), the strongest determinants of firm performance are industry effects. On the other hand, Rumelt (1991) discovered that the most important sources of profitability are firm-specific and that industry membership is much less important. In any case, it is clear that vertical integration will only create value if the industry segments chosen for vertical integration are structurally attractive or can be made attractive.

The importance of organizational factors is increasingly recognized by academics and industry participants. If a vertical integration strategy is not properly implemented, the firm may fail in creating the purported operational and financial synergies. In turn, the successful implementation is dependent on organizational factors like organizational structure, systems, culture, and managerial capabilities.

Finally, the dependent variable is performance, generally defined as a measure of firm profitability. The next section will provide a detailed analysis of performance measures used for this study.

3.3.5.3. Performance Evaluation

Despite some attempts to develop conducive models specifically for the media industry (see Hendriks, 1995), there is yet no one agreed upon way of operationalizing research aimed at quantifying the overall economic performance or effectiveness of media firms. The task of establishing an appropriate performance measure for firms is further complicated by the multidimensional nature of performance (Wirth & Bloch, 1995, p. 18).

3.3.5.3.1. Overview of Performance Evaluation

Venkatraman and Ramanujam (1986) distinguish three general categories of business performance measures: financial performance, operational performance, and organizational effectiveness. Financial performance is the narrowest, but the most frequently used concept in both finance as well as the empirical strategic management studies (Hofer, 1983). Measures used are either accounting-based, such as sales growth, profitability, earnings per share, or
market-based like share price returns. To widen the perspective of the concept of business performance, Venkatraman and Ramanujam (1986) combined financial and operational performance. Operational performance can be evaluated with non-financial measures such as market share and product quality reflecting the fulfillment of economic and operational goals. However, no generally accepted measures have yet been introduced, and most studies have continued using financial and business performance measures. Research in the field of finance and strategic management has been criticized for using accounting-based data to measure performance (Datta, Rajagopalan et al., 1991; Hoskisson, Hitt et al., 1993). This criticism draws on the weakness of accounting data caused by its ability to manipulate firm performance and suggests that researchers should focus on market-based performance measures exclusively or at least in order to countercheck the results obtained with accounting data (Nayyar, 1992; Dalton, Daily et al., 1998).

It has also been suggested that static measures are, on the whole, less appropriate than dynamic, growth-related measures (Mancke, 1974).

3.3.5.3.2. Performance Measures Employed in the Case Studies

3.3.5.3.2.1. Variables Measuring Profitability

A combination of static and dynamic growth measures and static profitability ratios has been chosen as the least biased solution. To aid comparison with other research, the results of this study will be examined with measures most commonly found in other work: growth in sales and profits. To overcome the problem of differing corporate accounting policies, wherever possible operating income needed for the compilation of the profitability ratios was measured as earnings before interest and taxes (EBIT).

Several static financial ratios were selected to represent profitability. Return on assets (ROA) and return on equity (ROE) are measures that show the effectiveness and efficiency of the management (Quian, 1997). Return on equity shows how much profit has been generated using the shareholders’ capital. Return on assets indicates how effectively the assets of the firm were working to generate profit.

The gross profit margin or return on sales (ROS) gives an indication on whether the average mark-up on goods and services was sufficient to cover expenses and make a profit and thus indicates the effectiveness with which the profit has been generated. In particular, the
divisional ROS provides a good instrument in order to illustrate the contribution of individual business units to overall profitability. In addition, the cumulated annual growth rates (CAGR) for overall and divisional ROS indicate whether the enterprise and/or its respective business units have achieved an increase or suffered from a decrease in profitability as represented by the ROS over the time period under study.

All financial data have been provided from company annual reports. Total media revenues or sales include all content production businesses and all distribution operations.

3.3.6. Quality Measures of the Research Design

Four measures are most commonly applied to ensure the quality of research, and are therefore adapted for the present dissertation (Stake, 1994; Cook & Campbell, 1976; Scandura & Williams, 2000). These measures ensure the validity and reliability of the presented research:

1. Construct, or concept validity (the degree to which a study investigates what it claims to investigate);
2. internal, or logical validity (the degree to which findings correctly map the phenomenon in question);
3. external validity, or generalizability (the extent to which findings can be reproduced in another setting);
4. reliability (the extent to which the study is free of random errors).

3.3.6.1. Construct Validity

In the literature, construct or concept validity relates to research procedures, and applies to the data collection period. The construct validity of a procedure denotes the quality of the conceptualization of the relevant concept (Smaling, 1992). Construct validity therefore refers to the extent to which the chosen procedure leads to an accurate observation of reality (Denzin & Lincoln, 1994).

Denzin & Lincoln (1994) and Yin (1994) have formulated three methods to ensure construct validity (Denzin & Lincoln, 1994; Yin, 1994): (1) the use of multiple sources of evidence, (2) the establishment of a clear chain of evidence, and, most importantly, (3) triangulation.
In general, unlike other research strategies, the case study method per se allows for a multitude of sources of evidence, which are all integrated into the final case study report. As shown in the paragraph on data collection, this study draws on several sources of evidence for each of the six case studies.

According to Yin, four measures should be taken to ensure that a clear chain of evidence has been followed. First, the report should make extensive citation of the relevant case study databases. Second, the actual circumstances under which the case study data was collected, should be indicated. Third, the procedure should be compared to the case study protocol which details the specific procedures and questions used during the case study data collection. Fourth, the protocol should indicate the link between the protocol on the one side and the initial research questions on the other (Yin, 1994, p.102). For this dissertation, therefore, all data sources were thoroughly referenced in the final case study reports. Furthermore, the research questions and data collection procedures have been laid out in detail in the preceding sections.

Triangulation is also widely recommended in the literature to ensure construct validity (Yin, 1994; Denzin & Lincoln, 1994; Pettigrew, 1990). The basic principle of triangulation can be applied to several areas: method triangulation (combining quantitative and qualitative research methods), researcher triangulation (two or more researchers are involved in the study), and data triangulation (Smaling, 1992; Denzing, 1989; Lincoln, 1994). In data triangulation, the collected data is validated by correcting errors of fact (see Yin, 1994, pp. 143-145). The usual approach is to have key informants and research peers review the actual facts presented in the case study (Yin, 1994). This helps alleviate the likelihood of reporting false or commercially sensitive data, or can help in portraying a situation from different perspectives and viewpoints. A common approach is also to use non-reactive, i.e. historical or archival data, to test the claims of the case study, since non-reactive data is not influenced by the perceptions or biases of individuals providing or gathering the data (Denzin & Lincoln, 1994). For the purpose of this study, data resulting from the unstructured informal interviews was thus always counterchecked with archival or otherwise publicly accessible data. In the

---

12 Except for anonymously provided information from the unstructured interviews that were conducted with all six media conglomerates.
event of discrepancies between interview and archival data, further data was collected and analyzed until the discrepancies could be solved.

3.3.6.2. Internal Validity

Internal or logical validity tests whether the reasoning or logic of the research framework provides arguments that are powerful and compelling enough to defend the research conclusions. Essentially, the concern here is to establish causal relationships whereby certain conditions are shown to lead to specific outcomes, as distinguished from random relationships (Yin, 1994, p. 40). In contrast to construct validity, internal validity therefore applies more to the data analysis phase (Yin, 1994, p. 105). However, the non-experimental nature of the case study makes it difficult to establish causalities (Yin, 1994, p. 105). This is especially true for descriptive and, to a lesser extent, for explanatory case studies. The latter's internal validity can be tested through pattern matching and convergent validity (Yin, 1994; Denzin & Lincoln, 1994).

Pattern matching has been emphasized as the most opportune strategy for ensuring internal validity of explanatory case studies. Pattern matching compares an empirically-based framework with a predicted one. If the patterns match, internal validity can be assumed (Yin, 1994). This form of pattern matching has also been referred to as convergent validity (Denzin & Lincoln, 1994) which states that the validity of findings can be enhanced if they can be shown to be consistent with similar findings in other contexts.

Pattern matching and convergent validity are applied to the case studies presented in this dissertation. The predicted patterns as defined by the literature review of vertical integration theories are consistently compared with the empirically observed patterns of the individual case studies.

3.3.6.3. External Validity

Theory development depends on the ability to generalize the research findings. Generalizability, in turn, depends on the type of case study being chosen (Yin, 1994; Stake, 1995). Given the small sample size of even multiple-case study designs, case studies in general do not allow for statistical generalization (Yin, 1994, pp.38-40). Thus the empirical research findings reported in this dissertation could be idiosyncratic to the cases researched.
3.3.6.4. Reliability

Reliability refers to the extent to which later researchers can arrive at the same insight as previous researchers, if the former were to conduct the same study all over again (Smaling, 1992; Denzin & Lincoln, 1994). When applied to the research findings, reliability of a study demands the absence of random errors (Smaling, 1992; Yin, 1994). To ensure the absence of random errors, research procedures should be documented as closely as possible in order to make the process by which the results were found as transparent and replicable as possible (Smaling, 1992). For case studies, the most widely used approach to ensure reliability is that of Yin (1994). Research should be conducted "as if someone were always looking over your shoulder" (Yin, 1994, p. 45). Reliability in case studies is therefore simply a function of documentation. One way to ensure exact documentation is to establish a case study protocol which can further be complemented by a case study database.

A case study protocol should give a general overview of the case study project, describe the data collection procedures, and list the case study interview questions. Thus, it serves also as a guide for the final case study report, and helps the researcher to stay focused on the initial aims and intentions of undertaking case study research.

The compilation of the case study database further ensures the reliability of a given study (Yin, 1994). In the present study, an extensive case study database has been compiled for all of the presented media conglomerates. The database comprises all literature that has been reviewed for the companies presented in the case studies, the companies' financial reports between 1990 and 2005, other company archival documents, interview summaries, Datastream, Compustat, Capital IQ data compilations, press reports and articles.

In conclusion, to ensure validity and reliability of the presented research the four quality measures have been applied as far as possible to data collection and analysis in this dissertation.

\[^{13}\text{For two of the selected media conglomerates, i.e. News Corporation and Bertelsmann AG, the historical annual reports could only be obtained from 1995 and 1996 onwards.}\]
4. EMPIRICAL PART I: MEDIA CASE STUDIES

4.1. Introduction

This chapter constitutes the first of two empirical sections which provide answers to the research hypotheses formulated in chapter II. The first empirical part introduces the selected media case studies, and addresses the first hypothesis with its respective sub-hypotheses:

\textit{\textbf{H1:}} Vertical integration has been the dominant corporate strategy for the major media conglomerates.

\textit{\textbf{H1.1.}} The six major media conglomerates have, between 1995 and 2005, evolved into their present form by mainly following a strategy of vertical integration.

\textit{\textbf{H1.2.}} The six major media conglomerates vertical integration strategies are closely related in their extent and mode.

The six leading media conglomerates that were selected for the multiple-case study design of this dissertation will each be analyzed in detail according to the following schema: Firstly, an overview over the conglomerate’s corporate history is given, where all major corporate developments from the founding of the company to the year 2006 are described in detail, complemented by an analysis of internal and external factors that have led to or otherwise influenced the conglomerates’ evolution. Secondly, an overview of the conglomerate’s overall corporate strategy in general, followed by an analysis of the conglomerate’s particular strategy of vertical integration. The most defining vertical integration decisions will be evaluated according whether the envisaged benefits were realized or not, and in the latter case, possible reasons will be outlined. A description of the profiled company’s corporate culture and organizational form concludes the corporate strategy analysis. Each case study ends with a classification of all major transactions according to their type of integration, i.e. vertical, horizontal or unrelated, in order to determine whether vertical integration–motivated transactions have indeed prevailed for the media conglomerate under study.
4.2. Case Study: Time Warner

4.2.1. Corporate History: Time Warner

Time Warner, Inc. was founded as Time, Inc. in 1922 with the launch of Time magazine, which initially consisted of a compilation of abstracts and articles. Circulation had reached 250,000 by the late 1920s (with advertising revenue up from US$13,000 to US$414,000), and given Time magazine’s success, Fortune was launched in 1930, Life in 1936, and Sports Illustrated in 1954, riding the wave of photojournalism. The 1970s saw the launch of two further successful magazines with Money in 1972 and People Weekly appearing in 1974.

In the 1960s, Time Inc. decided to vertically integrate into paper production through a merger with Temple Eastex. At the same time, the company decided to enter the cable television market with the launch of the Home Box Office (HBO) channel. This expansion can be classified as diversification rather than vertical integration, as Time Inc. had no content operations other than in the magazine industry.

Time Inc.’s management was originally opposed to the idea of diversification into cable television as it still saw itself as a pure print media organization. In 1974, however, when HBO had emerged as the largest pay cable programme supplier in the United States, resistance waned. HBO employed a number of successful strategies that helped it to grow rapidly. First of all, it relied on premium content like theatrical movies and sports entertainment. Secondly, instead of adopting the complex pay per view payment structure, it charged a monthly per-channel fee. Thirdly, HBO was the first U.S. company to use satellite communications for the transmission of television programming, a move that laid the groundwork for all later U.S. satellite cable networks (Gershon, 1997). By 1978, HBO had vertically integrated into cable system provision with the acquisition of American Telecommunications Corporation (ATC). Both companies together now generated more than 50 per cent of Time Inc.’s revenues.

To extend its magazine operations further, Time Inc. acquired Southern Progress Corporation in 1988 and launched Entertainment Weekly in 1989, thus bringing its stable of magazines to 25.
4.2.1.1. Time Warner Merger

In the early 1980s Time Inc. entered a critical period. Revenues from the magazine division stagnated and the magazine market showed signs of saturation with decreasing growth rates (Gershon, 1997). HBO also faced a major downturn in pay cable revenues, resulting from the growing success of video rentals. Time Inc.’s difficulties were further increased by its heavy dependence on the U.S. entertainment markets since by the mid 1980s, only 10 per cent of its revenues came from its international operations (Gershon, 1997). Time Inc. needed a global strategy that would enable it to compete with the world's leading media companies. Time's management reasoned that only further vertical integration into entertainment content would provide the much needed fast growth impetus and turn Time Inc. into a true media conglomerate. Industry analysis showed that only two companies would provide the right strategic match: Warner Communications and Paramount Pictures. The boards of both Time and Warner Communications approved the merger in March 1989, after long negotiations between the two companies. Both Steve Ross (Warner Communications) and Richard Munro (Time Inc.) would serve as co-CEOs of the newly formed company. In order to finance the merger Time Inc. assumed an US$11.2 billion debt load. Until the death of Ross in 1992, the two men's different management styles often clashed, and integration of the two companies was proving difficult. In 1992, Levin, the former head of HBO, was appointed new CEO, representing a new leadership generation. Levin was regarded as someone who valued Time's print media tradition as well as the importance of new technology (Gershon, 1997).

In sum, the Time Warner merger was intended to take the strategy of vertical integration to the next level in terms of planning and operations. Time Warner could now control an idea from its appearance in a book to its debut on HBO as well as gaining additional press coverage through the company's own magazines. However, due to the difficult post-merger integration, none of the envisaged synergies could be realized, and in-fighting between the divisions consistently hindered cooperation. Despite these difficulties, both companies had highly complementary assets. Time Inc. brought its magazine division, its pay television channels with HBO and Cinemax, and the second largest cable multi-service provider (MSO), American Telecommunications Corporation to the combination. Warner Communications brought in television and film content production with Warner Brothers Studio and Lorimar Television Entertainment. Warner Brothers Studio was a key supplier of programming to the cable industry and Warner Cable was also the fifth largest cable channel provider in the
United States. It also added music entertainment with Warner Brothers Records, Atlantic Records, and Elektra Entertainment.

The early 1990s were characterized by a worldwide recession, which made times difficult for the newly created Time Warner, given its high debt load. Growth became slower than anticipated, and advertising revenues decreased substantially. Total revenues still increased year-on-year, but net income was negative in 1993 through 1995 due to the high interest and amortization expenses, retirement of debt, and restructuring charges (Time Warner Annual Reports, 1993, 1994, 1995).

After the merger, Time Warner nevertheless began an aggressive overseas expansion. The magazine division, Warner Music Group and HBO became major players in the overseas market. Time Warner's foreign direct investment (FDI) grew from less than US$740 million in 1984 to US$4 billion in 1994 (Gershon, 1997).

4.2.1.2. Time Warner – TBS Merger


The rationale behind this merger was to increase Time Warner's breadth of vertically integrated content and distribution operations still further. A combination of the news and programming assets of TBS with Time Warner's existing assets secured access to both content and distribution systems in the global marketplace. Time Warner's cable networks now included CNN, TBS, TNT, HBO, the Cartoon Network, Cinemax, the WB Network, and a 50 per cent interest in Comedy Central. Time Warner Cable was now the second largest cable system operator in the United States, after AT&T (S&P Industry Survey, 2000, Time Warner, Inc. Annual Report, 2004).

Both mergers failed to produce significant synergies because of a lack of cooperation between the merged companies. Time Inc., Warner Brothers and TBS continued to be run independently under a decentralized corporate structure. Each business unit operated as a separate company and profit center. Nevertheless, Suzuki (2006) shows that some efficiency gains resulted from the Time Warner – TBS merger. The merged systems carried their newly
affiliated networks more frequently than the non-merged systems. In addition, prices in merged markets were lower, and the newly affiliated networks saw their subscriber numbers increase to a greater degree than those in non-merged markets.

Throughout the mid- and late 1990s, Time Warner had also started to pursue several eventually unsuccessful online ventures. In 1994, the "Pathfinder" website was launched as a gateway to the World Wide Web, complete with free email, a search engine, and content from all Time Warner brands. However, funding shortfalls led to the demise of Pathfinder one year later. In 1999, Warner Brothers created a new digital media business unit and launched "Entertaindom" which disappeared as fast as it had been created due to escalating costs and increasing competition (Rose, 2000).

4.2.2. Corporate History: AOL

America Online, Inc. was founded by Steve Case as Quantum Computer Services in 1985 and relaunched as AOL in 1989. AOL provided one of the first dial-up accesses to the Internet, and this first mover advantage would secure its success until 2000, when competition intensified through the entry of telecommunications firms into the Internet access market.

In 1999, AOL began to implement a vertical integration strategy of its own with several software acquisitions, that would provide its access platform with valuable online services. The most important acquisition was that of Netscape, the first widely popular web browser. With the Netscape acquisition AOL pursued three different goals: Firstly, it provided AOL with browser software to replace Microsoft's Internet Explorer in 2001, when AOL's contract with Microsoft ended. Secondly, Netscape’s Internet access point NetCenter could be used by AOL to expand its own customer base, and thirdly, Netscape's excellent development team provided valuable human capital.

4.2.2.1. Business Model

The AOL service could be accessed from anywhere in the world by using high-speed or dial-up connections. Because AOL acted both as an Internet Access and Internet Service Provider, the pricing model was developed accordingly. Subscribers could either subscribe to using AOL as their ISP or to use AOL solely as their provider of services and information.
The prominent feature of the AOL services was its easy-to-use design. Borrowing from the television industry, content on AOL was presented as "channels" and integrated with Internet offerings in order to allow members to easily find their areas of interest such as news, sports, travel, health, computing, or entertainment. AOL had also quickly realized that its user retention rate could not be attributed to information that could basically be found anywhere on the Internet, but rather to the interaction generated by the users themselves. AOL therefore offered its customers a variety of tools such as chat rooms, instant messaging, bulletin boards, and email (Newsweek, 2000).

For its online content, AOL from the start followed a strategy of quasi vertical integration where it formed partnerships and alliances with the large established media conglomerates in order to ensure access to attractive and globally exploitable content. AOL charged its partners like CBS Sportsline.com or eBay rent in exchange for a slot as an exclusive provider of information or services on AOL. This strategy in essence created "walled gardens" on the Internet, giving AOL subscribers access to a multitude of sites that had been developed with proprietary tools (South China Morning Post, 2001). AOL followed the same strategy for its e-commerce operations, which were bundled in the AOL shopping channel, where retailers were charged for a space on the channel. AOL derived further revenues from trading conducted through its brokerage center as well as from MovieFone, its movie listing and ticketing service.

Prior to its proposed merger with Time Warner, AOL’s broadband Internet strategy flowed from its larger objective of maximizing the profits of its Internet access and services provision. Lacking any significant interest in any particular broadband transmission network, AOL maintained a strong incentive to make its service available over all broadband platforms. In 1999, AOL announced its "AOL Anywhere" strategy which enabled it to receive dual revenue streams from narrowband as well as broadband customers.

The broadband competitive landscape, however, became hostile to AOL as cable providers instituted a tying strategy where broadband customers needed to purchase their own broadband portal service in conjunction with broadband transport. In this case, the lack of vertical integration into broadband distribution prohibited AOL from developing a sustainable competitive advantage over its integrated rivals, who in turn exercised their gatekeeper position vis-à-vis AOL.

In general, the strategic motive for a vertical integration of portal service and broadband transport is the ability to lock in customers by tying the distribution and portal services
together. By denying outside portals access to the number of customers needed to maintain minimum efficient scale, tying also enhances their gatekeeper positions and generates positive network effects for the gatekeepers. The network effect in turn allows the broadband providers to attract premium content to their portals and, at the same time, raise barriers to entry for other firms seeking to offer competing portal and transport services (Economides, 1996). Within two years of initiating their tying arrangement, vertically integrated cable firms such as AT&T succeeded in convincing a substantial percentage of customers to sever their ties with competing ISPs. Thus, 66 percent of AT&Ts @Home users had previously been AOL users, but had since cancelled their AOL accounts (Simons, 1999); because when consumers received broadband Internet service with the purchase of broadband transport, maintaining their subscriptions to AOL amounted to paying twice for the same services.

AOL’s response to this exclusionary threat was again to undertake a quasi vertical integration in the form of business partnerships. It negotiated a series of agreements with the largest incumbent local carriers—Bell Atlantic, SBC, GTE—to provide services over DSL (AOL press release, 1999). Yet these business partnerships suffered the various drawbacks of quasi vertical integration, including lack of control, difficulties in knowledge integration, and questionable long-term viability for AOL (Collis & Montgomery, 1997).

However, when the technical difficulties associated with a national rollout of DSL became apparent, AOL finally decided to acquire a significant interest in a cable and broadband system operators, agreeing to purchase Time Warner in January 2000 for US$131.5 billion (Deogun & Wingfield, 2000).

4.2.3. The AOL Time Warner Merger

Under the terms of the merger agreement, Time Warner shareholders received 1.5 shares of AOL Time Warner for each share of Time Warner stock they owned and America Online shareholders received one share of AOL Time Warner for each share of the original AOL. Upon completion, AOL’s shareholders owned approximately 55 per cent of the new company and Time Warner's shareholders owned 45 per cent of the new company. When the deal closed on January 11, 2001, the market capitalization of the new AOL Time Warner stood at US$216.7 billion (Sandoval, 2000).

AOL Time Warner's competitors feared that the size of the newly formed company would limit their moves in the cable and Internet industry segments, and Microsoft and Disney
started numerous antitrust violation lawsuits both in the United States and in Europe. The Federal Communications Commission finally approved the merger in January 2001, but with several restrictions (McConnell, 2001).

From Time Warner's point of view, the merger presented a way out of its current problems. Time Warner's existing businesses had all more or less reached maturity, and its Internet efforts had largely failed and produced huge losses (Gunther, 2001). AOL now provided Time Warner with the possibility to vertically integrate the new Internet distribution channels with its traditional media businesses, and exploit its content via an a new high-growth and high-margin distribution outlet. Time Warner had also realized that the Internet would disrupt the traditional business models of the music, television, and publishing enterprises, and the merger with AOL presented a unique opportunity to acquire the knowledge as well as the property-based capabilities to successfully adapt the traditional media segments to the new economics of the Internet.

4.2.3.1. Proposed Synergies

The combined firm forecasted US$1 billion in EBITDA synergies (Blodget, 2000; Merrill Lynch Media Research, 2000). These synergies would be split with a 40:60 spread between revenue enhancement opportunities resulting from cross-selling existing products, and reduced operating expenses. It was expected that the latter would be the first to be realized, resulting immediately from the combination of both companies' assets. It was expected that new revenue opportunities would be generated through advertising sales, increased broadband penetration, subscriptions and new premium AOL services. Cost savings would be obtained through the elimination of duplicated operations such as marketing and customer support, and through the exploitation of cross-promotion of shared assets, including subscription renewals, telecommunications and network costs, and online business development (Blodget, 2000).

---

14 Time Warner retained Pathfinder and Entertainindom, its efforts to encompass its offline content offering, as well as original online content, onto the Internet. Time Warner also co-owned RoadRunner, an ISP aimed at utilizing its cable lines. Yet all of these properties had collapsed under corporate bureaucracy and conflicts of interests, and did not sustain growth on the levels hoped for by Time Warner (BMG Entertainment, HBS Case Study).
In contrast to AOL’s fast-paced and collaborative corporate culture, Time Warner was characterized by its rather slow-moving and decentralized management style. All of Time Warner’s business lines were run as completely independent profit centers, and cooperation had not been demanded and enforced after the two previous mergers with Warner and TBS. Most of the divisions’ CEOs had never even met before they were placed around one table for the merger talks. The potential benefits arising from a culture of cooperation for Time Warner's businesses alone would have been substantial, as cross-promoting would finally be realized between Time Warner's traditional media assets as well (Gunther, 2001). In addition, the combined company would create long-term strategic cooperation possibilities for all of AOL Time Warner's divisions that would go beyond basic cross-marketing and a reduction in operating expenses.

4.2.3.2. Analysis of Benefits Resulting from the Vertical Integration of AOL and Time Warner

First of all, the merger finally allowed AOL to vertically integrate into broadband transmission and pursue its envisaged broadband strategy. AOL now owned access to 20 per cent of US households and 946,000 subscribers with cable broadband access through Time Warners’ RoadRunner service. Combined with AOL's existing DSL subscribers, AOL could now establish itself as one of the dominant players in the high-speed Internet access market. The combined AOL Time Warner also had the potential to develop compelling content for its broadband channels, which, combined with the strength of the Time Warner brand names, seemed certain to attract consumers (Sandobar, 2000).

For Time Warner, the broadcast and cable networks could be promoted on the AOL websites, and in 2001 the WB network showed an impressive increase in revenues after having promoted its stars and shows on AOL (Gunther, 2001).

Concerning the publishing business, Time Inc. had already had considerable success with brand extension in the magazine and books publishing segment. Features from magazines like Southern Living and Sports Illustrated, had been turned into successful books by the division's book publishing arm. With the merger, brands could now be extended and further exploited through the Internet. Fortune magazine accordingly put an extended online version of its magazine on the AOL site, offering additional online financial information services. Sports Illustrated, Money, Time, and People, all offered analogous opportunities. In 2001, AOL had already sold more than 600,000 trial subscriptions to Time Inc.'s magazines, with
many subscribers agreeing to be billed by credit card – a crucial factor to improve renewal rates (Gunther, 2001).

Regarding classical film content, AOL’s MovieFone allowed movie clips to be used as promotional pieces when users would look up a movie. The company could then track information such as which movies generated the most interest and thus develop profiles for individual users. Movie tickets could also be bought and distributed online. Time Warner also realized the online potential for video-on-demand or pay-per-view services for its film content, but an early execution was hindered by the relatively slow uptake of broadband access.

In the music business, AOL Time Warner now owned one of the largest music studios in the world and the potential to develop a platform for digital music delivery was enormous, given that AOL also owned one of the most popular mp3 players "WinAmp". Analysts stated that digital music delivery would significantly lower production, sales and distribution costs, reduce the risk associated with producing individual artists, and allow for direct marketing to individual music buyers (Blodget, 2000). However, due to regulatory reasons, Time Warner had to sell its music business after the merger.

Did AOL capture the formula for a successful, vertically integrated company that harnesses convergence in the Internet and media sectors, or did it simply exit the volatile technology market with its high valuation intact? Interestingly, the new media divisions have been affected most by the revenue downturns and cost cuts, while the traditional media divisions experienced for the most part revenue and margin improvements.

The company's corporate strategy envisaged a lengthy and methodical post-merger process from the outset. The focus was on a gradual symbiosis of content properties with their future digital and broadband channels of distribution (Collis & Montgomery, 1997), which should have realized economies of scale in content distribution as the company built a larger subscriber base to distribute the pre-produced content to (Time Warner Press Release, 2001).

Further vertical power could be exerted through foreclosure of, exclusion from and less preferential access to Time Warner content by other online service providers. Time Warner theoretically has the ability to withhold content, or provide content at disadvantageous terms, to online service providers that are in competition with AOL.

AOL and Time Warner together controlled six of the top fifteen news, information and entertainment digital properties. As the online services market increasingly served consumers
with broadband access, consumers in turn demanded “broadband content”, i.e. music and video content products. Time Warner through the merger controlled the rights to a substantial fraction of broadband content. Its music content rights were deemed by the Federal Communications Commission (FCC) to present a sufficient vertical foreclosure threat, so that a divestiture was ordered. The merger would have created one of the major music distributors in the world. Apart from its strong position in music content, Time Warner owned further premium content in the form of its Warner Brothers film and television studios, and its premium cable networks. Discriminatory pricing of this content could severely disadvantage AOL’s rivals in the online services market because of their dependence on premium content in order to ensure their advertising revenue streams.

4.2.4. Post-Merger Development

In 2001, after positive year end results, AOL Time Warner projected a 25 per cent growth rate per year for the new combined entity. Incremental growth for AOL Time Warner’s cash flow was forecasted with at least 50 per cent per year (Gunther, 2001).

However, things started to look different in 2002, when AOL Time Warner’s share price had fallen from US $73 to US$ 9.95 since the announcement of the merger. As a consequence, Time Warner had to write-off US$54.2 billion to account for the impairment to goodwill on its balance sheet. Another write-off of US$45.5 billion followed, reflecting the loss of value at its various business units. The AOL unit was responsible for the majority of the charge, at about US$33.5 billion, but the cable operations caused US$10.5 billion of the total while the music segment booked US$1.5 billion.

Credit rating agencies were also becoming concerned about Time Warner’s long-term debt level, which had grown from US$22.8 billion to US$28.2 billion in 2002. AOL Time Warner announced to take steps to reduce net debt from about US$25.8 billion at the end of 2002 to below US$20 billion by the end of 2004, through either revenue growth or asset disposals. This target has been accomplished mainly through the disposal of the Warner Music Group, the sale of its 50 per cent interest in the cable channel Comedy Central to Viacom, and the sale of its stake in Hughes Electronics’ satellite broadcasting operations, with Time Warner’s debt level standing at around US$20.7 billion in 2005.

Between 2001 and 2003, AOL lost more than 2.5 million subscribers, and Time Warner acknowledged that dial-up losses would continue. The decrease in U.S. subscriber numbers
was driven by an industry-wide maturing of premium dial-up service business, as consumers migrated to higher-speed broadband and lower cost dial-up services (Gunther, 2001). The subscriber losses were to some extent offset by the “AOL for Broadband” initiative, where AOL subscribers could use their AOL identities while accessing the Internet over a high-speed connection supplied by another company. Nevertheless, advertising revenues continued to decrease, and in 2004 AOL effected a restructuring which eliminated close to 1,000 jobs, in order to align the size of the workforce with AOL’s business outlook (CNET News.com, 2001). AOL announced that it would focus on generating higher margin advertising and search revenues. In 2005, AOL finally abandoned its strategy of creating walled gardens and offered all content for free on the AOL portal, in order to increase user numbers and thus attract higher advertising revenues. In 2004, AOL had acquired Advertising.com, an interactive ad firm, which has now become the main driver of AOL’s advertising revenues which increasingly replace the connection fees it had traditionally relied upon. The first hint of cooperation between Time Warner’s business units was also the announcement that AOL and Time Warner Cable would merge their broadband operations and develop a customized broadband offering for all current subscribers to the two services (Time Warner Inc. Annual Report, 2004).

In 2005, Time Warner set aside a further US$3 billion to settle legal claims over the merger (The Economist, 2005). With a total market capitalization of US$82 billion, Time Warner is still the world's largest media company, but the share price has fallen by a total of 76 per cent since before its merger with AOL. In order to raise further cash to reduce its still enormous debt, Time Warner has successfully established Time Warner Cable as a separately listed entity with a current 16 per cent free float (The Economist, 2005). Once Time Warner has completed its 2005 acquisition of the bankrupt Adelphia cable operator, about half of Time Warner's profits will come from the cable division. However, the costs for the digital upgrades of the cable networks demand heavy capital expenditures, and the cable industry faces new competition from telecommunications and satellite broadcasting companies, with the prospect of a price war possibly ruining profitability for both sides (The Economist, 2005).

4.2.5. Analysis of AOL’s and Time Warner’s Corporate Culture

Time Warner’s corporate culture has always been characterized by a decentralized organizational structure, with each division being operated as an independent profit center.
This is also the reason why no significant synergies were realized after both the acquisition of Warner Communications as well as TBS.

Not surprisingly, AOL’s management, who already had introduced centralized decision-making at AOL, pushed for a change in Time Warner’s corporate culture in order to make the merger work. Pittman, Time Warner’s COO after the merger, began to centralize operations by inducing divisions start by cooperating. Meetings with all division heads were held twice a month, which constituted the first attempt ever to gather the Time Warner’s senior executives regularly around one table. A central email system was introduced, and human resources, public relations, and marketing have been bundled for all divisions. For example, a "Marketing Council" was formed to bridge gaps between the two halves of the company. Time Warner has also introduced several partnerships between traditional media and online businesses since the close of the merger. The company has created new units to explore ways to sell advertisements or develop new businesses using elements from different divisions.

In sum, Time Warner’s overall organizational structure is still characterized by decentralization, and the business units still enjoy considerable autonomy, but several central functions have been successfully introduced in order to facilitate cross-promotion efforts across the group. It remains unlikely that Time Warner will ever be shaped according to the vision of one man, as has been the case for News Corporation, Viacom, and to a lesser extent, Disney under Michael Eisner.

4.2.6. Classification of Time Warner’s M&A Activities According to their Type of Integration

<table>
<thead>
<tr>
<th>Year</th>
<th>Activity / Type of Deal</th>
<th>Value</th>
<th>Type of Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>Time, Inc. merges with Warner Communications</td>
<td>US$7.5bn</td>
<td>Vertical and Horizontal Integration</td>
</tr>
<tr>
<td>1992</td>
<td>Acquisition of Minority interest in American Telecommunications Corporation</td>
<td>US$1.3bn</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1995</td>
<td>Acquisition of Houston Industries Cable Television Network</td>
<td>US$2.3bn</td>
<td>Vertical Integration for Group, Horizontal for Cable Unit</td>
</tr>
<tr>
<td>1996</td>
<td>Time Warner merges with Turner Broadcasting Systems (TBS)</td>
<td>US$7.6bn</td>
<td>Vertical and Horizontal Integration</td>
</tr>
<tr>
<td>1997</td>
<td>Disposal of interest in Hasbro</td>
<td>US$200m</td>
<td>N/A</td>
</tr>
<tr>
<td>1997</td>
<td>Sale of stake in E! Entertainment</td>
<td>US$250m</td>
<td>Horizontal Disintegration</td>
</tr>
<tr>
<td>Year</td>
<td>Activity / Type of Deal</td>
<td>Value</td>
<td>Type of Integration</td>
</tr>
<tr>
<td>------</td>
<td>-------------------------</td>
<td>-----------</td>
<td>--------------------------------------</td>
</tr>
<tr>
<td>1998</td>
<td>AOL acquires Personal Library Software (developer of information indexing and search technologies) and NetChannel, Inc. (web-enhanced television company)</td>
<td>US$46m</td>
<td>Horizontal Integration (content)</td>
</tr>
<tr>
<td>1998</td>
<td>AOL acquires Compuserve Online Services</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1998</td>
<td>Acquisition of Mirabilis (instant communications and chat technology) by AOL</td>
<td>US$287m</td>
<td>Vertical Integration (downstream into technology)</td>
</tr>
<tr>
<td>1998</td>
<td>Disposal of Six Flags Mountain Theme Parks</td>
<td>US$475m</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>1999</td>
<td>Sale of 10% stake in CanalSatellite (satellite television distribution service in France and Monaco) to Canal+</td>
<td>US$97m</td>
<td>Partial Vertical Disintegration</td>
</tr>
<tr>
<td>1999</td>
<td>AOL acquires AtWeb and PersonaLogic, Inc. in an all share transaction</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1999</td>
<td>AOL acquires Tegic in an all share transaction</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1999</td>
<td>AOL acquires Moviefone in an all share transaction</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1999</td>
<td>AOL merges with Netscape in an all share transaction</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1999</td>
<td>AOL acquires Nullsoft and Spinner (Internet music providers) in an all share transaction</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1999</td>
<td>AOL acquires When, Inc. (personalized event directory and calendar services) in an all share transaction</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1999</td>
<td>AOL acquires Shoutcast, WinAmp and DMS</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1999</td>
<td>Sale of Primestar (direct broadcast satellite operations) to DirecTV (Hughes Electronics)</td>
<td>N/A</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2000</td>
<td>AOL acquires Prophead Development</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2000</td>
<td>AOL acquires MapQuest.com</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2000</td>
<td>Sale of UK and Canada book club operations to Bertelsmann</td>
<td>N/A</td>
<td>Horizontal Disintegration</td>
</tr>
<tr>
<td>2000</td>
<td>AOL acquires Time Warner, formation of AOL Time Warner</td>
<td>US$181bn</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2000</td>
<td>Acquisition of Quack.com, a leading provider of technology for enabling Internet voice portals and websites</td>
<td>US$201m</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2000</td>
<td>Acquisition of remaining shares (20%) of Digital City, Inc.</td>
<td>US$80m</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2000</td>
<td>Acquisition of Times Mirror Magazines</td>
<td>N/A</td>
<td>Horizontal Integration in Publishing Content</td>
</tr>
<tr>
<td>2000</td>
<td>Acquisition of iAmaze, Inc. and Local Eyes Corporation (software development companies)</td>
<td>US$76m</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of IPC Media Group Ltd. in the UK</td>
<td>US$1.6bn</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>Year</td>
<td>Activity / Type of Deal</td>
<td>Value</td>
<td>Type of Integration</td>
</tr>
<tr>
<td>------</td>
<td>---------------------------------------------------------------------------------------</td>
<td>---------------</td>
<td>-------------------------------------------</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of Business 2.0</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of eVoice, Inc.</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of Infointeractive, Inc.</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of Obongo, Inc.</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of additional 60% of Synapse Group Inc. (leading US magazine subscription agent). Time Warner already had a 20% stake in Synapse.</td>
<td>US$285m (=60%)</td>
<td>Vertical Integration into Magazine Distribution</td>
</tr>
<tr>
<td>2002</td>
<td>Consolidation of Road Runner Joint Venture, increasing AOL TimeWarner's ownership to 82%</td>
<td>N/A</td>
<td>Vertical Integration (Internet access)</td>
</tr>
<tr>
<td>2002</td>
<td>Repurchase of Bertelsmann's 50% stake in AOL Europe</td>
<td>US$6.45bn</td>
<td>N/A</td>
</tr>
<tr>
<td>2002</td>
<td>Repurchase of AT&amp;T's interest in Time Warner Entertainment</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>2003</td>
<td>Sale of stake in Hughes Electronics (Satellite Broadcasting)</td>
<td>US$800m</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2003</td>
<td>Sale of Time Life Direct Marketing Business</td>
<td>US$312m</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2004</td>
<td>Sale of Investment in Gateway</td>
<td>US$280m</td>
<td>Horizontal Disintegration</td>
</tr>
<tr>
<td>2004</td>
<td>Sale of Viva Media AG and Viva Plus</td>
<td>US$134m</td>
<td>Horizontal Disintegration</td>
</tr>
<tr>
<td>2004</td>
<td>Sale of Atlanta Thrashers and Atlanta Hawks Teams</td>
<td>N/A</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2004</td>
<td>Acquisition of Advertising.com</td>
<td>US$435m</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2004</td>
<td>Disposal of WEA CD and DVD Manufacturing unit</td>
<td>N/A</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2004</td>
<td>Disposal of Warner Music Group</td>
<td>US$2.6bn</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2005</td>
<td>Acquisition of Adelphia Cable Systems together with Comcast</td>
<td>US$12.7bn</td>
<td>Horizontal Expansion of Cable Properties</td>
</tr>
</tbody>
</table>

Table 2: Time Warner: Classification of M&A Activities According to Type of Integration
Source: Own Compilation, Company Annual Reports
4.3. Case Study: The Walt Disney Company

4.3.1. Corporate History:

4.3.1.1. Early Vertical Integration Moves

In 1928, the Disney brothers achieved overnight international success as they introduced their cartoon character Mickey Mouse and produced cartoons with added synchronized sound, something that had never been attempted before. Disney quickly realized that cartoon shorts would not sustain the studio indefinitely. By 1929, Disney decided to vertically integrate into sound production by establishing the Disney Film Recording Company\textsuperscript{15}.

Over the next decades the company was growing fast, and in 1940, Disney decided to go public to finance its expansion strategy. Numerous feature animated and live action films were released and plans to vertically integrate into the theme parks industry were developed\textsuperscript{16}. WED Enterprises and Retlaw Enterprises were privately formed and owned by Walt Disney to monitor, control and design the first Disneyland theme park as well as control all merchandising rights to the Walt Disney name.

The Walt Disney Productions company also vertically integrated into the merchandising industry offering consumers a wide array of character memorabilia.

After the war, the company was in financial difficulties, and Walt Disney decided on further diversification to spread the risk and increase the company's revenue sources. The Walt Disney Music Company was created to exert vertical control upstream over Disney's music copyrights and to recruit further artists. Disney’s next strategic move was again influenced by the desire to own the company’s existing vertical relationships in the distribution segment by

\textsuperscript{15} http://corporate.disney.go.com/corporate/complete_history_1.html

\textsuperscript{16} In 1937, Disney released the world’s first full-length, full-color animated feature with Snow White and the Seven Dwarfs which earned the company an unprecedented amount of Academy Awards. After this success the company scaled up considerably with the employee base growing sevenfold, and a new studio being built in Burbank. The company went public in 1940 to finance its expansion strategy.
establishing Buena Vista Pictures Distribution and ending the 16-year-old distribution agreement with RKO in 1953, a step that extended Disney's vertical integration downstream. By eliminating distribution fees, Disney could save one-third of a film's gross revenues.

The first Disneyland theme park opened its doors in 1954, and its success was immediate. The park had been a risky undertaking for the company as it had heavily indebted itself to build it. Corporate sponsorship was exploited to minimize the cost of upgrading attractions and adding exhibits. To conserve capital, Disney first licensed the food and merchandising concessions to outside contractors. Once the park had generated sufficient revenue, the company brought back all operations within the park. The park's success finally put the company on solid financial footing.

In 1971, Walt Disney World followed, and instantly became the top-grossing park in the world, pulling in US$139 million from nearly 11 million visitors in its first year. Its two on-site resort hotels were the first hotels to be operated by Disney. To generate traffic in the park, Disney opened an in-house travel company to work with travel agencies, airlines and tours. Disney also started bringing live shows like Disney on Ice to all major cities of the world. Disney’s theme park strategy underscores the importance of vertical integration for the company as a means to exert total control not only over the individual segments of the media value chain, but also over the individual value chains of its business units. For example, by owning all elements of the theme park value chain, starting with travel agencies, over food and merchandising, to the accommodation of the parks’ visitors, Disney made sure that all possible revenue streams were channeled into the group without intermediary-related losses.

The next major expansion was Tokyo Disneyland, announced in 1976. Although wholly owned by its Japanese partner due to FDI restrictions, Disney received 10 per cent of the gate receipts, and 5 per cent of other sales together with ongoing consulting fees.

Film output during the years of theme park construction declined substantially and creativity in the film division was limited to sequels. To help stem the decline of its film division in the late 1970s and early 1980s, Disney developed Touchstone Pictures in order to allow the Disney company to venture into new markets and target the adult audiences where revenues where still growing strongly. Touchstone Pictures also allowed Disney to keep their animated films and earlier family-oriented productions separate from this new venture, thus maintaining the innocence and purity in Disney films and products.
From 1980 to 1983, the company's financial performance worsened considerably as Disney was incurring heavy costs in order to finish Walt Disney World’s EPCOT center, which opened in 1982 at double the projected costs. To finance the project, the company had borrowed heavily and had cut spending on the upkeep of Disneyland and Walt Disney World. In addition, park attendance fell to 1974 levels due to rising petrol prices.

Despite its precarious financial situation, Disney further extended its vertical reach by investing in the development of a new cable venture, The Disney Channel, launched in 1983, which allowed the exploitation of Disney content on the additional distribution platform cable television.

But since film division performance remained erratic, no premium content was available to distribute to the various outlets, and earnings continued to stagnate. Disney became a hostile takeover target for corporate raiders until the Bass Group stepped in as a white knight with a US$365 million investment.

Backed by the Bass group, Michael Eisner was named Disney's chairman and chief executive officer in October 1984. Eisner believed in the creation of shareholder value and promised a 20 per cent return on equity while he was in office. The main priority of the new management was to reinvigorate Disney's television and theatrical content businesses. Disney had stopped producing shows for network television in order not to cannibalize demand for the recently launched Disney Channel. But Eisner believed that television network content would create additional demand by highlighting Disney's renewed commitment to quality programming. Disney also decided to vertically integrate into syndication in order to exploit further revenues by licensing the individual film rights of Disney’s by now extensive television content library to independent television stations.

Concerning its theatrical content division, Disney's share of box office had fallen to 4 per cent in 1984, lowest among the major studios. Eisner brought in Jeffrey Katzenberg, who convinced some of Hollywood's best talent to sign multi-deal contracts with Disney. The emphasis was on producing moderately budgeted films rather than big-budget blockbusters. Management held movie budgets to certain target ranges that acted as a financial box within which creative talent had to operate. By 1988, the film division had increased its market share to 19 per cent share of the total U.S. box office, making it the market leader. In addition, Hollywood Pictures was established as the third production studio, and in 1993 Disney acquired Miramax, an independent production studio, for US$80 million. Since then,
Miramax’ profits have increased every year. According to published reports, Miramax is worth an estimated US$3 billion (Lyons, 2003). The merger presented substantial benefits for both sides: Miramax gained guaranteed access to Disney’s national and international distribution network, and Disney could increase its content product diversity by securing content of the type that it lacked in its Disney, Touchstone and Hollywood Pictures output (Lyons, 2003). Through the Miramax acquisition Disney increased movie output from 18 films per year in 1988 to 68 new films in 1994. However, during that time, less than 50 per cent of the films released generated more than US$20m.

In order to exploit the windowing possibilities of its now substantial content library, Disney’s video division Buena Vista Home Video (BVHV) pioneered the "sell-through" approach, marketing videos at low prices for purchase by the consumer (instead of selling primarily to video rental stores at a higher price). BVHV achieved the same market leadership role overseas, with marketing and distribution operations in all major foreign markets.

Disney's animation division was slower to turn around, in part because animated movies took so long to produce. Disney decided to expand its animation staff and digitize the animation process in order to accelerate production.

The only business unit that had so far not realized the full benefits of a full vertical integration strategy in its segment, was the consumer products division. But in 1987, the business unit vertically integrated downstream into retailing by launching the Disney stores. Furthermore, the division entered book, magazine, and record publishing in order to control and proliferate the distribution outlets for Disney’s merchandising products17.

In its theme park division Disney raised attendance prices by US$5 and spent over US$280 million upgrading the parks and adding new attractions. Park operating margins went from 18 per cent to 30 per cent. The next major project was Euro Disney (or Disneyland Resort Paris, as it is called since 2002), which opened in 1992 outside of Paris. Disney only had a 49 per cent ownership stake, but could thus keep its initial investment cost to US$200 million on the US$4.4 billion park. In return for operating Euro Disney, the company received 10 per cent

17 Hollywood Records was founded in 1989 for less than $20m, and in 1990 and 1991 Disney established Disney Press and Hyperion Books. Disney also established new distribution channels through direct-mail and catalogue marketing.
from ticket sales and 5 per cent from merchandise sales, regardless of the profitability of the park.

Further vertical integration of content and distribution was undertaken by entering the theatre industry through the acquisition of the New Amsterdam Theatre in New York, and by introducing stage versions of Disney's most popular animated films.

For the first 10 years of Michael Eisner's reign, annual profits went from US$291 million to US$1.11 billion and Disney’s share price increased 1,300 per cent.

In 1994, Disney’s luck changed again. Katzenberg resigned because of personal conflicts with Michael Eisner, and a number of key executives left with him, leaving Disney’s management incomplete and vulnerable. In addition, several areas of the company were also affected by increasing competition and a general economic downturn.

4.3.1.2. ABC Capital Cities Acquisition

In July 1995, Disney announced its acquisition of Capital Cities/American Broadcasting Corporation (ABC). The strategic rationale of the acquisition was to extend its forward or downstream vertical integration by adding critical television distribution outlets for Disney’s content. At the same time, the acquisition provided valuable horizontal integration of ABC’s television content library. Access to one of the U.S.’ major television networks also allowed Disney to get direct access to its audiences, thus enabling it to collect valuable information about its viewers, which meant an improved responsiveness to its audiences’ wants and preferences, which would eventually improve profit margins. The merger was essentially a method to get rid of the distribution bottleneck in reaching its audiences directly and would give it control over an expansive area of entertainment ranging from family programming to sports broadcasting.

The acquisition made Disney the largest entertainment company in the U.S. and provided it with worldwide distribution outlets for its creative content. ABC included the ABC Television Network, 10 television stations, cable stations such as ESPN and ESPN2, several newspapers, and over 100 periodicals.

Integrating the two companies would also lead to significant economies of scale. Overlapping jobs in research, casting, marketing, and advertising were combined and branding names were distributed between the companies in order to make them more familiar with the
audiences of both companies. Financially, fixed production costs could now be amortized, which Disney had so far been unable to do because of the unreliability of distribution. Disney also aimed to reduce the costs of using outside television content aggregators who until then had served as intermediaries between Disney and its television audience. Fees to all outside distribution partners were curtailed, resulting in substantially lower transaction costs for its distribution operations. The bottom-line was Disney's desire to reduce costs by achieving a more cost-efficient internal transfer price. This would also benefit ABC’s revenue margins as this would create substantial savings in content acquisition cost for the network.

4.3.1.3. Post-Acquisition Difficulties

Despite the synergy euphoria after the acquisition, Disney's financial performance began to deteriorate in the late 1990s, especially since the performance of the ABC network had fallen from first to third place in 1997\textsuperscript{18}. In 1997, Disney's net income stood at a high of almost US$2 billion, but one year later income declined to US$1.8 billion which initiated a five year downward slide with equally disastrous effects on Disney’s share price. Revenue growth returned in 2000, but profitability was still hurt by rising content acquisition costs, especially for sports rights that were of prime importance for Disney’s ESPN Channel.

In the area of non-animated films Disney's approach had radically changed since 1994. Joe Roth, Jeffrey Katzenberg's successor, was forced to scale back the film budgets after several costly box-office failures. The cost of producing animated films had also risen rapidly in the 1990s. Moreover, the most successful animated movies had in the last years been created by Pixar, with which Disney had a five-film distribution deal. To make computer-generated imagery films like Pixar, Disney invested in a US$70 million digital studio, which has yet to prove its worth. Outside of its work with Pixar, Disney's movies showed continuous poor performance at the box-office. Disney's home video division had been a major growth driver during the 1990s, but by 1999 revenues were falling due to a lack of new premium content. Disney hoped to counteract this trend with the introduction of the DVD as consumers switched from VCRs to DVD players and would repurchase the classic Disney films on

\textsuperscript{18} Wall Street Journal, 04/08/1995, p. A8
Overall net income decreased to US$920 million in 2000, which was half the 1997 level.

In 2001, Disney acquired Fox Family Worldwide for US$5.3 billion from News Corporation and Saban Entertainment, and renamed it ABC Family (Disney Press Release, 2001). The cable television properties inherent with the purchase distributed Disney's content to a further 81 million cable and satellite television subscribers in the U.S., and extended Disney's presence in European and Latin American markets.

When the network failed to perform, the press concluded that Disney had severely overpaid. A worldwide recession and the terrorist attack of September 11, 2001 severely affected the entertainment industry in general and Disney’s theme-park attendance figures in particular. The company posted a US$158 million loss and Disney’s share price was back at its 1995 level.

Even though Disney returned to profitability in 2002, the majority of its theatrical content continued to fail at the box office and retail stores were struggling. Disney again relied on Pixar’s successful “Finding Nemo” which generated US$400 million in profits for Disney.

Disney also made a major attempt to establish its presence in the Internet, with mixed results. The first large scale entry into the online world commenced in 1998/1999 with the acquisition of the search engine Infoseek, and a new entity was created which bundled all of Disney's web sites in one portal, called Go.com. Go.com never reached profitability and was shut down in 2002 with high operating losses. Apparently, Disney's strategy regarding the Go.com portal was inconsistent and information was being siphoned off to other sites like Disney.com, ABC.com, or ESPN.com, thus hindering the establishment of a broad and loyal user base.

The Internet setbacks and the general disappointing performance of the Disney Corporation forced management in 2002 to introduce effective cost cutting measures and undertake further restructuring. First of all, Disney renegotiated the value of deals made with film producers, and further trimmed its film budgets. Secondly, the company consolidated purchasing actions for the theme parks and cut about 4,000 jobs. These cost savings were so effective that Disney could significantly reduce the expected decreases in revenues and

---

19 Wall Street Journal, 27 March 2000
operating income for 2002. After the restructuring of the consumer products division, which led to the closing of about one third of the Disney store locations, and by substituting these locations with contractual arrangements with the big retailing chains, the consumer products segment showed an increase in revenues of 7 per cent to US$840 million. The reduction of Disney’s retailing presence constitutes a partial vertical disintegration of parts of the consumer products operations. Full vertical integration in this segment was replaced with a mix of full and quasi vertical integration, through continued ownership of the remaining two thirds of the Disney stores, while the contractual relationships with the major retailers present a quasi integration. The benefits of this combined strategy have yet to be evaluated.

4.3.1.4. Disney’s Development Post Eisner

As the company struggled, the board came under increased scrutiny. Questions were raised about the independence and the qualifications of the board members, who were all friends and acquaintances of Michael Eisner. Already in 1999, Disney's board was listed at the bottom of Business Week's annual list of the worst boards in America (Byrne, 2000). By 2002, Stanley Gold and Roy E. Disney (nephew of Walt Disney) had initiated an internal campaign on the board to replace Eisner, but the majority of directors continued to support their CEO. While Gold and Disney waged their battle behind the scenes, the press also noted problems with Disney's leadership. The Corporate Library, which rates boards on behalf of institutional investors, gave Disney's board a grade of F and ranked it as one of the ten worst of 1,800 American public companies (Gunther, 2003).

In January 2004, Disney ended its relationship with Pixar after unsuccessful negotiations over an extension of the output deal. The negative publicity was enormous, and less than four weeks later Comcast announced a US$48 billion hostile takeover bid for Disney in order to expand into content. But the same day the Comcast bid was made public, Disney released very positive results for the first quarter of 2004 showing improved performances in all business segments. A large part of this revenue increase was due to DVD and video sales of the films "Finding Nemo" and "Pirates of the Caribbean" (Annual Report, 2004; Hernandez, 2004). Disney's share price accordingly increased to US$28, up from a low of US$15 in September 2002 (Bloomberg Database, 5 February 2007). So less than a week after the Comcast offer, Disney's board officially rejected the bid.
However, Roy E. Disney and Stanley Gold continued with their now officially named SaveDisney.com campaign, and in February 2004, the records of a shareholder lawsuit pertaining to the US$140 million severance package of former Disney president Michael Ovitz were unsealed. As a consequence, several of Disney's biggest institutional shareholders announced that they would withhold support from the board (Henderson, 2004). At the next shareholder meeting, 43 per cent of shareholders withheld their votes for Eisner's reelection to the board and Michael Eisner put in his letter of resignation in September 2004.

Disney continued to improve its performance in 2004, with growing revenues in all business segments. Revenues in the television and cable broadcasting operations increased due to improved advertising revenues created by ABC’s strengthened ratings and lower rights acquisition costs (Disney Annual Report, 2004). Concerning the acquisition of further television stations to strengthen ABC's existing network, in contrast to its rival media conglomerates, Disney stayed inactive, although the ABC network consists of just 10 owned-and-operated broadcast affiliates, compared with 34 at Viacom and 33 at Fox. Disney does not have a single market "duopoly," a newly permitted arrangement involving the operation of two stations in certain single markets, although financial markets value the cost efficiencies to media groups from such duopolies very highly. In 2003, Viacom already had nine and Fox Television eight (Diorio, 2003). Alternatively, Disney has invested even more heavily than its media rivals in cable webs, including US$5.3 billion purchase of ABC Family from Fox in 2001.

After its failed Internet initiatives of the late 1990s, Disney had for the most part been a mainstay of the old-media world, with capital-intensive assets such as theme parks, radio stations, and consumer products, and little ambition to enter the digital age.

This has changed with the acquisition of Pixar Entertainment for US$7.4 billion in an all share deal, thus securing Pixar’s output for Disney distribution networks. Since the CEO of Pixar, Steve Jobs, is also the Chairman of Apple, Disney negotiated a deal where Disney-produced movies and television shows would be available in Apple’s iTunes store (Grover, 2006b). Disney also negotiated a deal with Comcast to stream several premium shows of its television content to Comcast’s video-on-demand customers. This agreement gives Disney access to more than 24 million Comcast television subscribers and another 11 million high-speed Internet customers (Grover, 2006b). The consumer-product unit is also venturing online by undertaking further vertical integration into new media areas like computer games (Grover, 2006a).
Hong Kong Disneyland was opened in September 2004, and the theme park strategy of combining park visits with family holidays has started to pay off. But although Disney's parks and resorts unit has operations "with a scale and scope unmatched by anybody in the industry", margins are becoming increasingly thin (Diorio, 2003). The same is true for Disney’s radio stations, which will be sold in the near future.

4.3.2. Summary of Disney’s Corporate Strategy

Disney’s core competencies involve drawing upon new and classic entertainment brands through its film studios and content library, and exploiting them through ancillary assets. Animated films are an ideal product for the global media market. There are no royalties to pay stars, large cross-selling and cross-promotional possibilities exist, they are easily translated into any foreign language, and do not suffer from the need to be adapted to cultural differences.

An aggressive competitor in the traditional media markets, Disney’s ambitions now involve extending its brands into the new media distribution channels.

<table>
<thead>
<tr>
<th>Generic Strategy</th>
<th>Strategic Behaviour</th>
<th>Growth Strategy</th>
<th>Internationalisation Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disney</td>
<td>Differentation</td>
<td>Innovative</td>
<td>Globally Unified Products</td>
</tr>
</tbody>
</table>

Table 3: Disney: Overview Corporate Strategy

Source: Own Illustration

4.3.2.1. Analysis of Disney’s Vertical Integration Strategy

In general, Disney has been the first media conglomerate to implement a strategy of extensive vertical integration not with the help of acquisitions, but through mostly organic growth\(^{20}\) (Disney Annual Report, 2005).

Disney's significant yet limited M&A history nevertheless provides an indication of how the firm has strategically adjusted to major industry changes where organic growth would have

\(^{20}\) According to Disney Vice Chairman Roy Disney, the acquisition of Cap. Cities/ABC was the only major acquisition in eleven years of leadership under CEO Michael Eisner. (www.Disney.go.com, Investor Relations, 1995 Capital Cities/ABC section).
provided too slow a reaction. The firm had primarily grown and gained market share through leveraging its internal content resources on the traditional distribution platforms (e.g. home video and cable television) and through organic growth in new markets such as consumer products (Collis & Montgomery, 1997). For example, Disney’s business segment theme parks has only seen internal growth, while segments like Disney’s television and cable broadcasting operations had to be brought in through external acquisitions (Sjurts, 1999). In the late 1980s, after the relaxation of the Financial Interest and Syndication Rules ("Fin-Syn Rules"), which had barred TV and feature film producers from owning distribution outlets and vice versa, television networks integrated upstream to secure their own content supplies, keep price control over content, and establish product-specific economies of scale. In turn, feeling threatened by the potential loss of network content acquisition activity, some of the studios either launched their own or acquired other broadcast networks to secure distribution channels for their content. Disney was the first to execute a downstream or forward vertical integration strategy and acquire a television network of its own, thus joining the value chain segments of content production and content distribution. Eisner knew that content was key, but in order to become increasingly profitable, the company had to create superb content and retain the right to distribute it. This strategy provided an additional area where high value could be captured. Under Eisner, Disney changed its focus from a primarily content creator to a creator and distributor. He moved the company further along the value chain –closer to the end-consumer– to capture more profit, taking control of the channels through which Disney products flowed.

The underlying motive of the ABC/Capital Cities acquisition was to vertically integrate forward by adding the critical television distribution outlet for Disney’s theatrical content studios while also performing horizontal integration by collecting ABC’s content assets into its own asset pool. With the ABC acquisition came multiple television and radio stations in leading American media markets and a major sports-cable network (ESPN) (Disney Annual Report, 1995). This move was mutually reinforcing, and allowed Disney to move closer to the end-consumer. Furthermore, the strategic assets of brand, content and scaled reach were merged and thus provided a sustainable competitive advantage over rivals.

With the acquisition of Fox Family from News Corporation in 2001, Disney’s aim was to increase its market penetration in the cable television market. The cable television properties inherent with the acquisition took Disney’s content to a further 80 million cable and satellite subscribers in the U.S., and deepened Disney’s presence in Europe and Latin America. The
combined new channel was able to leverage content costs across multiple platforms, gain scale as well as realize internal synergies (Dixon, 2001). The new cable assets also provided a valuable platform for new advertising revenues at the cable network level, while also increasing affiliate fees to offset any potential advertising downturns (Dixon, 2001).

4.3.2.2. Analysis of Disney’s Corporate Culture

Disney is so far the only media conglomerate that operates a synergy group, with representatives in each business unit. The group's purpose is to "maximize synergy throughout the company, serve as a liaison to all areas, and keep all businesses informed of significant and potentially synergistic company projects and marketing strategies"21.

Divisions file monthly operating reports in which they are expected to discuss new cross-divisional projects. Larger bonuses are awarded to those who are most committed to synergy and who have established synergistic connections between divisions22.

As the business units expanded under Eisner’s leadership, overlaps among them emerged. Like other vertically integrated companies, Disney employed negotiated internal transfer prices for any activity performed by one division for another. In 1987, a corporate marketing function was installed to stimulate and coordinate company-wide marketing activities. Management also jointly coordinated important events like Mickey's 60th birthday in 1988. A meeting of all divisions generated ideas and coordinated schedules, and build commitment and cohesion among the different divisions.

4.3.2.2.1. Synergies from Economies of Scale and Scope

In Disney's case, synergies have increased revenues through either cross-promotion efforts and or through the realization of economies of scale and scope in production, thus lowering operating expenses. A prime example for synergies from cross-promotion is Disney's leverage of animated content investments across divisions. In the year before the movie's official release, creators from Disney animation present their film to the heads of consumer

---

21 Source: http://corporate.disney.go.com/corporate

22 Ibid.
products, home video, and theme parks. Participants then brainstorm on product options and reconvene monthly to update one another. Once divisions have their strategies in place, Disney approaches the licensing partners for cross-merchandising. Thus each animated film functions as its own mini-industry.

Synergy also affects the cost side. For example, in 1999, Touchstone Television was merged into a division of ABC to save an estimated US$50 million a year and increase cooperation (Disney Annual Report, 1999).

However, synergy also had its limits. For example, the effectiveness of cross-promotion was decreasing by 1999. Royalty rates from licensees of toys and other merchandising products have been decreasing, and Disney decided to reduce the number of its licensed products by half, after it had sought throughout the early 1990s to build market share by signing as many licensees as possible. As part of this strategy, Disney decided to place less emphasis on merchandise tied to the latest films and more emphasis on products featuring the core characters like Mickey Mouse, Winnie the Pooh, and others (1999, Disney Annual Report, 1999).

4.3.2.2.2. Synergies from Geographic Integration

In 1999, Disney still only generated about 21 per cent of its revenues from abroad, and Eisner calculated that if Disney could drive per capita spending levels on Disney merchandise in Britain, Italy, France, Germany and Japan to 80 per cent of the U.S. level, US$2 billion per year would be created in incremental annual revenue (Germain, 1999). Disney also aimed to better integrate its overseas operations and consolidated the foreign offices under regional executives. This allowed further cost reductions through coordinated advertising and cross-promotion. The ambition to increase Disney’s foreign sales has, however, remained unachieved, since the percentage of international revenues still stands at only 22.3 per cent in 2005 (Disney Annual Report, 2005).

23 The percentage of international revenues still stands at only 22.3 per cent in 2005 (Disney Annual Report, 2005)
4.3.2.2.3. Synergies from Vertical Integration

Almost all of Disney’s forays into new distribution markets for its content products can be classified as vertical integration moves. Major initiatives were of course the acquisitions of broadcast and cable television operations. Disney also early on realized the potential of the Internet as a further distribution channel for its brands and its theatrical and television content libraries. However, Disney's distribution status with regard to the Internet still represents its main weakness in its strategy towards digital convergence. The company, although having a diversified Internet presence and global content properties, does not retain a gatekeeper status for any platform that allows for digital content transmission. Threats include competitors such as Time Warner and ComCast, who could secure bargaining advantages over Disney's products through the cable and satellite ends of the media distribution value chain, should Disney not secure its own integrated broadband operations.

This is especially relevant for the provision of video-on-demand services. The popularity of its content grants Disney some bargaining advantages via cable operators who own the downstream channels for video-on-demand. A longer-term, and more expensive strategy would involve acquiring or merging with a cable provider and effectuating further downstream vertical integration. In acquiring a digital content buyer, Disney would be performing a strategy analogous to its purchase of Capital Cities/ABC. Cable operators are increasingly resembling the broadcast networks of the 1990s and threatening the distribution access to Disney's products through their channels\(^24\).

4.3.3. Classification of Disney’s M&A Activities According to their Type of Integration

<table>
<thead>
<tr>
<th>Year</th>
<th>Activity / Type of Deal</th>
<th>Value</th>
<th>Type of Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>Acquisition of Pixar Animation Studios</td>
<td>US$7.4bn</td>
<td>Horizontal Integration (content extension)</td>
</tr>
<tr>
<td>2004</td>
<td>Acquisition of film library and intellectual property rights for the Muppets</td>
<td>US$68m</td>
<td>Horizontal integration of further content</td>
</tr>
</tbody>
</table>

\(^{24}\) By raising the prices of rights to its ESPN channels for cable operators by 20% each year for four consecutive years since 1998, Disney upset cable operators such as Comcast. Comcast has by now retaliated by making a hostile takeover bid for the whole Disney Corporation. Sources: Water, Richard: "Broadband communications go back to the future.", FT.com, 18 July 2001.
<table>
<thead>
<tr>
<th>Year</th>
<th>Activity / Type of Deal</th>
<th>Value</th>
<th>Type of Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>Sale of Disney Stores in North America</td>
<td>US$650</td>
<td>Vertical Disintegration (out of Retailing)</td>
</tr>
<tr>
<td>2003</td>
<td>Sale of the Anaheim Angels Baseball Team</td>
<td>US$16m</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2002</td>
<td>Sale of remaining shares in Knight-Ridder publishing</td>
<td>US$601m</td>
<td>Horizontal Disintegration</td>
</tr>
<tr>
<td>2002</td>
<td>Sale of Disney Stores in Japan</td>
<td>N/A</td>
<td>Vertical Disintegration (Out of Retailing)</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of Fox Family Worldwide (now called ABC Family, includes the Fox Family Channel (cable and satellite subscriptions) and 75% of Fox Kids Europe (also cable subscriptions))</td>
<td>US$5.2 bn</td>
<td>Vertical and Horizontal Integration</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of the rights to the Baby Einstein product range</td>
<td>US$25m</td>
<td>Horizontal Integration of Content</td>
</tr>
<tr>
<td>2000</td>
<td>Sale of Eurosport</td>
<td>US$93</td>
<td>Horizontal Disintegration (Pay Cable Channels)</td>
</tr>
<tr>
<td>2000</td>
<td>Sale of Ultraceek Corporation</td>
<td>US$153m</td>
<td>Vertical Disintegration (Internet)</td>
</tr>
<tr>
<td>1999</td>
<td>Sale of Fairchild Publications (acquired with ABC Inc.)</td>
<td>US$243m</td>
<td>Horizontal Disintegration (Publishing)</td>
</tr>
<tr>
<td>1999</td>
<td>Acquisition of Infoseek (internet)</td>
<td>US$815m</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1999</td>
<td>Sale of Starwave Corporation to Infoseek against Infoseek shares</td>
<td>US$345m</td>
<td>See above</td>
</tr>
<tr>
<td>1997</td>
<td>Acquisition of Starwave (internet technology)</td>
<td>N/A</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1997</td>
<td>Sale of ABC's publishing businesses</td>
<td>US$2.86bn</td>
<td>Horizontal Disintegration</td>
</tr>
<tr>
<td>1997</td>
<td>Sale of KCAL (LA radio station)</td>
<td>US$387m</td>
<td>Horizontal Disintegration</td>
</tr>
<tr>
<td>1995</td>
<td>Acquisition of Capital Cities/ABC</td>
<td>US$18.9bn</td>
<td>Vertical Downstream Integration</td>
</tr>
</tbody>
</table>

Table 4: Classification of M&A Activities According To Type of Integration

Source: Own Compilation, Company Annual Reports
4.4. Case Study: News Corporation

4.4.1. Corporate History: News Corporation

4.4.1.1. From Print to Television: Early Vertical Integration Moves

The foundation of Rupert Murdoch’s News Corporation can be traced back to the print industries, and more specifically, the newspaper business. The profitability of his two Australian newspapers\footnote{In 1952, Rupert Murdoch took over the Australian newspaper "Adelaide News" from his father. Two years later, owing to financial difficulties, the other dominant Adelaide newspaper, the "Adelaide Advertiser" agreed to merge with News under Murdoch's leadership} allowed him to acquire the two British tabloids “News of the World” and the “Daily Herald”, the latter of which would be relaunched as the “Sun”.

Both acquisitions soon resulted in leaner cost structures and more politically outspoken editorials. In 1981, Murdoch bought "The Times", and the "Sunday Times" of London, two of Britain's most respected newspapers. By 1985, the Times commanded a 30 per cent market share and the Sunday Times had become the world's largest selling Sunday newspaper. Nevertheless, Murdoch's London newspapers were still struggling financially, mostly due to increasing demands from British print unions. His response was to bundle printing operations for all papers in one new factory, which allowed him to reduce the number of print workers from over 2,000 to 570, and the number of packers from 1,469 to 132. News Corporation’s U.K. profits increased by 85 per cent as a result (Shawcross, 1997). During the early 1980s the U.K. publishing operations were the major contributor to News Corporation’s profits.

Murdoch was convinced that a global media business had to have a strong presence in the United States, so in the 1970s, backed by the strong cash flows of the English papers, he acquired three financially week newspapers in Texas and, three years later, the struggling New York Post. By 1983, each of Murdoch's newspapers in the United States was earning significant profits (Shawcross, 1997).
News Corporation continued to acquire struggling newspapers in different countries and turn them around. By 1988, News International had become the world’s largest English-language newspaper publisher and realized significant synergies from these operations by sharing knowledge, ideas, computer systems, and press purchasing across the newspaper businesses in different countries.

In the late 1980s and early 1990s Murdoch decided to expand News Corporation’s operative radius by vertically integrating into consumer magazines and book publishing. He acquired the Triangle Group\textsuperscript{26}, Harper & Row, the William Morrow Company, Avon Books, Amistad Press, and Fourth Estate, thus making News one of the largest integrated newspaper, magazine and book publishers.

In general, the 1980s saw News Corporation accelerate its development. The company was among the earliest movers in the modern media vertical integration game. By the early 1980s, entertainment had become the second-largest export sector in the United States, and Murdoch saw entertainment as one of the truly global industries (Shawcross, 1997). After an unsuccessful attempt to purchase Warner Communications, News Corporation finally managed to acquire Twentieth Century Fox for US$575 million in 1985\textsuperscript{27}. This acquisition can be classified as a backward or upstream vertical integration, where the downstream publisher acquires an upstream content producer in order to generate entertainment products which could potentially be promoted by the publishing arm.

Since cross-promotion opportunities between theatrical and television content were rather limited, News Corporation in the same year further extended its vertical reach by acquiring Metromedia, a chain of independent television stations based in seven major metropolitan markets in the United States\textsuperscript{28}. The ambitious aim of the acquisition was to, firstly, launch a fourth broadcast television network to compete with ABC, CBS, and NBC, and, secondly, [insert footnote text here]

\textsuperscript{26} The Triangle Group published the magazine “TV Guide” which had a 20 per cent share of the magazine market and other popular magazines like Seventeen, Good Food and Racing Form.

\textsuperscript{27} Murdoch believed that the studio's library which included hits like "The Sound of Music" and "Star Wars", was itself worth more than the market valuation of the studio (Edmonds, 1993).

\textsuperscript{28} FCC regulations prevented any non-U.S. citizen from owning more than 25 per cent of U.S. television stations. In 1983, Murdoch therefore became a U.S. citizen, and sold the New York Post to satisfy FCC restrictions on cross-ownership of television stations and newspapers in the same town. Ten years later, the FCC would allow Murdoch to repurchase the New York Post after the paper was about to close down due to inefficient management.
create a distribution outlet for the content created by the Twentieth Century Fox studio (Shawcross, 1997). Murdoch had realized that, unlike newspapers, television content could become more profitable with age as capital expenses decreased and syndication revenue increased. The Metromedia acquisition constitutes a forward vertical integration of content production into distribution.

The Fox Television Network, created out of the Metromedia stations, was launched in 1986 with Barry Diller as chief executive, and gradually developed its own distinct style as programmers realized that they had to attract young viewers which so far had no allegiance to the established “Big Three” networks. With this purchase, News Corporation also became the first company to integrate newspaper assets with television operations.

The increased debt involved with the above described acquisitions was of such magnitude that Murdoch was obliged, in 1988, to commit News Corporation to a significant debt reduction programme following a little reported financial crisis that was only overcome by Murdoch guaranteeing the company with his own personal wealth (Chenoweth, 2001). This commitment, however, did not restrain the company from further expansion.

4.4.1.2. News Corporation’s Entry into Satellite Broadcasting

Murdoch’s next vertical move was into satellite broadcasting. Commercial satellites presented cost efficiency and scale benefits over terrestrial and cable television, which required large sunk investments in infrastructure to establish the hard- and software necessary for television signal transmission. By contrast, satellite transmission initially required renting relay devices on communications satellites (“transponders”) at a fraction of the cost of setting up other hardware (Edmonds, 1993).

In 1983, News Corp. had already spent US$75 million to purchase a stake in Inter-American Satellite Television Inc., a company that leased five transponders from a private communications satellite (Shawcross, 1997). Due to a lack of attractive channels the venture had to be closed down with significant losses for News Corporation. Undeterred by the first failure, Murdoch bought a controlling interest in Sky Television, a pan-European channel that

---

29 By 1990, 49 per cent of Fox’s audience was between 12 and 34 years old, compared with 37 per cent for ABC, 31 per cent for NBC, and 25 per cent for CBS (Shawcross, 1997)
broadcast common programmes to several countries across continental Europe. By 1987, Murdoch had spent £40 million on Sky Television, yet the platform struggled as demand for advertising remained sluggish due to a lack of pan-European brands (Shawcross, 1997). Murdoch decided to move the channel onto the Luxembourg-based Astra satellite so that it could be beamed into the United Kingdom, and launched a four-channel satellite service called Sky in 1989 (Shawcross, 1997). Sky in the U.K. was in direct competition with a second direct-to-home satellite service, British Satellite Broadcasting (BSB), and competition between the two platforms became intense. With the British economy going into recession from 1990 onwards, demand continued to emerge slowly for both platforms. By the end of 1990, Sky and BSB were each losing over £2 million per week. Seeking to differentiate their movie and sports channels, both platforms bid aggressively for content rights, driving content prices up even further. Neither side, however, could afford a war of attrition, and in 1991 they merged into a News Corporation dominated company called British Sky Broadcasting. Thus, BSkyB had effectively established a monopoly position in the U.K., with high barriers to entry due to the spiraling content prices.

BSkyB remained the U.K.’s sole satellite provider, and maintained this gatekeeper position until 1997 (Spar, 1998). With improved technical features for tracking subscriber data and customized pay-per-view options, BSkyB locked in customers, built scaled growth and gained a competitive edge by positioning itself early for the introduction of digital TV since the set-top-boxes that enabled any sort of digital television reception for consumers were under the control of News Corporation’s subsidiary DataCom.

Consequently, BSkyB continued to require enormous investments from its partners to grow its subscriber base, and the cash drain combined with a weak global economy nearly drove News Corporation into bankruptcy. Stagnating newspaper sales, a still-struggling television network in the United States, and Murdoch’s refusal to fund expansion through share issues in order to preserve his family’s 45 per cent shareholding, resulted in News Corporation

---

30 The high content prices did not affect BSkyB as it had negotiated exclusive long-term licensing agreements to distribute content with the leading Hollywood studios. In 1992, BSkyB acquired for US$465 million, the exclusive broadcasting rights of the Premier League soccer games, and almost one million viewers subscribed to BSkyB immediately. Revenues rose accordingly, and in 1993 BSkyB reached operating profit break-even.

31 By 1997 25% of British homes subscribed to Sky, which gave Sky a market share in the pay-TV market of approximately 85 per cent (Shawcross, 1997)
becoming unable to service its short-term debt of US$2.3 billion in 1991. News Corporation's market value had fallen to one-fifth of its 1990 net asset value, while borrowings rose to five time stock market capitalization (Shawcross, 1997). However, Murdoch, with the backing of Citibank, managed to convince all 146 of his debtor banks to sign new agreements that would cover US$7.6 billion of short- and medium-term debt (Shawcross, 1997).

In 1998, BSkyB was the first pay-TV operation in the world to go digital. Since competition from cable operators and digital terrestrial television had increased, and especially as cable operators increasingly tried to leverage their "triple play" offerings (Internet, telephony and cable television), BSkyB reacted by offering a variety of interactive television services that exploited the technological capabilities of digital technology. Combined with aggressive marketing efforts, BSkyB could count 5 million customers by 2001, compared to 1.5 million for ITV (digital terrestrial television), and 1 million for cable competitors.

BSkyB's success engendered enormous respect among media industry executives for Rupert Murdoch's strategic insight and management skills. By the late 1990s, News Corporation had replicated its U.K. experience and emerged as the dominant platform in Asia, through an investment in the incumbent Star Television, and in Australia, through a joint venture with the leading Australian telephone company. Nonetheless, in 2001, all News Corporation’s satellite operations were losing money.

Murdoch's plans to own or establish a satellite platform in the U.S., the idea of which he harbored since 1983, became reality in 2000, when News Corporation offered US$22 billion for a 35 per cent stake in DirecTV. But negotiations proceeded slowly and were hampered

---

32 The acquisition of a 64 per cent ownership stake in Star TV first of all brought more problems than successes. Restrictions on foreign ownership hindered growth in several markets, and Star's pan-Asian English-language programming strategy failed completely. By 1996, Star had lost US$100 million. By 1999, however, due to the localization of content, Star India and Star Taiwan were both leading the ratings, and Star's joint venture channel in China (Phoenix) was profitable by 2000 while its own main Chinese channel was also becoming more and more successful.

33 BSkyB was losing money due to the large up-front costs it had incurred when upgrading its services to interactive standards, and StarTV had consumed US$1 billion in the eight years since News Corporation had bought it. The Latin American satellite properties were also unprofitable (News Corporation Annual Report, 2001).

34 DirecTV was the first entertainment service in the U.S. to deliver all digital, multi-channel television programming via satellite, and thus provided an attractive alternative to cable for viewers.
by a 25 per cent decline in the stock of Hughes Electronics (DirecTV's parent company) in February 2001. News Corporation then reduced its bid for a 30 per cent stake, and in August 2001 lost out to Echostar who had put in a rival offer of US$32.3 billion which was accepted by Hughes. Murdoch began to lobby intensely and succeeded in having the merger blocked on antitrust grounds. Finally in April 2003, News Corporation acquired General Motor's 19.9 per cent stake in Hughes Electronics and a further 14.1 per cent stake from public shareholders and institutional investors thus effectively taking control of Hughes Electronics and its subsidiary DirecTV.

The transaction presents both a “vertical” integration of assets because of the association of DirecTV’s distribution platform and News Corporation’s content assets as well as a horizontal integration concerning the expansionary characteristics this acquisition has for News Corporation’s existing satellite assets. The DirecTV deal ensures even wider distribution for the conglomerate’s movies, news, sports, and original television content. "We are going to see a landslide of Murdoch content produced for DirecTV and his global satellite network, and it will just blow everybody else away" (Fallows, 2003).

Additionally, News Corporation had a 38.5 per cent ownership stake in the leading interactive TV channel guide service Gemstar-TV Guide, a property that would present technical synergies with DirecTV's integrated personal video recording capabilities and its interactive programming guide (Hayes, 2001). Satellite subscriber could be presented with advanced interactive, digital and content storage functions while News Corporation could track transaction revenues from its subscriber base. In addition, the Gemstar interactive programming guide could lead DirecTV subscribers to News Corporation’s Fox television and cable channels. These features should be advantageous to lure customers away from cable operators and lock them in until comparable services have been developed by the cable companies. In addition, News Corporation expected significant synergies between the U.S. satellite business and its global operations. These synergies are part technology-related, for example by sharing security software or electronic programme guides, and part content-related, as for the example the combined bidding for global sports rights.

However, it looks as if satellite might be losing its competitive advantage in the near future. Its most immediate challenge comes from the cable industry, which has invested heavily in its infrastructure and now offers integrated service bundles of digital television, broadband and voice service. At the moment, satellite cannot offer this "triple-play" option: it has only television. Neither can it sell as full a video-on-demand service, because it beams the same
television signal across whole regions. In Britain and Italy satellite also competes with attractive free digital-terrestrial television services.

In response, News Corporation is in the process of adding broadband and voice to its satellite-television products around the world. In Britain, BSkyB bought Easynet, a broadband internet-access company, for US$385 million in 2005. News Corporation is also working on a way to add broadband to DirecTV's portfolio, and expects to announce a solution in the near future (The Economist, 2006).

4.4.1.3. Vertical Integration of Television Broadcasting

In 1995, the publishing businesses still provided more than half of News Corporation's profits. Newspaper businesses in the U.K. and Australia benefited from cost-cutting and rationalization initiatives.

In order to aid the still struggling Fox Television Network, Murdoch managed to acquire the exclusive broadcasting rights to the National Football League (NFL) in 1993 for US$1.6 billion. By acquiring premium sports rights for his television network, Murdoch essentially followed the same content strategy as for BSkyB, using sports programming to access new markets. The NFL rights forced cable operators to air the Fox channels and thus helped establish Fox as a brand among television audiences. All through the 1990s, Fox Television launched new channels like the FX channel and Fox Sports (News Corporation Annual Report, 2001). The Fox Sports cable channel was launched in 1997 following the acquisition of 21 local and regional sports channels. In contrast with Disney's ESPN national sports programming strategy, Fox sports programming was on a local as well as a national level with sports coverage tailored to each local market. In 1999, Fox Sports acquired the television rights to the NASCAR motor racing series, which was by that time the second-most popular viewing sport in the United States. The television package was split amongst various cable channels of Fox, with the top races aired on Fox Sports and the lower series on FX, Speed Channel, and Fox Sports Net. Having multiple channels allowed each one to minimize overhead, and often a single sales team could manage several Fox channels, enabling superior leverage with advertisers. Every channel was nonetheless responsible for its own content costs and profitability.

Fox News was launched in 1996, amidst several failed attempts by other media companies like Disney's ABC network. Murdoch's intent was to have the channel launched within six
months, with less than two-thirds the staff of comparable news operations at NBC and CNN, and with one-third the budgets of rival news networks. A major obstacle to the launch was to persuade cable operators across the country to carry yet an additional news channel. Against all common industry practices, Murdoch offered them a one-time payment of between US$10 and US$20 for each of their subscribers as a cash incentive. Typically, cable operators paid a small fee per subscriber to specific channels. Most cable operators immediately agreed to carry Fox News (Shawcross, 1997).

With the 1996 Telecommunications Act the FCC loosened the previous restriction on ownership of more than one television station in any market. Fox responded with aggressive consolidation of its station presence and the acquisition of Chris-Craft's television stations which were located in key markets. Television station duopolies in a market enabled Fox to leverage economies of scale, and by 2001 News Corporation's television stations operated at 50 per cent profit margins (compared to 40 per cent margins of most other competitors) (News Corporation Annual Report, 2002).

In 1998, a substantial part of News Corporation was subjected to an initial public offering (IPO). A new entity, Fox Entertainment Group, was created for this purpose, which essentially included all Twentieth Century Fox assets: the Fox Television network, the 22 Fox television stations, the Twentieth Century Fox movie and television studios, and interests in nearly 30 national and regional cable networks. News Corporation retained 81 per cent of the stock of the new entity, and by floating the remaining 19 per cent managed to raise US$2.9 billion, which was used to reduce the parent corporation's still significant debt. Fox Entertainment Group serves as a perfect model of vertical integration between television content production and distribution. Fox produces and owns television shows, movies, and sports events that it distributes over Fox-owned broadcast and cable networks (Gunther, 1998).

Another reason for the partial IPO of Fox Entertainment Group was the consistent underperformance (in relation to its competitors) of News Corporation’s stock price over the

---

35 By 2000, through its combination of ownership of local television stations and its affiliated network, bound together by the high quality of its content, Fox Broadcasting had the ability to deliver its programming service to 98 per cent of the total U.S. network. In the future, station ownership would increase Fox’s distribution position as a result of all U.S. television stations being required to convert to digital by 2005. Each analogue channel can be converted into six digital channels, increasing station distribution potential even further (McQuade, 2004).
last decade. The main strategic rationales behind the IPO were to gain access to new capital sources and to be able to use shares as a currency for further acquisitions (Gunther, 1998).

In 2006, News Corporation also renegotiated the carrying contracts for the Fox news channel with all cable operators that aired the channel for the first time in 1996 after having received large cash incentive by News Corporation. In 2006, the situation was much more in favour of News Corporation. Fox Network Corporation, with 85 million subscribers and the most intense brand loyalty of any news channel, expected the per-subscriber fee for renewed contracts to come in between US$1.00 and US$2.00 a month. Fox News Channel subscriptions, which approximated US$41 million during the channel's maiden year, would come in between US$1 billion and US$2 billion under the anticipated increase.

4.4.1.4. Vertical Integration of New Media and Internet Assets

In 1999, News Corporation decided to turn its attention to the Internet and new media, albeit reluctantly. News helped fund E-partners, a London-based venture capital firm that invested in Internet start-ups, interactive television, and wireless communication. Besides E-partners, Murdoch considered a stock swap with Yahoo in early 2000 that would have allowed News Corporation to develop wireless access to the Internet, especially via satellites (Usborne & McIntosh, 2000). The burst of the Internet bubble in April 2000 and subsequent high losses from the e-Partner venture led News Corporation to shelve its Internet plans and close down all start-ups (Fletcher, 2001).

Due to the new media losses and the disappointing performance of the satellite division, 2001 saw News Corp.’s debt rating in risk of being downgraded to junk bond status, especially after Saban Entertainment exercised its option to force News Corporation to purchase its 49.5 per cent stake in Fox Family Channel. A change in accounting policy to U.S. GAAP added further to the losses. In 2002, the company again published losses of A$12 billion, for which three reasons were given: Firstly, the company had been forced to write down the value of its

---

36 Murdoch believed that the stock market penalized News Corporation for its complexity and for its long-term approach to building value. The penalization was, however, probably more due to the family-owned nature of News Corporation and its dependence on its founder and leader Rupert Murdoch.

sports rights, secondly, the investment in a German pay-TV platform was rendered worthless by bankruptcy, and the value of two further investments (in Gemstar's TV Guide and in Italy's pay-TV platform Stream) had to be written down to book value (News Corporation Annual Report, 2002). In contrast, Fox Entertainment Group was the top-performing major media stock in 2002.

In sharp contrast to 2001 and 2002, 2003 was the single most successful year in the history of News Corporation. The company's operating income rose to US$2.5 billion. News Corporation planned a further expansion of its television business with a history and a business channel to compete with CNBC. In Asia, Star TV enjoyed its first full year of operating profitability, and in Italy, News Corporation had established the new venture Sky Italia, with more than two million new subscribers and hence significant profit potential.

News Corporation's movie studio, Twentieth Century Fox, had recorded revenues of US$641 million, up 26 per cent from 2002. News Corporation was now the most stable and predictable of the media conglomerates (Gunther, 2003).

By 2003, 81 per cent of News Corporation’s operating revenue and 76 per cent of its total revenue was obtained from its U.S. operations (News Corporation Annual Report, 2004).

In 2005, News Corporation openly acknowledged the importance of a digital and online strategy to the company, and followed with three internet-related acquisitions: Intermix Media, owner of MySpace.com, a social-networking site, for US$580 million, Scout.com, a college sports site, and IGN Entertainment, a video-gaming and entertainment site, for US$650 million. The sites' combined traffic, added to News Corporation's own web properties, FoxSports.com, Fox News.com and Fox.com, has pushed News Corporation up among the dominant players of the internet (The Economist, 2006).

4.4.2. Summary of News Corporation’s Corporate Strategy

<table>
<thead>
<tr>
<th></th>
<th>Generic Strategy</th>
<th>Strategic Behaviour</th>
<th>Growth Strategy</th>
<th>Internationalisation Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>News Corporation</td>
<td>Cost Leadership</td>
<td>Reactive</td>
<td>External Growth Through Mergers and Acquisitions</td>
<td>Transnational/Global</td>
</tr>
</tbody>
</table>

Table 5: News Corporation: Overview Corporate Strategy  
Source: Own Illustration
4.4.2.1. Vertical Integration as the Central Strategy

News Corporation has been among the earliest movers in the development of a vertically integrated media conglomerate that can exploit the revenues from its content operations through a presence in multiple distribution segments of the media value chain.

Through the acquisition of television, cable and satellite broadcasting assets, News Corporation went from being an enterprise whose assets were overwhelmingly in newspaper and magazine publishing in the 1980s to one that now has 63.7 per cent of its total asset base in the areas of film, television, and cable/satellite network programming (News Corporation Annual Report, 2005). By establishing reliable content production and distribution channels in the U.S. and by realizing economies of scale between these operations, News Corporation has been able to maximize the potential of its production capabilities across its entire global operation. It has been Murdoch's long-standing determination not simply to broaden News Corporation's portfolio-by diversifying, for instance, into new or unrelated businesses -- but to extend his strategic control of the supply and distribution channels on which his existing businesses rely. His father had moved from print to radio with the understanding that each medium could publicize and support the other. Murdoch's companies now constitute a production system unmatched in its integration. They supply theatrical, television, cable and satellite television content, as well as newspapers, magazines and books. They sell the content to the public and to advertisers in newspapers, on the broadcast network, and on the cable and satellite channels. And they operate the physical distribution system through which the content reaches the customers. Murdoch's satellite systems now distribute News Corporation’s content in the United States, Europe, and Asia (Gunther, 1998).

For News Corporation, vertical integration has also been a strategic means to build up market power and possibly create lucrative gatekeeper positions in various media markets. So far, this ambition could only be realized in the U.K. satellite broadcasting market. Concerning News Corporation’s recent entry into the U.S. satellite markets, the same strategic rationale holds true: News Corporation’s acquisition of DirecTV has intensified the two major battles that are waging in the US$72 billion U.S. pay television industry (Gunther, 2003). Firstly, there is intense competition for subscribers between the cable operators and the satellite providers. Secondly, there is a "game of leverage" between content providers and distributors, where cable and satellite providers for once cooperate in order to hold content prices down (Gunther, 2003). Over the next years, the cable industry will most probably consolidate in a way that a few – probably not more than three- cable providers will act as gatekeepers to the
industry. As a result, the balance of power will shift from content providers to the content acquirors. News Corporation, like other content providers, wants to avoid downward price pressure exerted on them by the cable gatekeepers, and the strategic rationale behind News Corporation's entry into the U.S. satellite market is to become one of the gatekeepers itself (Gunther, 2003)\(^38\).

Cable operators, as a consequence, now fear that News Corporation will put popular Fox channels exclusively on satellite to lure away subscribers (Gunther, 2003).

Apart from its focus on vertical integration, News Corporation has always sought to globalize its presence and operations as much as possible. Compaine (2000) has argued that there is only one truly global media enterprise, and that is News Corporation. News Corporation generates 44.3 per cent of its revenues outside of the U.S., as compared to 21 per cent for Time Warner, 22 per cent for Disney, and 16.5 per cent for Viacom. 32.2 per cent of News Corporation’s assets are held outside of the U.S., with roughly 10 per cent each in Europe, Asia and Latin America, and Australia (News Corp Annual Report, 2005).

While the other U.S. media conglomerates continue to just sell their content products to the rest of the world, News Corporation has systematically engaged in the building of a geographically dispersed asset base through foreign direct investment, strategic partnerships, and mergers and acquisitions. Another characteristic of News Corporation's global orientation is the significant role played by joint ventures and strategic partnerships, i.e. through the acquisition of a minority stake, in its investments outside its three “home markets” of the

\footnotesize{\(^38\) To appease the Federal Communications Commission, News Corporation argued as follows:

"...The public will benefit from the efficiencies and economies of scope and scale that News Corporation will bring to DirecTV. We believe by sharing “best practices,” and by using management and expertise from our worldwide satellite operations, we will be able to substantially reduce DirecTV’s annual expenses by US$65 to US$135 million annually. Other efficiencies include sharing facilities of the various subsidiaries of News Corp. and Hughes in the U.S., and developing and efficiently deploying innovations, such as next-generation set-top boxes with upgraded interactive television and digital video recorder capabilities and state-of-the-art anti-piracy techniques. When Hughes becomes part of News Corp.’s global family of direct-to-home (DTH) satellite affiliates, it will benefit from a number of scale economies that will more efficiently defray the enormous research and development costs associated with bringing new features and services to market. Moreover, common technology standards for both hardware and software across the News Corp. DTH platforms should help to drive down consumer equipment and software costs. Through these various cost savings, DirecTV will be able to finance more innovations in programming and technology to ensure that it achieves and maintains the highest level of service for its customers at competitive prices." (http://www.newscorp.com/news/Murdoch_testimony_5_8_03.pdf)
United States, Australia, and the U.K. The following table presents a short overview of News Corporation current joint ventures:

<table>
<thead>
<tr>
<th>UK &amp; Europe</th>
<th>Asia</th>
<th>Japan</th>
<th>Latin America</th>
<th>Australia &amp; New Zealand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broadcasting, Cable and Satellite TV</td>
<td>BskyB (36%) Sky Italia (50%) Balkan News Corp. (75%)</td>
<td>STAR TV (87.5%) Phoenix Satellite TV (37.6%) ESPN STAR Sports (50%) Vijay TV (51%) Viva Cinema (50%) Zee Telefilms (3.9%) Space Shower Networks (10%) Taiwan Cable Systems (20%) Hathaway Cable and Datacom (26%) SKY PerfecTV! (8.1%) News Broadcasting Japan (80%) Sky Sports (14.3%) Sky Movies (50%) Nihon Eiga Satellite Broadcasting (15%) Cine Canal (22.5%) Sky Latin American DTH platforms: Mexico -Innova (30%) Brazil – NetSat (36%) Sky Multicounty Partners (30%) FOXTEL (25%) Fox Sports Australia (50%) Sky Network TV (30%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Movie Production &amp; Distribution</td>
<td>NDS (79%) The Wireless Group (19%) Sky Radio (71.5%) Radio 538 (42%) News Outdoor Group (75%)</td>
<td>Beijing PDN Xinren Information Technology (69.6%) 21CN Cybernet Corp. (41%) UTV Software Communications (19.9%) Digiwave Infrastructure (50%) Yesky.com (20%)</td>
<td>Fox Studios Baja Canal Fox Telecine (12.5%)</td>
<td></td>
</tr>
<tr>
<td>Other Interests</td>
<td></td>
<td></td>
<td></td>
<td>News Interactive Festival Records Newspoll (50%)</td>
</tr>
</tbody>
</table>

Table 6: News Corporation: Overview Joint Ventures  
Source: Own Illustration, Company Annual Reports

In sum, the strength of the Fox entertainment operations, coupled with News Corporation’s satellite platforms in Australia, Asia, the U.S., and Europe, attest to the conglomerate’s aggressive approach towards preparing for digital convergence and the predominance of the Internet and broadband transmission as the coming major distribution means. Yet the satellite priority also reflects the firm’s patterned strategy towards seeking market advantage. News Corporation has thus gradually executed an M&A strategy to expand its core competencies of media content and communications channels over multiple platforms and markets. It has
shown that it is easier to buy than to build the technological platforms necessary for scaled growth in the media business. Currently, satellite broadcasting and the recent Internet acquisitions constitute the company’s most ambitious distribution platform investments. The integrated set-top boxes should act as entry barriers to this digital distribution chain and thus provide its sustainable competitive advantage. Yet the satellite broadcasting strategy also has considerable risks, considering the intensifying platform competition from cable operators and satellite’s limited potential for broadband transmission services. Regarding its string of recent Internet-related acquisitions, the fact that News Corporation has chosen to buy a social networking site where users create the content shows that the company is not merely reproducing itself online by utilizing the Internet as distribution system and adding another source of advertising revenues, but that it may have grander plans for its position in the digital era.

4.4.2.2. Analysis of News Corporation’s Corporate Culture

Murdoch and his family still control 30 per cent of the voting shares and 10 per cent of non-voting shares of News Corporation, which has been publicly listed in Australia since 1973 and in the United States since 1985.

Murdoch's management style is exemplified in the company's lack of formal structures – News Corporation has no official organizational chart. Murdoch encourages rapid decision making, instant feedback, and risk-taking behaviour, but at the same time stays in control over every single decision taken at News Corporation. In essence, News Corporation is a strict hierarchy with an informal structure for every position below CEO level. If News executives want to launch a new business and have obtained Murdoch's backing, the resources of the whole corporation will be called upon to support.

The office of the chairman of News Corporation, which comprised Rupert Murdoch and five top executives, meets up every week to make decisions on upcoming projects, review strategic developments and exchange ideas, and to review division reports compiled and summarized into a report known as the "Flash". The Flash included budgeted figures for

---

39 As the majority of News Corporation’s assets are in the U.S., the primary listing has since 2002 also been transferred to the U.S.
Empirical Part I: Media Case Studies

every aspect of the operating unit's affairs, set against the actual figures for the week, and then compared with the same week in the previous year. This weekly reporting might be a burden on the divisions, but it gives News Corporation's managers a weekly oversight of News Corporation’s worldwide operations and thus enables them to react extremely rapidly to arising problems in any given business segment or any given market. Murdoch also achieved control by detailed telephone briefings and personal unannounced checks on the details of a business' activities and management. At key moments, Murdoch always took personal control of everything. This retention of control is probably central to his ability to maintain strategic agility determining the priorities and focus of corporate development across the globe.

Unlike the other media conglomerates, News Corporation does not have a formal business planning department. Acquisitions are not always undertaken with the rationale of realizing synergies with the core businesses, but can also have the motivation of buying an asset for a discount and sell it for a sizeable profit after it has been turned around. Expansion has been mostly the product of Murdoch's strategic vision.

Murdoch has abandoned the high-debt strategy he used to build his company in the 1980s, replacing it with a more conservative management style. However, News Corporation's ownership structure makes the conglomerate less dependent on the need to create short-term shareholder value and thus gives him the opportunity to take a certain course of action or realize a long-term vision even if shareholders and financial markets would likely oppose such actions.

4.4.3. Classification of News Corporation’s M&A Activities According to their Type of Integration

<table>
<thead>
<tr>
<th>Year</th>
<th>Activity / Type of Deal</th>
<th>Value</th>
<th>Type of Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>Acquisition of Twentieth Century Fox</td>
<td>US$575m</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1985</td>
<td>Acquisition of Metromedia television chain</td>
<td>US$2bn</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1991</td>
<td>Sky Television merges with British Satellite Broadcasting (BSB)</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1992</td>
<td>Acquisition of Premier League Soccer rights by BSkyB</td>
<td>US$465m</td>
<td>Content deal</td>
</tr>
<tr>
<td>1993</td>
<td>Acquisition of a 64% ownership stake in Star TV</td>
<td>US$525m</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>Year</td>
<td>Activity / Type of Deal</td>
<td>Value</td>
<td>Type of Integration</td>
</tr>
<tr>
<td>------</td>
<td>------------------------</td>
<td>-----------</td>
<td>---------------------</td>
</tr>
<tr>
<td>1993</td>
<td>Acquisition of a four-year package for the exclusive broadcasting rights for the NFL</td>
<td>US$395m</td>
<td>Content deal</td>
</tr>
<tr>
<td>1996</td>
<td>Acquisition of New World Communications (10 television stations)</td>
<td>US$3.4bn</td>
<td>Group – vertical Fox – horizontal</td>
</tr>
<tr>
<td>1997</td>
<td>Acquisition of the Heritage Media Group</td>
<td>US$1.4bn</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1998</td>
<td>Acquisition of Los Angeles Dodgers</td>
<td>N/A</td>
<td>Content deal</td>
</tr>
<tr>
<td>1998</td>
<td>Acquisition of stake in TM3 (German television channel)</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1999</td>
<td>Acquisition of Applied Decision Systems Group</td>
<td>N/A</td>
<td>Vertical Integration (online technology)</td>
</tr>
<tr>
<td>1998</td>
<td>Acquisition of remaining 50% stake in Fox/Liberty Networks LLC</td>
<td>US$2.15bn</td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>Acquisition of Hearst Book Publishing</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1999</td>
<td>Acquisition of Channel [V]</td>
<td>N/A</td>
<td>Vertical Integration (Music Television Distribution)</td>
</tr>
<tr>
<td>1999</td>
<td>Merger of TV Guide into Gemstar</td>
<td>N/A</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1999</td>
<td>Sale of 50% stake in Fox Sports Australia</td>
<td>N/A</td>
<td>Horizontal Disintegration for Fox</td>
</tr>
<tr>
<td>1999</td>
<td>Sale of NDS Digital Television Products Business</td>
<td>N/A</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>1999</td>
<td>Acquisition of Australian Mushroom Records</td>
<td>N/A</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2000</td>
<td>Sale of Kesmai Corporation (online games software)</td>
<td>N/A</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2000</td>
<td>Sale of Falkiner &amp; Sons Pty.</td>
<td>N/A</td>
<td>Horizontal Disintegration (Publishing)</td>
</tr>
<tr>
<td>2000</td>
<td>Acquisition of Fourth Estate Ltd. (Book Publishing)</td>
<td>N/A</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2000</td>
<td>Acquisition of Media Support Services Ltd. (Outdoor Advertising)</td>
<td>N/A</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2000</td>
<td>Acquisition of Orbis Technologies Ltd. (Interactive online betting)</td>
<td>N/A</td>
<td>Vertical Integration (Forward into Online)</td>
</tr>
<tr>
<td>2001</td>
<td>Sale of stake in TM3 (German television channel) to KirchMedia</td>
<td>N/A</td>
<td>Horizontal Disintegration</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of Chris-Craft Industries, Inc. (TV channels)</td>
<td>N/A</td>
<td>Vertical for group/horizontal integration for Fox Television</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of BHC Communications</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of United Television, Inc.</td>
<td>N/A</td>
<td>Vertical for group, horizontal for Fox Television</td>
</tr>
<tr>
<td>Year</td>
<td>Activity / Type of Deal</td>
<td>Value</td>
<td>Type of Integration</td>
</tr>
<tr>
<td>------</td>
<td>-------------------------</td>
<td>----------</td>
<td>------------------------------------------</td>
</tr>
<tr>
<td>2002</td>
<td>Acquisition of WPWR-TV in Chicago</td>
<td>US$425m</td>
<td>Vertical/horizontal Integration</td>
</tr>
<tr>
<td>2003</td>
<td>Sale of 50% stakes in Sports Channel Chicago and Sports Channel Bay Area</td>
<td>US$150m</td>
<td>Horizontal Disintegration</td>
</tr>
<tr>
<td>2003</td>
<td>Acquisition of Telepiu together with Telecom Italia to form SKY Italia (stake of 80% owned by News Corp.)</td>
<td>US$874m</td>
<td>Vertical for group/horizontal for Sky subsidiary</td>
</tr>
<tr>
<td>2003</td>
<td>Acquisition of Media Highway middleware business</td>
<td>US$73m</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2004</td>
<td>Sale of 40% in Staples arena</td>
<td>US$128m</td>
<td>Unrelated Disposal</td>
</tr>
<tr>
<td>2004</td>
<td>Acquisition of 34% stake in DirecTV (Hughes Electronics)</td>
<td>US$6.8bn</td>
<td>Vertical/horizontal Integration</td>
</tr>
<tr>
<td>2004</td>
<td>DirecTV and News Corp enter into a series of transactions with Grupo Televisa, Globopar and Liberty Media to reorganize the direct satellite broadcast TV platforms in Latin America</td>
<td>N/A</td>
<td>Vertical Alliances</td>
</tr>
<tr>
<td>2004</td>
<td>Acquisition of remaining 20% stake in SKY Italia, thus taking SKY Italia ownership to 100%</td>
<td>US$108m</td>
<td>Vertical for group/horizontal for Sky subsidiary</td>
</tr>
<tr>
<td>2004</td>
<td>Sale of 20% stake in Rogers Sportsnet to Rogers Broadcasting Ltd.</td>
<td>US$41m</td>
<td>N/M</td>
</tr>
<tr>
<td>2004</td>
<td>Acquisition of not yet owned 58% stake in Queensland Press (Australian Newspaper Publishing)</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2004</td>
<td>Sale of Los Angeles Dodgers</td>
<td>US$421m</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2005</td>
<td>Acquisition of remaining 18% of Fox Entertainment Group</td>
<td>US$6.3bn</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>Sale of stake in The Wireless Group</td>
<td>US$60m</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2005</td>
<td>STAR acquires 26% in Balaji Telefilms Ltd. (largest television content production company in India)</td>
<td>US$34m</td>
<td>Vertical Upstream Integration</td>
</tr>
<tr>
<td>2005</td>
<td>Acquisition of InTermix Media Inc. with platform MySpace.com</td>
<td>US$580m</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2005</td>
<td>Acquisition of ING Entertainment (internet entertainment portal)</td>
<td>US$650m</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2006</td>
<td>Acquisition of 51% majority stake in Jamba (mobile entertainment/mobile handsets personalization/games)</td>
<td>N/A</td>
<td>Vertical Integration</td>
</tr>
</tbody>
</table>

Table 7: Classification of News Corporation’s M&A Activities According to their Type of Integration  
Source: Own Illustration, Company Annual Reports
4.5. **Case Study: Viacom Inc.**

4.5.1. **Company History: Viacom**

Viacom was founded in 1971 when CBS had to spin off its entertainment content production and syndication businesses as an independent public company in order to comply with the FCC's Financial Interest and Syndication Rules ("Fin-Syn"). Throughout the early 1980s, Viacom followed a strategy of aggressive forward vertical integration into distribution, acquiring several television and radio stations, and assembling a group of cable television systems. Expecting increasing growth in cable programming, in 1976 Viacom launched Showtime, a pay cable channel which showed films without advertising by charging subscribers an additional fee to their monthly access payment for the basic cable networks. In 1985, Viacom acquired two further cable networks: MTV, a music video channel, and Nickolodeon, which focused on children's entertainment.

By the late 1980s, due to worsening economic performance, Viacom became the target of hostile takeover bids, and Sumner Redstone, a minority investor in Viacom and owner of National Amusements launched a successful US$3.4 billion takeover bid. Being the owner of National Amusements, a movie theater chain, Redstone was particularly guided by the strategy that content is the most important asset to own in the entertainment industry\(^\text{40}\). Redstone had formerly bought stakes in Columbia Pictures, MGM/UA, and Loews, thus amassing the capital needed to launch his still highly leveraged bid for Viacom, which at that time was a little known cable, broadcast, and syndication company (Gunther, 1999).

Redstone hired Frank Biondi from Coca-Cola as CEO, who replaced most of Viacom's senior executives and focused the new team on increasing cash flow in order to service Viacom's US$2 billion of debt. The next six years were spent on strengthening Viacom's balance sheet with neither divestitures nor acquisitions occurring.

---

\(^{40}\) National Amusements would only get second-class programming from the major studios until Redstone sued the studios on discrimination grounds and thus eventually got access to their most popular pictures (Gunther, 1999).
4.5.1.1. Early Vertical Integration Moves: Paramount and Blockbuster Acquisitions

In the early 1990s, Viacom intensified the pace of its vertical integration strategy. In 1993, it announced the acquisition of Paramount Pictures for US$9.9 billion. The acquisition of Paramount would turn Viacom into one of the leading global provider of branded entertainment content. Because Viacom already had the distribution assets in the form of the premium cable television networks MTV, the Showtime network, and Nickolodeon, the added values of Paramount's film library and ongoing content productions provided Viacom with the strategically important theatrical content assets. The Paramount acquisition is an exemplary case of an upstream vertical integration from theatrical exhibition into theatrical content as well as a horizontal merger to further expand and diversify the existing cable networks content production facilities. Paramount Pictures and Television represented a massive product extension into mainstream media content for Viacom, which could offer and promote premium branded content across multiple media.\(^{41}\)

To finance the acquisition, Viacom looked for strategic partners, and found Blockbuster Entertainment, the U.S.’s largest chain of video rental stores, who agreed to invest US$600 million. This partnership quickly evolved into plans to merge Blockbuster Entertainment into Viacom. This would prove to be another key downstream vertical integration move for Viacom. Recognizing the market extension opportunity of releasing content through the lucrative video sector, this deal provided long-term value through internal synergies as the video window for Paramount's theatrical content could now be exploited in-house.

Due to the saturation of the market, established structures and lack of potential takeover targets in the United States, most conglomerates focused on expanding overseas and into emerging markets. After the successful formation of the U.K. pay service BSkyB through News Corporation, Viacom also successfully collected the higher rents possible for content suppliers (Paramount) as more pay services were established in other European countries.

By 1995, Viacom had decided to follow suit and engage in international expansion. Viacom's Paramount Pictures decided to continue the long-term supply contract with German media company Beta Taurus (later part of the KirchGruppe) instead of taking up offers by other

\(^{41}\) These media include film, cable TV, radio (Infinity Broadcasting) and publishing (Simon & Schuster). Source: www.Viacom.com.
European media companies of an equity stake in the new platforms. While the potential upside from owning equity in a platform was large, Viacom reasoned, so were the downside risks, given the scale of investments required and the likelihood of competing platforms. The long-term nature of the Beta Taurus contract provided protection in the event of a platform merger, and also offered the license fees needed to offset margin pressure caused by increasing talent and marketing costs for Paramount's theatrical content. Still, the decision not to forward integrate into the European distribution platforms by taking an equity stake was, from today’s point of view, the wrong decision as Viacom could have cheaply gained a foothold in another important distribution platform.

Viacom also launched unique versions of its Nickolodeon children’s channels in major international markets. Locally tailored channels were required to match the high levels of brand identification Nickolodeon had achieved in the U.S., and to accommodate the limited foreign language proficiency of young children.

Nickolodeon's localized approach was in stark contrast to the strategy MTV pursued, which had launched regional services in Europe, Asia, and Latin America, each serving many countries with a single channel. In 1995, MTV Europe was already well established, reaching 59 million homes across Europe through a single satellite channel, with an EBITDA margin of 25 per cent (Viacom Annual Report, 1995). However, MTV Europe faced increasing competition from services that operated in one single country and programmed music videos in the local language. The natural response for MTV Europe was to follow Nickolodeon’s strategy and localize its content. Since the new European platform providers were likely to either launch their own music video channels or to enter into joint ventures with MTV Europe's competitors, ensuring distribution was a strategic priority for MTV.

Until the late 1990s, the most important value creators for Viacom were its high-margin cable networks, which enjoyed double digit earnings gains as they expanded globally in the 1980s (Gunther, 1999).

By the end of the 1990s Viacom’s CEO Redstone had also accomplished the task to change the unwieldy, debt-burdened conglomerate created by the 1993 merger with Paramount, into

---

42 Germany was the principal target market for Nickolodeon in Europe, because it had enough cable TV homes to justify the high costs involved in localizing the service. Nickolodeon had secured cable distribution in Germany through a joint venture with Ravensburger, the German toy company.
a more focused and disciplined company. By selling a variety of assets like Madison Square Garden, cable systems, radio stations, the publisher Simon & Schuster, and a videogame company, Viacom's debt had been cut from US$11 billion to US$4 billion and Viacom was free to focus on further vertical integration opportunities for its entertainment divisions (Gunther, 1999).

4.5.1.2. Extending Distribution Through Vertical Integration: The Viacom – CBS Merger

Viacom merged with Columbia Broadcasting System Corporation (CBS) in 2000. The combination with CBS strengthened Viacom’s vertical integration profile, and provided further synergistic opportunities among its business units. In addition, the combined company had considerable discretionary cash flow potential to invest in internal business development and acquisition opportunities.

Business integration benefits of the merger were expected to be substantial between Viacom’s content output and CBS's distribution network in the form of television and cable channels. CBS did not have major content production facilities, nor was it positioned to take advantage of the elimination of the "Fin-Syn" regulations. Viacom, in contrast, was very strong in production but owned only a 50 per cent stake in the small broadcast network United Paramount Network (UPN) (Picard, 2005).

Combining CBS and Viacom's UPN programming, affiliate, and advertising sales operations would realize substantial cost advantages and synergies (Gunther, 2000). Viacom announced several cost-saving initiatives, such as the elimination of duplicate support functions. After the merger closed, Viacom restructured several assets among its divisions to capture possible synergies. The CBS cable networks were merged into the MTV Networks division and it was announced that CBS’ regional sports networks would be divested. Paramount Parks, which formerly operated as a separate division, was integrated into the Viacom Entertainment group, which also contained the Paramount Motion Picture Group. The Paramount Television Group, which had been part of the entertainment group, was integrated into the CBS Television Stations Division (Merrill Lynch, 2000).

Further revenue benefits were expected to come from the broad platform of advertising outlets, which included the second-largest U.S. radio group Infinity Radio, the CBS and Viacom station groups, the CBS Network, the Viacom and CBS cable television channels, and the largest U.S. outdoor advertising unit. The merger also created a number of cross-
promotional opportunities. The CBS network could exploit the young demographics of Viacom’s cable networks to promote new shows targeted to younger audiences, a premium target group for advertisers. Viacom’s broad asset mix now allowed management to leverage the stronger media properties to promote and drive the distribution of the weaker or developing properties.

Mel Karmazin, CBS’ CEO, took over as Chief Operating Officer (COO) of the combined entity, and he and Mr. Redstone would effectively control Viacom as a two-men team until Karmazin left in 2004. This partnership created constant tension and disagreement between Redstone, who had his vision of what he wanted Viacom to look like in the future, and Karmazin who put all his focus on increases in sales and cost controls (Flint, 2004).

Even before the merger with CBS, Viacom had established very strong niche positions with MTV and Nickelodeon in the fragmented broadcast television market. MTV still is the globally leading music video channel. Nickelodeon has developed into a leading children’s network, a market that is becoming increasingly competitive as other programmers (such as News Corporation, Time Warner, and Disney) invest heavily in developing their own children’s channels. The Showtime Network lagged Time Warner’s HBO in cable distribution, but had greater success in penetrating the direct broadcast satellite market.

Among the challenges facing the merged network operations was the escalating cost of content and, as a result, achieving and maintaining healthy profit margins. CBS had entered into long-term contracts for premium sports content, and these multi-year contracts represented large liabilities even under a sustained strong economy, thus imposing limits on the future profitability and cash flows of the merged entity (Moody's Investor Services, 2000).

In 1999, Viacom started a major push into the Internet and created a separate division for its online interests. One of the main strategic differences between Viacom and other large media conglomerates is that Viacom focuses on product differentiation through audience segmentation in order to create a sustainable competitive advantage. Following this strategy, the internet division created separate destinations for all of Viacom’s different audiences, and to offer all genres in a personalized format to the consumer (Krigel, 1999).

43 See www.viacom.com/prodbyunit1.tin?ixBusUnit=19
4.5.1.3. Horizontal Integration: Acquisition of BET Entertainment

In 2001, Viacom announced a horizontal integration with its acquisition of Black Entertainment Television (BET). This deal represented an example of Viacom's network segmentation approach to television in that BET offered a fully integrated network specifically targeted to African Americans. By adding this asset to its already significant portfolio of networks, Viacom further expanded its reach without resorting to pushing targeted content through a mass-market network.

In addition to an additional advertising revenue stream, the acquisition presented several synergistic opportunities for both companies. By BET's integration into an integrated media conglomerate with its strong relationships to media time buyers, its brands would increase their attractiveness for national advertisers, thus strengthening its revenue potential. Secondly, Viacom could exploit its existent content assets through a further distribution channel. The increased overall revenues could be dedicated in part towards further expansion of BET's assets. As a privately held mid-size company, BET had faced limited growth opportunities through its lack of access to international financial markets. Lastly, Viacom would gain significant cross-promotional opportunities with the acquisition.

In 2003, Viacom also took full ownership of Comedy Central, its specialized comedy cable channel, by buying out Time Warner's 50 per cent stake for US$1.2 billion.

4.5.1.4. Recent Vertical Disintegration Moves

Viacom’s share price has, since 2003, shown persistent underperformance in relation to other comparable media conglomerates. All attempts to increase the share price through, for example, share buy-backs, debt reduction or disposals of unrelated assets largely failed. The underlying reason might be Viacom’s heavy dependence on advertising revenues, and the general uncertainty of how much of the traditional advertising revenues will shift to the Internet in coming years. Viacom’s major competitive advantage so far has been its ability to sell advertising across its integrated range of popular media assets, and the strategy was working well until the advertising industry's severe downturn in 2001 forced the company to

---

44 In 2004, 70 per cent of Viacom's revenues were advertising revenues (Viacom, Inc. Annual Report, 2004).
scale back their earnings expectations considerably. Viacom’s cable networks now constitute Viacom’s main earnings drivers, however, their positive development is masked by the poor performance of the rest Viacom’s portfolio. In addition, Viacom’s radio and outdoor segments had to write off US$18 billion for goodwill impairments in 2005 (The Independent, 25 February 2005) due to flat revenues and advertising income shifting to other sources like satellite radio and the Internet. The write-downs were also an admission that Viacom had overpaid when acquiring these assets through its acquisition of CBS in 2000 (Gunther, 2005).

Viacom also undertook a first partial vertical disintegration in 2005 with the spin-off of the Blockbuster unit. In general, the video rental industry is slowly being eradicated due to changes in the home entertainment market, where consumers have shifted from the core rental business to buying DVDs or using online video-on-demand services.

In terms of the future direction of its corporate strategy, Viacom faced limited options. Another big acquisition would have increased the company’s debt-to-equity ratio to over 65 per cent, which would surely not have been rewarded by the financial markets.

In consequence, Viacom has decided to turn to vertical disintegration as a move to unlock the value of its individual assets. The company has announced that the conglomerate will be split up into two separate businesses in order to raise the share price (Chaffin, 2005). A split would not change underlying profitability, but the high growth businesses (comprising MTV Networks) would be set free, while a more sedate advertising-focused group with nonetheless large cash flows (comprising the CBS and UPN broadcast television services and radio) could appeal to investors seeking yield (Gunther, 2005). This move, in effect, reverses the vertical integration between the CBS broadcast network and the Viacom content businesses which created the media conglomerate five years ago. The strategic rationale of the CBS/Viacom was the synergy potential such a combination could create. The split is a recognition that these have failed to materialize.

Redstone reasoned that "a separation of Viacom’s businesses into distinct and strong operating entities allows the optimization of capital structure and creates unique investments that are more appealing to investors with different objectives" (Chaffin, 2005).

On the other hand, dividing Viacom into two separate entities (a) involves significant separation costs and increased expenses by doubling central corporate functions and the respective staff positions, (b) eliminates most cross-promotional opportunities, and (c) creates potential conflicts if the two companies want to acquire the same asset (Gunther, 2005).
These negative effects of the separation were the reason why the share price of both entities did not increase after the actual split at the end of 2005. However, since the beginning of 2006, CBS has performed very well as a separate entity, while the new separate Viacom saw a further 20 per cent share price decrease (Chaffin, 2006).

It has already been argued above that Viacom’s share price underperformance is most likely due to a shift in advertising revenues from traditional media to the Internet. The main competition for advertising revenues now comes from Internet portals and search engines which, through their paid search technologies, allow advertisers to specifically target their customers. Viacom, however, still lacks a convincing and coherent new media strategy, and its current Internet offerings have neither the size nor the scale they need to obtain a sufficient share of online advertising revenues (Chaffin, 2006). Viacom announced a new multi-platform strategy which would eventually enable it to leverage existing media brands on the Internet, mobile devices, video games and interactive television. The 2005 acquisition of the online video and gaming developers IFilm and Atom Films show that Viacom intends to start by focusing on the above markets. This strategy could prove to be a difficult one as both industries are characterized by strong incumbents and intensifying competition.

### 4.5.2. Summary of Viacom’s Corporate Strategy

<table>
<thead>
<tr>
<th>Generic strategy</th>
<th>Strategic behaviour</th>
<th>Growth strategy</th>
<th>Internationalization strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Viacom</td>
<td>Differentiation</td>
<td>Innovative</td>
<td>External growth through acquisitions</td>
</tr>
</tbody>
</table>

**Table 8:** Overview of Viacom’s Corporate Strategy  
Source: Own Illustration

#### 4.5.2.1. Analysis of Viacom’s Vertical Integration Strategy

Until 2005, Viacom’s main strategic focus points were vertical and horizontal integration, with a clear dominance of vertical integration moves. In general, ownership of one of the six
major Hollywood Studios\textsuperscript{45} was seen as a threshold resource in order to compete at the highest level in global entertainment. With the acquisition of Paramount and Blockbuster, Viacom had become one of the largest vertically integrated media companies in the world, and was finally on par with rivals like Time Warner, Disney, and News Corporation.

After these defining acquisitions, Viacom's strategic priorities were to realize the benefits of vertical integration, which would allow the company to (1) strengthen the bargaining position of its content business vis-à-vis distributors seeking to exercise monopoly power; and (2) use its integrated content and distribution resources to facilitate further national and international expansion. With the acquisition of Blockbuster, who had so far been one of the largest customers of Time Warner's content businesses, Blockbuster’s dependence on external content could be decreased and Paramount content could be increasingly promoted. In order to further strengthen its existing television content production and syndication businesses, Viacom undertook further vertical integration by launching its own broadcast network called United Paramount Network (UPN) with Chris-Craft Industries as an initial partner. To ensure distribution for UPN, Viacom continued to undertake extensive horizontal integration with continued acquisitions of additional television stations.

When the repeal of the “Fin-Syn” Rules by the FCC allowed broadcast networks to re-enter the syndication market and become self-subsistent content producers and distributors, major content producer like Viacom's Paramount Pictures threatened market foreclosure. Initially, they had responded to this threat from their content buyers by launching their own broadcast networks. Yet these nascent networks lacked the audience share and the brand awareness of the top networks, so Viacom, like Disney before it, acquired a top-three U.S. broadcast network in CBS to protect its television distribution platform. The Viacom/CBS merger thus represented a downstream vertical integration to give Viacom "greater control over its markets, lessening the probability of being ignored or shut out by middlemen" (Scherer & Ross, 1990, p. 95).

At the time, Redstone, who has always regarded his company’s share price performance as the main justification for Viacom’s corporate strategy, saw his vertical integration moves being rewarded by the financial markets on the grounds of synergy and scale opportunities.

\textsuperscript{45} Sony/Columbia, Disney, 20th Fox, Warner Bros, Universal, Paramount (Vogel, 1998)
In recent years, however, financial markets have shown increasing prudence in rewarding potential media chain synergies, as most of the envisaged cost reductions and revenue increases have remained elusive, due to the poor or non-existent post-integration management of most vertical acquisitions. Redstone has followed suit by accordingly adapting Viacom’s corporate strategy to one of vertical disintegration. It remains to be seen whether this reverse in corporate strategy will produce better results than Viacom’s initial strategic direction.

4.5.2.2. Analysis of Corporate Culture

Viacom, like News Corporation and Bertelsmann, has one majority shareholder, who controls and essentially owns Viacom by holding the majority of voting shares (71 per cent (Viacom, Inc. Annual Report, 2004). Sumner Redstone, Viacom’s majority shareholder, traditionally occupied the position of Chairman, while keeping sole control over the selection of the CEO.

Viacom has, for the most part of its corporate history, operated under a decentralized structure, which was introduced in Viacom’s early days by former CEO Frank Biondi, leveraging his previous working experience at the Coca-Cola Company.

Corporate management exercised divisional control mainly through the setting of financial targets, the level of which would be proposed by the divisions themselves (Campbell & Gould, 1988). This practice held the danger of short-term revenue maximization at the expense of long-term and thus riskier investments, as divisions preferred to operate in financially predictable environments.

Viacom’s corporate culture is characterized by a complex scheme of performance related pay and positively tensed organizational atmosphere with informal communications and little bureaucracy. The compensation of senior divisional managers basically has four components: base salary, annual bonus, long-term incentive, and stock options. For executive managers, 70 per cent of their annual bonus was based on division performance against budget; the balance determined by company-wide performance. About half of the company-wide component was based on the executive's contribution to inter-divisional activities; the rest was linked to Viacom's corporate financial results. Long-term incentives were focused on divisional financial performance for overlapping three-year cycles. In addition, each year, each of Viacom's divisions reviews its strategy with corporate management. These strategic plans include long-range financial projections.
As mentioned above, two main dangers arise out of this practice of linking compensation to financial results: First, unwanted risk aversion is promoted because people fear failure, and start-up efforts may be stifled and new ideas may not be acted upon. Secondly, it raises competition between the divisions and thus makes it increasingly difficult to realize synergies through inter-divisional initiatives and cross-promotion.

From 1995 onwards, however, faced with the strategic decisions regarding MTV's and Nickolodeon's course of action in Europe, doubts were raised whether Viacom's decentralized structure and management processes were well suited to its strategies of vertical integration and global expansion. Viacom's management debated whether a change in organizational structure would allow the company to better exploit its scale and scope in a coordinated manner in international markets.

The obvious benefits of decentralized decision-making are better information available at divisional level and the ease of establishing localized services such as localized TV programming. Disadvantages include the slow decision-making due to the amount of lateral and vertical consultations necessary in an attempt to seek solutions acceptable throughout the firm. Divisional competition and the lack of lateral communication eliminate possible synergies because from the limited perspective of a divisional manager it is more difficult to identify remote markets for strategic integration opportunities (Eisenmann, 2000).

A centralized organizational structure has allowed rival media conglomerates like News Corporation and Disney to exploit the advantages of centralized decision-making by being able to act more quickly and thus gaining first mover advantages in new markets – a particular benefit in environments that are characterized by technological change like the media industry. Eisenmann (2000) argues that when expansion entails major capital commitments, divisional managers may be reluctant to accept the career risks associated with the sponsorship of risky projects.

2006 saw the departure of Viacom’s long-standing CEO Frank Biondi, due to internal disagreements between Biondi and Redstone about Viacom’s strategic direction. Redstone has since consolidated his power, changing Viacom’s corporate culture from decentralized to centralized management style, thus inviting a comparison of his new role to the autocratic leadership style of Rupert Murdoch of News Corporation (Irish Times, 2006). The split of Viacom into two separately listed entities, however, will hinder Redstone to realize the full benefits of this change in organizational structure.
4.5.3. Classification of Viacom’s M&A Activities According to their Type of Integration

Overview

<table>
<thead>
<tr>
<th>Year</th>
<th>Activity / Type of Deal</th>
<th>Value</th>
<th>Type of Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>Acquisition of Viacom majority stake by National Amusements (Redstone)</td>
<td>US$3.4bn</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1994</td>
<td>Acquisition of Paramount Communications</td>
<td>US$10bn</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1994</td>
<td>Acquisition of Blockbuster</td>
<td>US$8.4bn</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1995</td>
<td>Sale of Madison Square Garden and related properties to ITT</td>
<td>US$1bn</td>
<td>Horizontal Disintegration</td>
</tr>
<tr>
<td>1995</td>
<td>Sale of cable systems to John Malone's TCI</td>
<td>N/A</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>1996</td>
<td>Westinghouse/CBS acquires Infinity radio broadcasting and outdoor advertising group</td>
<td>US$4.7bn</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1996</td>
<td>Viacom acquires the Waite Group</td>
<td>N/A</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1996</td>
<td>Nickelodeon buys Barron Entertainment, producer of kids' programming in Australia</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1996</td>
<td>Blockbuster acquires 50 retail outlets from Video Chile and 22 from Video Argentina</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1996</td>
<td>Blockbuster buys Denmark's largest home video retailer, Christianshavn Video (31 stores)</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1996</td>
<td>Blockbuster acquires Xtra-vision Group (video stores in Ireland)</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1996</td>
<td>Blockbuster acquires all retail operations of Video Invest Espanola SA</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1996</td>
<td>Viacom announces it will exercise its option for 50% ownership interest in UPN</td>
<td>N/A</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1997</td>
<td>Viacom's equity in Spelling increased to 80%</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1997</td>
<td>Viacom sells interest in USA Networks</td>
<td>N/A</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>1997</td>
<td>Blockbuster buys 39 Video stores in Australia</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1997</td>
<td>Sale of Viacom’s educational, professional and reference publishing businesses to Pearson</td>
<td>US$4.6bn</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>1999</td>
<td>CBS acquires King World Productions, leading television program syndicator</td>
<td>US$2.5bn</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1999</td>
<td>CBS/Infinity acquires Outdoor Systems</td>
<td>US$8.3bn</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>Year</td>
<td>Activity / Type of Deal</td>
<td>Value</td>
<td>Type of Integration</td>
</tr>
<tr>
<td>------</td>
<td>----------------------------------------------------------------------------------------</td>
<td>------------</td>
<td>--------------------------</td>
</tr>
<tr>
<td>1999</td>
<td>Viacom and CBS merge</td>
<td>US$43.5bn</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of BET Entertainment</td>
<td>US$3bn</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2002</td>
<td>Acquisition of KCAL-TV (Los Angeles) from Young Broadcasting Inc.</td>
<td>US$650m</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2003</td>
<td>Acquires Time Warner's 50% stake in Comedy Central</td>
<td>US$1.2bn</td>
<td>Vertical and Horizontal Integration</td>
</tr>
<tr>
<td>2004</td>
<td>Acquisition of Sportsline.com</td>
<td>N/A</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2004</td>
<td>Acquisition of CBS affiliate KOVR-TV 13 Sacramento</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2004</td>
<td>Spin off of 81.5% stake in Blockbuster to shareholders</td>
<td>US$738m</td>
<td>Vertical disintegration</td>
</tr>
<tr>
<td>2005</td>
<td>Acquisition of children's website neopets.com</td>
<td>US$160m</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2005</td>
<td>Acquisition of Ifilm, an online video company</td>
<td>US$50m</td>
<td>Vertical integration</td>
</tr>
<tr>
<td>2005</td>
<td>Acquisition of Midway Games Inc., a video game developer</td>
<td>N/A</td>
<td>Vertical integration</td>
</tr>
<tr>
<td>2005</td>
<td>Sale of KAUT-TV Oklahoma City</td>
<td>N/A</td>
<td>Horizontal disintegration</td>
</tr>
<tr>
<td>2005</td>
<td>Acquisition of DreamWorks SKG</td>
<td>US$1.6bn</td>
<td>Horizontal Integration (content expansion)</td>
</tr>
<tr>
<td>2005</td>
<td>Sale of WNDY-TV Indianapolis and WWHO-TV Columbus</td>
<td>N/A</td>
<td>Horizontal disintegration</td>
</tr>
<tr>
<td>2006</td>
<td>Acquisition of Harmonix (video game developer)</td>
<td>US$175m</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2006</td>
<td>Acquisition of Atom Entertainment (online video and gaming site)</td>
<td>US$200m</td>
<td>Vertical Integration</td>
</tr>
</tbody>
</table>

**Table 9:** Classification of Viacom's M&A Activities According to their Type of Integration  
*Source:* Own Illustration, Company Reports
4.6. **Case Study: Bertelsmann AG**

4.6.1. **Corporate History**

In 1835, the printer Carl Bertelsmann started a small, but very successful printing business publishing hymn books. The business soon grew to produce general education books and two newspapers, and in the next generation, fiction and non-fiction books were included, together with an altogether more commercial orientation.

Johannes Mohn, the son in law of Heinrich Bertelsmann, refocused Bertelsmann on theological subjects until in 1921 his son, Heinrich Mohn, took over and expanded Bertelsmann's product offering. Up to 1941, Bertelsmann grew rapidly, increasing sales sevenfold. However, after the war, Reinhard Mohn, had to rebuild the company from scratch. Since most public libraries had been destroyed in the war, management came up with the idea of a book club, by sending books to everyone who had signed up for this service. The success of this idea was overwhelming, and the Bertelsmann "Lesering" gained one million customers within three years.

4.6.1.1. **Early Vertical Integration Moves**

In 1956, the book club concept was leveraged into music with the creation of the "Schallplattenring", which led to Bertelsmann in fact entering the music industry itself by building its own record press and starting its own music label, Ariola. Bertelsmann’s entry into the music industry can be classified as one of the rare examples of an organic vertical integration, where without the help of acquisitions vertical entry into and within a new market segment was effected.

---

46 All information regarding the history of the Bertelsmann AG has been taken from the Bertelsmann website: www.Bertelsmann.de/Unternehmen/Chronik.
In 1962, Bertelsmann decided to expand the scale of its operations to include other European countries by introducing the book club model to Spain, and subsequently Portugal, the UK, Netherlands, and Italy.

Very early on, in 1964, Bertelsmann had the strategic insight to further advance its vertical reach by entering the emerging German television industry through the acquisition of the film production company UFA.

In 1969, Bertelsmann further increased its extent of vertical integration with the acquisition of a 25 per cent stake in Gruner + Jahr, a magazine publishing house which produced several of Germany's most influential magazine publications. By 1976, Bertelsmann could increase its stake in Gruner+Jahr to 74.9 per cent. This acquisition transformed Bertelsmann into a leading media company with a presence in publishing (books and magazines), printing and industrial services, book and music clubs, music, film and television.

With growing success in Europe, Bertelsmann now had the financial means to further its international expansion by entering the important U.S. market. In rapid succession, Bertelsmann expanded its presence in the United States with the acquisitions of music label Arista and the paperback publisher Bantam Books. Changes in music distribution and promotion led to a consolidation of the music industry, with many small, independent labels being acquired by the music majors. Bertelsmann anticipated this consolidation trend to continue, and wanted to secure its first-mover advantage.

By the early 1970s, Bertelsmann had grown into one of the biggest European media conglomerates, and Mohn changed Bertelsmann’s organizational form to a shareholder company in 1971, but he retained the majority of shares and did not take the company public as he feared that this would change Bertelsmann’s unique corporate culture and force it to act solely on the short-term increase of shareholder value. To ensure that his vision for Bertelsmann would remain in place even after he had relinquished control, he founded the Bertelsmann Stiftung in 1977, whose aim was to safeguard the company in the long-term - independent of ownership interests (Mohn, 1973). The foundation also promotes projects in education and culture, and it also acted as a think-tank and provided knowledgeable research for public administration, the government, and universities. In 1993, Mohn transferred the

47 The English equivalent of a "Stiftung" is a foundation or a trust fund.
majority of his shares without voting rights to the Stiftung, while 90 per cent of the voting rights were transferred in 1999 to the Bertelsmann Verwaltungsgesellschaft, which was managed by an eight member committee made up of representatives of the family, other shareholders, and employees.

By the end of the 1970s, Bertelsmann's three core businesses were book and magazine publishing, and its music business.

In 1981, Mohn resigned due to age reasons, and was succeeded by his trusted aide Mark Woessner. He has since remained, however, majority shareholder and head of the supervisory board of the Bertelsmann AG.

4.6.1.2. Increased International Expansion and Further Vertical Integration into Broadcasting

In order to improve Bertelsmann' ability to evaluate the importance of global changes and trends for the company, Woessner set up a strategic planning unit, which came to the conclusion that the further strengthening of its presence in the U.S. market was indispensable for Bertelsmann. This initiated a period of acquisition-driven growth: In 1986, Bertelsmann acquired the U.S. music label RCA and the Doubleday Group which included a trade publisher, book clubs, and printing plants. Consequently, Bertelsmann combined its worldwide music businesses into Bertelsmann Music Group (BMG), and united its two U.S. publishing houses into Bantam Doubleday Dell, in order to be able to realize synergies from the scale efficiencies of combined printing, warehouse operations, and sales and marketing efforts.

When entry restrictions into the German television market were relaxed and the first private television broadcasters entered the German broadcast market, Bertelsmann and Gruner+Jahr consolidated their electronic media activities in the Ufa Film- und Fernseh-GmbH, and with this vehicle acquired a 40 per cent stake in RTL Plus, the first private television channel in Germany. Until today, the RTL Group remains one of Bertelsmann's most important core business areas, accounting for about 30 per cent of Bertelsmann's total revenues (Bertelsmann AG Annual Report, 2005).

In the early 1990s, with the opening up of the former Eastern Block, Bertelsmann reacted with an immediate expansion into the newly opened publishing markets. In the United States, the acquisition of the New York Times women's magazine division further strengthened Bertelsmann's U.S. publishing activities.
Due to the increased extent of vertical integration and the increased size of Bertelsmann’s international operations, the Group was subjected to further reorganization: It now consisted of five main divisions – books, magazines, music, television, and industrial services. The aim of the reorganization was to facilitate collaboration and realize economies of scale and scope resulting from the extension of the group’s vertical scale. Soon after, two further divisions were added: multimedia and professional information.

In contrast to the other international media conglomerates, Bertelsmann started to develop its Internet presence early in 1995 with the acquisition of a 5 per cent stake in AOL. A joint venture was formed to launch AOL's services in Europe with both companies sharing the costs of the venture after Bertelsmann had invested an initial US$77 million to cover the start-up losses. In 1995, Bertelsmann also acquired a 75 per cent stake in Pixelpark, at that time Germany's leading multimedia agency, and further expanded its Internet activities by establishing an Internet portal for Europe in partnership with Lycos and by launching its own German Internet access provider, MediaWays.

Regarding Bertelsmann's broadcasting activities, the television operations that had been bundled in Ufa were merged with RTL's parent company, Compagnie Luxembourgeoise de Telediffusion (CLT). The resulting company, CLT-Ufa, was now the largest broadcaster in Europe, with 22 television channels and 18 radio stations in 11 countries.

When Thomas Middelhoff took over as CEO in 1998, Bertelsmann faced a rapidly changing competitive environment where industry boundaries were becoming increasingly blurred due to convergence and the rise of the Internet. Middelhoff accordingly formulated a strategic vision that would allow the company to face the coming internal and external challenges (CNNmoney, 2002). He saw three basic challenges for Bertelsmann in the near future: fragmentation of the customer markets, convergence, and globalization. In addition, Bertelsmann would be challenged by four different types of competitors: Firstly, the media conglomerates like Disney, Time Warner, News Corporation, and Viacom. Secondly, companies that operated in related sectors like Sony, IBM, and Microsoft. Thirdly, telecommunications companies and cable operators, and fourthly, the emerging online companies such as AOL, Yahoo, and Amazon who disposed of high cash amounts and highly valued shares as a currency for acquisitions after their initial public offerings (IPOs) (Middelhoff, 1998). The biggest threat at that time came from this last group since they had the capacity to match Bertelsmann's investment levels. Amazon, in particular, presented a danger for Bertelsmann's established book and music clubs. The latters’ most valuable assets
were records of what customers had bought in the past, allowing them to choose and recommend new offerings. Electronic commerce destroyed this distinction, and posed the problem for Bertelsmann how to respond to this threat without cannibalizing existing business.

Bertelsmann’s growth strategy continued and, in fact, accelerated under Middelhoff. In 1998, after selling its 5 per cent stake in the company back to AOL for US$1.4 billion, Bertelsmann acquired the U.S. publisher Random House, thus making it the leading book publisher in the U.S. market. In the same year, the company bought an 80 per cent stake in the leading German scientific publisher Springer-Verlag and acquired the Falk Verlagsgruppe, a cartographic publisher, thus extending its horizontal integration into professional publishing. Given the way the industry was evolving, especially given the increasing popularity of the Internet, industry analysts were surprised by Bertelsmann decision to acquire Random House, just as rivals such as Viacom and News Corporation were trying to limit their exposure to book publishing which was seen as an ailing industry.

Bertelsmann's formal response to the “Amazon challenge” started in 1998, when the group invested US$200 million to acquire a 50 per cent stake in barnesandnoble.com, the online arm of the biggest book store chain in the U.S. In 2000, Bertelsmann also invested US$300 million in BOL, its own online book seller and set up a BOL website in most European countries, with Japan, South Korea and China to follow. The music division set up a website called getmusic.com. In August 2000, it acquired the online music retailer CDNow, and in early 2001 formed a digital music service, MusicNet, with EMI, Warner Music, and RealNetworks (Harmon, 2001). However, one of Bertelsmann's major constraints in terms of Internet-related acquisitions was that they were becoming too expensive to finance with cash, especially given Bertelsmann's strict debt limits.

As a first remedy Bertelsmann decided the flotation of some of its new online businesses in order to be able to use those shares as further acquisition currency. In 1999, shares of barnesandnoble.com and Pixelpark began trading on Nasdaq and the Neuer Markt. These initial public offerings (IPOs) supplied the online business with the necessary capital to finance their own expansion, leaving Bertelsmann's core businesses to pursue growth strategies of their own. For example, the traditional printing business bought up several smaller companies offering Internet, data management and archiving services, while teaming up with the Bertelsmann Services Group in order to be able to offer a full customer service chain.
In 1998, Bertelsmann's television unit, CLT-Ufa, had to reduce its 33 per cent stake in the Pay TV operations Premiere\(^{48}\) to a 5 per cent stake due to European antitrust regulations. With the proceeds from the sale, CLT-Ufa acquired a 49.9 per cent stake in Vox Television. At the time of the sale, Bertelsmann already owned a 24.9 per cent stake in the channel, and considered the acquisition to be part of a channel-consolidating strategy. To further strengthen its television assets\(^{49}\), CLT-Ufa in 2000 acquired Pearson's Channel Five in the U.K. Subsequently, CLT-Ufa was renamed RTL Group, which now controlled a pan-European television network. In 2001, despite the deflation of advertising markets and a slowing economy, Bertelsmann looked to increase its stake in RTL in order to increase its television presence in Europe. To do so, a share swap was effectuated between Bertelsmann and Groupe Bruxelles Lambert (GBL), the majority owner of RTL. GBL would swap 30 per cent of RTL shares for 25.1 per cent of Bertelsmann shares. In order to be able to realize the value of the investment, GBL would have the option of listing the acquired Bertelsmann shares on the stock market from 2005 onwards.

In March 2000, Bertelsmann had to sell back its 49 per cent stake in AOL Europe to Time Warner for antitrust reasons following the merger of AOL and Time Warner, achieving a sale price of US$6.75 billion, which was three times the current stock market value of the stake (Buckley & Ayres, 2002). The two companies agreed to form an alliance that would continue to promote Bertelsmann's content on AOL, and AOL's various media properties would be promoted to Bertelsmann's own customer base. The loss of the AOL Europe stake led Bertelsmann to disintegrate its other Internet investments as well. The sale of MediaWays to Spanish Telefonica was announced in the summer of 2000. Since 1996, MediaWays had become one of Germany's biggest data networks, and had a license to offer national telephone services as well. On both disposals, Bertelsmann had realized enormous gains on the initial investments. However, on the sale of its online book seller BOL.com, Bertelsmann incurred heavy losses.

\(^{48}\) Premiere had originally been created as a joint venture between the KirchGroup, Canal Plus and Bertelsmann. However, in 1997, Canal Plus left the partnership and European antitrust regulations did not allow Bertelsmann and the KirchGroup to combine their interests into a single entity.

\(^{49}\) This included Fremantle Productions, and minority stakes in the U.K.'s Channel Five and Spain's Antenna 3.
Another strategic reevaluation led to the divestiture of the scientific publisher BertelsmannSpringer, which no longer fit into the concept of an integrated media company (Brychy & Jakobs, 2002). Apart from this divestiture, Bertelsmann made two acquisitions in 2002. It acquired an additional 22 per cent stake in the RTL Group from Pearson for US$1.5 billion, thereby increasing its stake to 89 per cent. The second transaction was the more or less forced acquisition of the U.S. based Zomba Records for US$2.7 billion since the company’s owner Clive Calder now exercised a put option from 1991. After the Zomba acquisition, Bertelsmann exceeded its self-imposed debt limit for the first time. Nevertheless, it remained the only major media conglomerate that generated positive net earnings in 2002 (Fox, 2002).

4.6.1.3. From New Media Back to Old Media

Due to Bertelsmann’s weak performance between 2000 and 2002, Middelhoff was asked to step down as CEO by the Mohn family in June 2002, and was succeeded by Gunter Thielen. Thielen had worked his way up through the Bertelsmann ranks since 1980, and, in contrast to Middelhoff, was considered self-effacing and "bland" (Cowell, 2002), but his operational skills were highly regarded. Unlike the public dismissals of other high-ranking media executives, Middelhoff was more often than not publicly credited for doing all the right things to turn Bertelsmann into a global player and some suggested that replacing Middelhoff with Thielen was going to be a big step backward for Bertelsmann (Landler et al., 2002). Of all the major media conglomerates, Bertelsmann was the most profitable at the time of Middelhoff's exit (Fox, 2002) and its debt was modest compared to competitors. Middelhoff had turned Bertelsmann into a world leader in new media, however, the group was nonetheless losing money on these investments (US$1.25 billion in 2001). Mr. Thielen’s first job was “to clean up the company” (Edgecliffe-Johnson, 2006) and refrain from further acquisitions that would take the company into new markets. Instead, Bertelsmann was, following Ms Mohn's insistence on avoiding a public listing, forced to borrow huge sums to buy back its own shares from investors who wanted to sell. Early in 2006, for example, Bertelsmann had to buy back a 25 per cent stake in Bertelsmann owned by Albert Frère, the

---

50 Bertelsmann's self-imposed financial debt limit is 1.5 times annual cash flow. Financial debt includes all financial debt including finance leasing obligations offset against cash and cash equivalents.
Belgian financier, by taking out a Euros 4.5 billion loan. Mr. Frère had negotiated the right to sell his stake either in an IPO or to Bertelsmann in 2001, when he swapped a 30 per cent share in RTL for the Bertelsmann stake. To repay the loan, Bertelsmann sold BMG Music Publishing to Vivendi Universal.

This share buy-back came just as the company had worked itself out of another such position where Bertelsmann was forced to buy out Zomba Records (see above). Both buy-backs banished the prospect of other big purchases, and raised the pressure to follow a strict cost-management strategy in order to be able to stick to Bertelsmann’s conservative self-imposed debt limits. The buy-out of Albert Frère, opposed by many of Bertelsmann’s senior executives, was forced upon the company by the representative of the Mohn family, Liz Mohn, who feared the listing planned by Mr. Frère would weaken the family's dominance. It has severely limited Bertelsmann’s investment capabilities at a time when traditional rivals such as News Corporation and Viacom work on developing comprehensive online strategies for their conglomerates (Wiesmann, 2006).

Bertelsmann’s debt load after the buy-back of the GBL stake prohibits an extensive acquisition strategy in the next two years. Announced smaller projects include a further strengthening of Bertelsmann’s television operations, which have for years generated nearly half of Bertelsmann’s profit. The group aims to buy back the 10 per cent of RTL Group’s stock which are traded on the stock exchange; and has announced the acquisition of ITV by the RTL Group jointly with several private equity investors. Regarding its online and digital strategy, Bertelsmann is in the process of establishing a German social networking site, which aims to copy the success of the U.S. MySpace.com. For the first time since Mr. Thielen took the helm in 2002, a Bertelsmann internet project will not be docked on to one of the five units, harking back to the separate "New Media" division of predecessor Thomas Middelhoff.

### 4.6.2. Summary of Bertelsmann’s Corporate Strategy

<table>
<thead>
<tr>
<th>Generic strategy</th>
<th>Strategic Behaviour</th>
<th>Growth Strategy</th>
<th>Internationalization Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bertelsmann</td>
<td>Differentiation</td>
<td>Innovative until the late 1990s, reactive since 2000</td>
<td>Internal and External Growth</td>
</tr>
</tbody>
</table>

Table 10: **Overview of Bertelsmann’s Corporate Strategy**

Source: Own Illustration
4.6.2.1. Analysis of Bertelsmann’s Vertical Integration Strategy

Bertelsmann has been following a strategy different from the other media giants who were strongly driven by their movie, television, or cable interests. It has also pursued a strategy of vertical integration, but has stopped short of the upstream filmed content value chain segments, and chosen the print and music segments, which overall present fewer opportunities for collaboration. And even the few existing collaboration opportunities have not been exploited due to Bertelsmann’s traditionally decentralized organizational structure. This notion will be further explained under section 6.6.2.2. But in general, the scope for leveraging cross-promotional concepts within the current six major business units is limited by geographical boundaries. Most of Bertelsmann's newspapers are aimed at local populations, and content is created locally and not translated. The same is true of the Bertelsmann’s radio and television interests, which broadcast in all major European markets but only cater to their local audiences. In books, the publishing and other exploitation rights were negotiated by region, and the Bertelsmann's subsidiaries often lost to independent higher bidders.

With one of the largest music companies as well as the largest book publishing division in the world, Bertelsmann’s strategy for digitalization and technological convergence is to focus on increasing the growth opportunities of these two assets through new online distribution channels. However, extreme competitive conditions, as well as its complex internal structure, have slowed Bertelsmann’s momentum in the digital distribution of content. Most of Bertelsmann’s forays into the digital or online media segments over the last five years have been somewhat random and seem to lack a common strategic intent. Nevertheless, Bertelsmann has been trying to expand the extent of its vertical integration into areas of new media, as the alliance with and eventual acquisition of Napster shows. Regarding online book retailing, Bertelsmann’s strategic actions have been more hesitant, especially after the failed attempt to establish its own service BOL.com in the late 1990s. Since then, Bertelsmann has resorted to a strategy of partial vertical integration through its acquisition of a 40 per cent stake in barnesandnoble.com. However, the control of this stake has been placed not with its publishing operations, but within its Direct Group professional business services division, thus hindering effective cooperation.

Unlike most of its rival media conglomerates, Bertelsmann also lacks ownership of hardware that will carry the convergent media services to consumers, leaving it with the competitive disadvantage of lacking vertical integration with scalable broadband cable access providers.
But large-scale acquisitions in technological hardware to complement its content assets would require the company to go public in order to raise the necessary funds, a move that has recently been excluded by the controlling Mohn family. A vertical downstream integration with a European cable company, or a content/distribution joint venture on a rival platform (e.g. satellite television or wireless communications provision), would allow Bertelsmann to compete effectively with its rival media conglomerates. Despite an overall fragmented broadband landscape Europe has growing broadband penetration rates, providing the opportunity to evolve into a pan-European diversified communications company.

4.6.2.2. Analysis of Corporate Culture

The foundation of Bertelsmann’s decentralized organizational structure was laid in the early 1960s, when the vertical integration into the music industry necessitated a reorganization of Bertelsmann's corporate structure. Reinhard Mohn introduced the characteristic divisional structure with multiple independent profit centers. While enjoying a significant degree of autonomy, all divisions nevertheless had to abide by the "Bertelsmann Essentials", a set of convictions and values formulated by Mohn himself, on which the company was based (Heuser, 2001).

Under Woessner, Bertelsmann underwent further reorganization regarding the grouping of its various business activities, but the general organizational form was left unchanged.

Significant changes to Bertelsmann’s corporate culture and organizational form were undertaken during the Middelhoff period, leading to a structural shift from decentralization to increasing centralization. Middelhoff believed that increasing convergence and the advent of the Internet would sharpen the need for different parts of the business to work together. He started by ordering the book and music clubs to share membership lists and marketing plans as they migrated their businesses to the Internet (CNNmoney, 2002). With the additional aim of strengthening the recognition of Bertelsmann as a brand, he next introduced the “one-voice” policy guideline, which required divisions to convey and coordinate any major announcement with the corporate communications department. In 2000, in order to facilitate better communication and thus coordination between the divisions, it was decided to introduce several communication rules like increased use of email, preference of English as the working language, and an expanded Intranet that would allow for better knowledge management across divisions. Next, the Bertelsmann University was created which would
offer a platform for cross-divisional knowledge flows and cooperation within the company (Bertelsmann Annual Report, 2000).

The share swap with Groupe Bruxelles Lambert, which had awarded a publicly listed company a stake in a privately held company, led to increased attention of financial analysts, and the major investment banks started producing detailed reports on the company. The increased scrutiny, among other factors like the need for access to external capital sources, led Middelhoff to announce an initial public offering of Bertelsmann shares for 2005. An IPO would help Bertelsmann to compete for scarce talent, as it could not afford to forego incentive schemes like stock options that the other companies were offering. In 1999, a virtual stock options plan had already been introduced for Bertelsmann executives which promised bonus rewards based on a weighted average of company, divisional, and corporate profits, and bottom-line growth over a multi-year period. In addition, an IPO would provide Bertelsmann with currency for further acquisitions.

Due to the economic downturn of 2001 and 2002 and the consequent decrease in advertising revenues, Bertelsmann suffered from increasingly disappointing financial results, and the company’s strategic direction for the future was again reconsidered. By mid-2002, Bertelsmann' strategic planning group launched the so-called Bertelsmann Excellence programme (BEX), which aimed at increasing operating performance with a set of three criteria that would be used to reevaluate the portfolio of all existing businesses. Business units would be reevaluated according to whether they really were media businesses, and they had to meet stringent performance targets using three measures: Return on sales, a positive Bertelsmann Value Added (BVA)\(^{51}\), which meant that return on invested capital (ROIC) had to exceed 10 per cent after tax, and a free cash flow that exceeded 100 per cent of earnings before interest, taxes, and amortization (EBITA). The third evaluation criterion was the ability of each unit to generate synergies with other divisions. In order to be able to assess such efforts, Bertelsmann set up a synergy committee that was headed by Middelhoff.

The company strategy now comprised the following points:

---

\(^{51}\) Essentially, the Bertelsmann Value Added (BVA) is a financial measure that subtracts taxes from the company's profit surplus.
1. Bertelsmann is dedicated to the media business\textsuperscript{52}

2. Bertelsmann is committed to creating corporate shareholder value. The company will achieve this goal by operating in attractive markets as well as having a strong position in those markets. Among the qualifiers for a strong position are a No.1 or No.2 position in all relevant markets as well as agreed upon return on sales (ROS), Bertelsmann Value Added, and free cash flow benchmarks.

3. Bertelsmann is an integrated media company, leveraging synergies to create value to the group that were formerly not possible.

To ensure stronger central coordination whenever cross-divisional projects were theoretically possible, Bertelsmann founded a new department which would deal with all cross-functional responsibilities in 2001. It was originally assigned to the Corporate Development Committee, and reported directly to the supervisory board. Initially, the department was called the Bertelsmann Content Network (BCN) and focused mainly on promoting the multiple usage of content in content-related business units (Thielmann, Sieprath, and Kaiser, 2003). In 2002, its activities included the promotion of multiple usage of formats, rights, brands, and customer data across organizational and national market borders. The goal was to translate cooperation into lower transaction costs through process optimization and better capacity utilization. Aiming to achieve further synergies, Bertelsmann also established shared service centers (Bertelsmann Annual Report, 2002). These shared services related to finance and legal affairs, technology management and Human Resources.

In summary, the establishment of BCN played a vital role in Bertelsmann's approach to synergy management. Regular communication platforms like the quarterly synergy committees had thus been established where the management both of divisions as well as geographic areas could communicate and exchange knowledge (Schulze et al. 2004). A "Synergy Award" was offered to those pushing forward ideas that capitalized on cooperation between business units.

BCN's most important cross-divisional project so far has been the 2006 FIFA World Cup Germany. In 2003, negotiations started between BCN, six different Bertelsmann business

\textsuperscript{52} This meant that each business unit would be evaluated according to whether it fit the criterion of being a media business. If not, a disposal would be likely.
units, EM.TV & Merchandising, and the Fédération International de Football Association (FIFA). Bertelsmann obtained the joint licensing rights for the official trophy, the official emblem, the official mascot for the German-speaking countries (Bertelsmann, 2004b). Bertelsmann utilized these licensing rights to offer more than 70 different media products ranging from magazines, encyclopedias, children's and specialized books to calendars, posters, and games (Schulze et al., 2004).

In spite of the success of the FIFA project, synergies have only been realized from formats and rights, or brands and customer data, while synergies from a multiple usage of content have been non-existent (Schulze et al., 2004). Nonetheless, Bertelsmann estimates that all BCN accompanied synergy projects between 2002 and 2004 have contributed about EUR 300 million to EBITA. Cost savings play only a subordinate role (Schulze et al. 2004).

With the departure of Mr. Middelhoff, however, all efforts regarding synergy realization through the introduction of a more centralized corporate organization with stronger cooperation between the individual businesses, were abandoned and, in most cases, even reversed. BCN today has been reintegrated into the business development department, and is no longer in existence as a stand-alone synergy unit. It still represents, however, the only major effort Bertelsmann has so far undertaken to reap the benefits from its vertical integration by undertaking cross-divisional marketing and sales projects (Schulze et al., 2004).

Bertelsmann has reemphasized its tradition of decentralization, and divisions are given strict financial performance targets in order ensure improved financial performance ratios of the individual business units, but apart from that, divisions are left to manage their operations independently. It remains to be seen if the absence of an overall vision for the company and the network of independent business units will allow Bertelsmann to sustain its place among the global media conglomerates.
4.6.3. Classification of Bertelsmann’s M&A Activities According to their Type of Integration

<table>
<thead>
<tr>
<th>Year</th>
<th>Activity / Type of Deal</th>
<th>Value</th>
<th>Type of Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964</td>
<td>Acquisition of stake in Ufa Films</td>
<td>N/A</td>
<td>Vertical Integration (entry into film and television business)</td>
</tr>
<tr>
<td>1973</td>
<td>Acquisition of majority stake in Gruner + Jahr magazine publisher</td>
<td>N/A</td>
<td>Vertical Integration (entry into magazine business)</td>
</tr>
<tr>
<td>1976</td>
<td>Acquisition of Arista Records (USA)</td>
<td>N/A</td>
<td>Vertical Integration (entry into music business)</td>
</tr>
<tr>
<td>1980</td>
<td>Acquisition of Bantam Books (USA)</td>
<td>N/A</td>
<td>Vertical Integration (from trade into popular publishing)</td>
</tr>
<tr>
<td>1984</td>
<td>Gruner + Jahr acquires 40% stake in first private German television channel RTL Plus</td>
<td>N/A</td>
<td>Vertical Integration (into television assets)</td>
</tr>
<tr>
<td>1986</td>
<td>Acquisition of RCA Records (USA)</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1986</td>
<td>Acquisition of Doubleday Group (USA)</td>
<td>N/A</td>
<td>Vertical &amp; Horizontal Integration</td>
</tr>
<tr>
<td>1995</td>
<td>Acquisition of 5% stake in AOL</td>
<td>US$50m</td>
<td>Partial Vertical Integration</td>
</tr>
<tr>
<td>1995</td>
<td>Acquisition of Bantam Books</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1995</td>
<td>Acquisition of Pixelpark Multimedia</td>
<td>N/A</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1998</td>
<td>Acquisition of 49.9% stake in Vox Television Channel from News Corp.</td>
<td>US$332m</td>
<td>Horizontal Integration (television assets)</td>
</tr>
<tr>
<td>1998</td>
<td>Sale of 5% stake in AOL</td>
<td>US$1.4bn</td>
<td>Partial Vertical Disintegration</td>
</tr>
<tr>
<td>1998</td>
<td>Acquisition of Random House Publishers</td>
<td>US$1.4bn</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1998</td>
<td>50% stake in Barnes &amp; Noble Online</td>
<td>US$200m</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1999</td>
<td>Acquisition of specialist publisher Springer</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2000</td>
<td>Acquisition of CDNow</td>
<td>N/A</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2000</td>
<td>Sale of 49% stake in AOL Europe</td>
<td>US$6.75bn</td>
<td>Partial Vertical Disintegration</td>
</tr>
<tr>
<td>2000</td>
<td>Sale of network services provider Mediaways to Telefonica</td>
<td>US$1.5bn</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of 30% stake in RTL Group from GBL</td>
<td>All share deal</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>Year</td>
<td>Activity / Type of Deal</td>
<td>Value</td>
<td>Type of Integration</td>
</tr>
<tr>
<td>------</td>
<td>-------------------------------------------------------------</td>
<td>-----------</td>
<td>---------------------</td>
</tr>
<tr>
<td>2001</td>
<td>Acquisition of further 20% stake in the RTL Group from Pearson</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2002</td>
<td>Acquisition of Napster (online music file sharing service)</td>
<td>US$8m</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>2003</td>
<td>Disposal of specialist publisher Bertelsmann Springer</td>
<td>N/A</td>
<td>Horizontal Disintegration</td>
</tr>
<tr>
<td>2003</td>
<td>Acquisition of Heyne Imprint Publisher</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2003</td>
<td>Acquisition of Zomba Records</td>
<td>US$2.7bn</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2004</td>
<td>Bertelsmann Music Group forms 50:50 Joint Venture with Sony Music</td>
<td>N/A</td>
<td>Horizontal Joint Venture</td>
</tr>
<tr>
<td>2006</td>
<td>Sale of BMG Music Publishing to Vivendi</td>
<td>€1.63bn</td>
<td>Vertical Disintegration</td>
</tr>
</tbody>
</table>

**Table 11:** Classification of Bertelsmann’s M&A Activities According to their Type of Integration  
Source: Own Illustration, Company Reports
4.7. Case Study: Sony Corporation

4.7.1. Corporate History

Sony was founded in 1946 as Tokyo Tsushin Kokyo Totsuken (Tokyo Telecommunications Engineering Company) by Masaru Ibuka and Morita. The company developed the first Japanese transistor radio in 1955 after it had acquired the licensing rights to the transistor patent from AT&T's Bell Laboratories. In 1956, an improved version of the transistor radio called Sony was introduced worldwide and became an immediate success. Due to the worldwide recognition of the Sony radio name, the company officially changed its name to Sony in 1958.

In the 1960s, the Sony Corporation successfully developed and introduced the portable videotape recorder, the transistor condenser microphone, the integrated radio circuit, and Trinitron TV technology, which revolutionized colour television. In 1979, Sony brought the "Walkman" onto the market, and in the same year, Sony and Philips invented the Compact Disc (CD), which began selling in 1982.

However, by the mid 1980s, Sony was losing its innovative capabilities and had not launched successful new products in several years. Japan’s consumer-electronics industry was also facing increasingly saturated global markets. As a result of slowing growth rates, Sony executives were concerned future revenues would not be sufficient to pay for the mounting costs of research and development and capital investments.

4.7.1.1. Vertical Integration of Sony’s Electronics Assets with Entertainment Content

The Sony Corporation's entry into music and film entertainment was a direct response to the company’s technological defeat in establishing a dominant videotape format (Gershon &

53 This section on the early history of Sony has been developed in part from The Sony Corporation case study (1996)in Quinn, JB, Mintzberg, H and James, RM (1998) : The Strategy Process: Concepts, Contexts and Cases, Prentice-Hall.
Kanayama, 2002), where its Betamax videocassette recorder had lost out against Panasonic’s VHS format. The lessons Sony drew from this experience were to focus on software development as a critical leverage for selling its technical equipment (Gershon & Kanayama, 2002), and adopt a corporate strategy of vertically integrating its existing hardware business with new software or content assets. Morita believed the next electronics war would be fought on a vast global scale over direct satellite broadcasting and high definition television. Expanding television markets in Asia and Europe desperately needed content, and Morita wanted to make sure his company had the software assets that would make consumers buy Sony’s hardware. He believed that Sony stood on “the threshold of a new wave of consumer electronics products driven by digital video technology – direct satellite broadcasting, digital videotapes, and digital videodiscs” (Klein, 1995).

Sony decided to start by integrating its successful audio products with musical content by acquiring CBS Records in 1988 (Newsweek, December 10, 1990). The logical next step was to follow the same strategy for its video and television electronics division by selecting an adequate theatrical and television content producer. Sony’s choice was to acquire Columbia Pictures, one of Hollywood’s major studios. Several of Sony's executives doubted the rationale behind this acquisition, as the studio was struggling and had less than 10 per cent market share of the U.S. market. The acquisition price of US$3.4 billion was seen by industry experts to be overvalued by US$1 billion (Businessweek, November 6, 2000).

Despite the voiced concerns, 1989, Sony’s board of directors approved Morita’s plan to purchase Columbia Pictures. To head Sony’s new motion picture division, Morita turned to Peter Guber and Jon Peters, who had produced two of the biggest blockbusters of the 1980s with “Batman” and “Rain Man”. In light of the negative publicity surrounding the acquisition of a Hollywood studio by a Japanese company, Sony chose not to interfere in the management of Columbia during the initial years of its acquisition and never questioned the decisions taken by the studio’s management.

The passive role played by Sony prevented any cooperation between the respective electronics and content businesses, and made the realization of potential synergies that the vertical combination would have allowed all but impossible.

Throughout the 1990s, Columbia Pictures revenues continued to decline, and Sony sustained repeated losses for its new entertainment division. The Columbia Pictures catastrophe was the result of poor performance at the box office combined with excessive spending of Guber and
Peters (Gershon & Kanayama, 2002). Sony’s management eventually became concerned that the highly publicized problems within the Sony Pictures Entertainment division would also disrupt harmonious relations inside the larger Sony family. To clear Sony Pictures’ balance sheet and make the company more attractive to potential strategic partners, Sony was forced to write-off US$3.2 billion in losses for Sony Pictures (Sony Annual Report, 1994). At this point, Sony decided to take an active part in the management of its movie business and Sony’s president Nobuyuki Idei appointed John Calley as President of Sony Pictures Entertainment and Masayuki Nozoe as Vice President, whose function it was to realize the long overdue synergies between the electronics and content businesses (Newsweek, October 21, 1996).

Sony survived the difficult and expensive expansion from electronics into entertainment, but learned some painful lessons along the way. Most industry experts agree that the clashing corporate cultures between Sony and Hollywood made the vertical integration of the two companies extremely difficult (Klein, 1991).

4.7.1.2. Unsuccessful Vertical Integration into Theatrical Content Distribution

In 1998, Sony further increased its extent of downstream vertical integration by acquiring just under 50 per cent of Loews Theaters, giving it access to over 2,600 screens in North America. The purchase added a distribution arm for Sony Pictures’ theatrical content. Howard Stringer, at the time president of Sony Corporation of America, noted that Sony Pictures Entertainment would not only be one of the top theatrical content production companies, but would be positioned to become “the global leader in theatrical exhibition” (Sony press release, 1998).

Theaters appeared to fit well into Sony’s overall corporate strategy of combining hardware and software (content). Sony was now present in most major segments of the media value chain apart from television, cable and satellite broadcasting: It would own or produce the movie, the movie theater, the snack bar, the soundtrack album, the television series adaptation and the video and audio players on which the entertainment content could be played.

However, the general trend among media companies toward integration of film production and exhibition was accompanied by a substantial increase in exhibition capacity, with the number of screens increasing by more than a third between 1988 and 1997 while tickets sales were relatively flat. With more screens available, exhibitors found that competition for films
increased the amount they paid to distributors, and competition for customers forced them to invest heavily in new luxury megaplexes, with stadium seating and high-quality sound. The result was that Loews, Regal, Edwards, and United Artists all filed for bankruptcy protection in 2001 or early 2002. With Loew’s bankruptcy, Sony officially left the exhibition business.

4.7.1.3. Partial Vertical Integration into Broadcasting Content Distribution

In the late 1990s, Sony’s entertainment unit focused on further strengthening Sony Pictures’ television business by launching an international cable channel and partnering with cable operators in Asia and Latin America for supplying its content. In 1997, the company formed a satellite broadcasting joint venture with the News Corporation to establish JSkyB in Japan. This investment was transformed into an 8 per cent stake in SkyPerfectTV, which became Japan’s leading satellite broadcaster after a series of mergers and acquisitions in the Japanese satellite broadcasting industry (The Economist, 2003). Sony entered into television licensing arrangements with leading broadcasting companies across the world to expand the reach of its satellite broadcasting services. The company also acquired stakes in leading television networks/channels across the world. This expansion of Sony’s presence in the broadcasting segment of the media value chain represents not a full, but a partial vertical downstream integration, since Sony was prohibited by U.S. law from owning a television network. Through the acquisition of equity stakes, i.e. a partial vertical integration, in important television distribution networks, access to further distribution channels could at least be enhanced for Sony’s content.

4.7.1.4. Vertical Integration Into the Computer Games Segment

Sony entered the video games industry in 1995 with a hugely successful hardware product, the PlayStation. For the provision of software, Sony at the beginning followed a strategy of partial or quasi vertical integration by acquiring software licenses from third party software developers rather than combining both the hardware and software operations in-house. The success of the PlayStation secured Sony a powerful first-mover-advantage and allowed it to dominate the market for digital video games for several years since the PlayStation rapidly outstripped sales of both the Nintendo and Sega platforms, establishing a worldwide market. By 1999, almost 38 per cent of Sony Corporation profits stemmed from its videogames division, Sony Computer Entertainment (Poole 2000).
To ensure availability of quality content for their new platform, however, Sony soon decided to replace its vertical joint ventures with full vertical integration. Sony started to develop its own software by applying the expertise gained from its alliances with Namco, a Japanese arcade games company, and U.K. based game developer Psygnosis.

Despite its interest in the movie business, Sony remained first and foremost an electronics company, with roughly 65 percent of its US$55 billion in fiscal 1998 revenues tied to the sales of items such as home-use digital camcorders, notebook computers, cellular phones, and assorted electronic components. Games, particularly the PlayStation console, constituted the fastest-growing part of Sony's repertoire, generating 10 percent of revenue and 22 percent of operating income in fiscal 1998 – an increase from zero in 1994 (Sony Annual Report, 1999).

4.7.1.5. Recent Strategic Responses to the Challenges of Technological Convergence and Digitization

In 2004, Sony announced its acquisition of MGM’s film library for close to US$5 billion. The content of the library helped Sony to increase its profits in the home video segment (DVD), a segment which is more profitable than theatrical distribution (Oligopolywatch, 15 September 2004). The acquisition also enabled Sony to improve its chances to establish its Blu-ray Disc technology for high-definition video storage as the successor standard to DVD. If Sony owned premium content, the new storage format could be promoted much easier, especially since the rival electronics companies Toshiba and NEC did not own any content of their own.

Despite all these initiatives, Sony has fallen behind its old rival Matsushita in 2005, and is loosing out against new entrants in business segments like portable and online music devices. Weak consumer demand, and increasing competition in Sony's core hardware markets, as well as losses at its music and movie divisions, have negatively impacted Sony's profitability. For 2005, Sony posted a 4.6 per cent drop in revenues. Income increased by 85 per cent, but this was mostly due to one-time gains and reduced restructuring charges. Sony's problems are most obvious in its core electronics business, which still accounts for two-thirds of its

\[54\] TVs, digital cameras, stereos and computers
revenues (The Economist, 2005). Due to increased competition in consumer electronics, prices for electronic products have decreased considerably, thus eradicating Sony’s profit margins. Even the gaming segment, one of Sony's main growth drivers in recent years, has seen a sharp decline in revenues since 2003 and Sony has been forced to cut prices on its PlayStation games consoles (EIU Viewswire, 2005). The movie division recorded flat sales in 2004, and the music division experienced a 43 per cent decline of revenues due to strong competition from online music download services. Sony reacted, albeit too late, by launching SonyConnect, its own online music service, and several new portable music devices. To increase its market power in traditional and online music content production and distribution, Sony Music announced its joint venture with Bertelsmann’s Music Group (BMG). The combined entity forms the second-largest music company after Universal Music (EIU Viewswire, 2005).

But the main challenge for Sony will be to link all of Sony’s devices together in a way that creates a sustainable competitive advantage over its electronics rivals. The difficulties of the Sony-Ericsson mobile telecommunications joint venture to increase its market share highlight the challenge that Sony faces in those markets in which the technology of a device is increasingly easy to license. Although the company can still earn money by licensing some of its technologies to others, it must increasingly work in large alliances to make things happen. And those alliances limit Sony's own share of and the control it can exercise over the market.

The disappointing performance of the Sony Corporation over the last couple of years has led to the reconstitution of the company’s top management, and the first ever non-Japanese CEO was appointed with the American Howard Stringer, who had previously overseen Sony’s U.S. operations. Stringer has so far ruled out a fundamental restructuring of the company by, for example, dividing its media division from its electronics business. Sony’s main strategic aim is still to make its new "Blu-ray" high-definition technology an industry standard, by including it in Sony’s bestselling electronic devices like the PlayStation, and thus proceed with its strategy of vertically integrating hardware and software in all media industry

---

55 The Blu-ray standard is backed by Disney, Paramount, ColumbiaTristar, Warner Brothers, Apple, Dell and Hewlett-Packard. Toshiba’s rival HD-DVD format, which could also succeed DVD as the dominant video-disc standard, cooperates with Microsoft and Intel. Although Toshiba’s product is cheaper, the backing of Blu-ray by the major Hollywood studios will most probably mean that Sony will emerge as the winner of this standards war (The Economist, 2005).
segments. The new PlayStation3 constitutes the centerpiece of this strategy as it allows Sony to maintain its lucrative dominance of the games industry; to seed the market for Blu-ray and establish the conglomerate in the emerging market for Internet video downloads; and finally, to demonstrate that Sony's gaming, electronics and content divisions really do cooperate closely in order to create the envisaged synergies. In the gaming industry, however, Sony now faces far stronger competition than it did when it launched the PlayStation 2 in 2000, which obtained a 70 per cent market share. Due to manufacturing problems and high initial pricing Sony is already lagging behind its main competitors Microsoft and Nintendo. In addition to the time lag, Sony will lose money on each PlayStation3 sold for the first couple of years until higher volumes will eventually reduce costs. A reliable profit source will only come from the PlayStation’s software sales, where Sony gets a fixed percentage of every game sold.

4.7.2. Summary of Sony’s Corporate Strategy

4.7.2.1. Analysis of Sony’s Vertical Integration Strategy

The present case study has so far detailed the advancement of Sony’s vertical integration strategy. The next step is to analyze whether Sony’s strategy of combining content and hardware businesses has effectively created any synergies. The table below shows the synergies that should have been realized after the acquisitions of CBS Records and the Columbia Tristar film studios.

<table>
<thead>
<tr>
<th>Business Units</th>
<th>Possible Synergies</th>
</tr>
</thead>
</table>
| Film and recording studios      | Cameras, broadcasting and recording equipment all provided by Sony  
                                    | Sony also manufactures all the blank recording tape and films required                                                                           |
| Film and music production       | Sony would determine the films and music which would be                                                                                         |
Sony also gained control over 12 television stations and the Columbia libraries, including 300 film titles and 20,000 recorded television shows. These TV shows alone provide Sony with an annual income of US$100 million.

**Table 12:** Synergies between Sony’s Hardware and New Software Products after the CBS/Columbia Tristar Acquisitions

<table>
<thead>
<tr>
<th>Business Units</th>
<th>Possible Synergies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>produced – and, critically, control the release formats</td>
</tr>
<tr>
<td></td>
<td>Sony also gained control over 12 television stations and the Columbia libraries, including 300 film titles and 20,000 recorded television shows. These TV shows alone provide Sony with an annual income of US$100 million</td>
</tr>
<tr>
<td>Consumer hardware</td>
<td>Sony manufactures: high-definition televisions; video recorders; the range of Walkman products covering audio cassettes, CDs and videos (8 mm format); CD and hi-fi equipment</td>
</tr>
<tr>
<td>Consumer software</td>
<td>Sony manufactures the film, video tape, compact discs and cassettes upon which the software will be released. There are, quite simply, several outlets for a single piece of recorded material. Additional opportunities for Sony lie in computer games based upon their movies and designed for high-definition television and the Sony PlayStation; and in the future in digital video discs which are seen as the replacement for video tape</td>
</tr>
</tbody>
</table>

So far, however, the benefits from vertical integration have not been realized to a satisfying extent. This is to a certain extent due to Sony’s corporate structure, which was organized as a bundle of “network companies”, loosely guided by the Group’s headquarters in Japan. Individual companies of this network, and especially foreign subsidiaries operated quasi independent, and thus the necessary coordination to realize synergies between the individual elements of the media value chain did not take place.

A more general factor that might be hindering the realization of integrative benefits is the volatility of the content industry. The box office market shares of Sony Pictures Entertainment have fluctuated substantially over the last ten years, which might explain the fact that sales of video/DVD recorders and its software (DVDs, VHS tapes) have not increased as much as expected. Analysts stated that though Sony had tried to push its technologies by offering its music content on digital audiotapes (DAT), and its films on new Video Walkmans, with the aim of selling more disks and videos in the U.S., such tactics failed to increase Sony’s hardware sales in the U.S (Fortune, 1996).

A further alternative explanation for the poor performance of Sony’s vertical integration strategy should also be considered: With Sony being a traditional Japanese electronics company, communicative problems with its U.S. acquisitions are not surprising and rooted in language as well as cultural differences. Gelsi (1997) states that “although Sony is a top
global brand and an expert at communicating with consumers, its own divisions have been known to have a rough time communicating with one another. The company’s recorded music, movies, consumer electronics and computer divisions have done little in the way of cross-promotion beyond a series of tie-in projects for new product introductions and seasonal initiatives. In the process, Sony has lost out on marketing opportunities and brand synergies that a more integrated approach would create” (Gelsi, 1997, p. 20).

Additional integrative difficulties stem from the inherently different motivations that drive the hardware and software businesses. The content side of the business is concerned about piracy and remains ambivalent about new devices. Especially with regard to the protection of intellectual property rights, the strategy of controlling hardware and software has recently proved to be an obstacle to product development. Although Sony had developed several online music download services, it had to hold them back from the market over concern over music piracy at its recording studies. When Sony finally launched Sony Connect, Apple’s iTunes were already firmly established in the market, and so far not even a minor market share could be established neither by Sony’s online music software nor hardware. 26 years ago, Sony had pioneered the portable music market with the original walkman, but in January 2006, Apple had 45 per cent of the Japanese market for digital music players, versus 15 per cent for Sony (Hall, 2006).

4.7.2.2. Analysis of Corporate Culture

Sony had traditionally been characterized by an extremely decentralized organizational structure: All business units constituted independent profit centers, which were linked together by a loose corporate network and the Sony brand. The degree of independence that was accorded to the individual subsidiaries is exemplified in the management of the Columbia Tristar Pictures acquisitions, where no interference or control was exerted by the Sony Group’s central management on the new business unit.

However, due to worsening financial performance figures, and in order to facilitate the realization of the benefits of Sony’ vertical integration between hardware and software as far as possible, the existing company system of “network companies” has been abolished in 2005 to make way for a more centralized management style. Operational units were reorganized around specific product categories and called business groups. Rigorous horizontal coordination in key areas-product planning, technology, procurement, manufacturing, and
sales & marketing – should allow for more rapid and streamlined decision making across product lines. This should also permit uniform software development that will assure seamless interoperability between Sony’s products, eliminate design and product redundancies, and assure decisive and rational R&D planning and spending (Hall, 2005).

4.7.3. Classification of Sony’s M&A Activities and Joint Ventures According to their Type of Integration

<table>
<thead>
<tr>
<th>Date</th>
<th>Activity / Type of Deal</th>
<th>Value</th>
<th>Type of Vertical Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>Sony and Time-Life Video Inc. jointly announce plans to make video programs for the Sony Color Videocassette System</td>
<td>N/A</td>
<td>Partial Vertical Integration Through Joint Venture</td>
</tr>
<tr>
<td>1976</td>
<td>Joint venture with Paramount Pictures called &quot;Sony/Paramount Home Entertainment Center&quot;, for producing and marketing Betamax software tapes</td>
<td>N/A</td>
<td>Partial Vertical Integration Through Joint Venture</td>
</tr>
<tr>
<td>1979</td>
<td>Sony Prudential Life Insurance founded as 50-50 joint venture with Prudential Life Insurance Co. of America</td>
<td>N/A</td>
<td>Unrelated Acquisition</td>
</tr>
<tr>
<td>1988</td>
<td>Acquisition of CBS Records</td>
<td>US$2bn</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1989</td>
<td>Acquisition of Columbia Pictures and Tri-Star Pictures from Coca-Cola</td>
<td>US$3.4bn</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1989</td>
<td>Acquisition of Loews cinema chain</td>
<td>N/A</td>
<td>Vertical Integration</td>
</tr>
<tr>
<td>1994</td>
<td>Sony Music buys ATV Music publishing library from Michael Jackson</td>
<td>US$500m</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>1997</td>
<td>Sony/Loews cinema chain merges with Cineplex Odeon</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2001</td>
<td>Disposal of Loews Cineplex</td>
<td>N/A</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2001</td>
<td>Announcement of Sony-Ericsson Joint Venture</td>
<td>N/A</td>
<td>Partial Vertical Integration Through Joint Venture</td>
</tr>
<tr>
<td>2002</td>
<td>Disposal of most of interest in Columbia House to Blackstone Capital Partners</td>
<td>N/A</td>
<td>Vertical Disintegration</td>
</tr>
<tr>
<td>2002</td>
<td>Disposal of Telemundo stake to NBC</td>
<td>N/A</td>
<td>Horizontal Disintegration of Television Asset</td>
</tr>
<tr>
<td>2004</td>
<td>S-LCD Joint Venture between Sony and Samsung</td>
<td>N/A</td>
<td>Partial Horizontal Integration</td>
</tr>
<tr>
<td>2004</td>
<td>Sony Music Entertainment merges with Bertelsmann's BMG Records</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2004</td>
<td>Sony Pictures takes 49% stake in Huasuo joint venture with Hualong Film Digital Production (China Film Group arm)</td>
<td>N/A</td>
<td>Horizontal Integration</td>
</tr>
<tr>
<td>2005</td>
<td>Sony consortium (inc Providence Equity Partners, Texas Pacific Group and DLJ Merchant Banking Partners) acquires Metro-Goldwyn-Mayer Inc.</td>
<td>US$5bn</td>
<td>Vertical and Horizontal Integration of Further Content Assets</td>
</tr>
<tr>
<td>2006</td>
<td>Acquisition of Single Lens Technology from Konica Minolta</td>
<td>N/A</td>
<td>Horizontal Integration (Photographic Equipment)</td>
</tr>
</tbody>
</table>
Table 13: Classification of Sony’s M&A Activities and Joint Ventures According to their Type of Integration

<table>
<thead>
<tr>
<th>Date</th>
<th>Activity / Type of Deal</th>
<th>Value</th>
<th>Type of Vertical Integration</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>Acquisition of Grouper Network (user generated video sharing platform)</td>
<td>US$65m</td>
<td>Vertical Integration</td>
</tr>
</tbody>
</table>

Source: Own Compilation, Company Annual Reports

4.8. Conclusion

The preceding sections have provided an in-depth overview of the strategic behaviour of six of the major international media conglomerates, with a specific focus on the analysis of all vertical integration activities that have been undertaken by the selected conglomerates.

In general, as found in the industrial economics perspective of vertical integration, the external environment shapes the strategic behaviour of a firm. As detailed in the discussion of the research model, in the case of vertical integration for a media corporation, the general environment of its operating bases such as its regulatory, economic, technological, cultural, and social environment influences not only the attractiveness and characteristics of the individual markets the corporation operates in, but also another set of external factors – the communications/media environment such as the communications infrastructure and demand for media products. Therefore, a media conglomerate’s decision to enter a specific industry through vertical integration is likely to be determined by its target industry’s basic characteristics such as market size, growth rate, profitability, and competition.
5. **EMPIRICAL PART II: INTER-CASE ANALYSIS**

5.1. **Introduction**

The purpose of this chapter is to provide an answer to the second research hypothesis and its respective sub-hypotheses:

H2: Differences in the media conglomerates’ segmental and inter-segmental vertical integration strategies have an impact on the performance of those companies.

H2.1. Vertical integration has an impact on the media conglomerates’ financial performance.

H2.2. Vertical integration has an impact on the media conglomerates’ share price performance.

H2.3. The choice of organizational form has an impact on the success of a strategy of vertical integration.

The chapter will be structured as follows: First, the extent and direction of vertical integration of the selected media conglomerates is examined by applying a SIC sector analysis. The results of this analysis are further corroborated by the compilation of a detailed activity profile for each firm, which will show the extent of the firms’ presence in the various segments of the media value chain. A meta-analysis will provide a vertical integration ranking for the selected case studies.

After having thus defined the extent and direction of vertical integration for each media conglomerate, overall profitability will be determined for each company, followed by an in-depth analysis of divisional profitability. The results will be compared and differences between the conglomerates’ performances explained by considering internal and external influence factors.

In order to provide a coherent picture of the financial situation and capital resource availability, each media conglomerate’s share price performance between 1992 and 2006 will be analyzed, in order to determine whether the adopted vertical integration strategy has had a positive, negative, or no effect at all on the share price performance of the selected case study companies.

The chapter will conclude the inter-case study analysis by comparing corporate performance with each conglomerate’s organizational structure, in order to determine whether
organizational structure and corporate culture have helped or hindered the implementation of a vertical integration strategy.

5.2. Extent and Direction of Vertical Integration for Leading Global Media Companies

5.2.1. Extent of Vertical Integration of the Selected Media Conglomerates

Media industry sectors can be differentiated according to their SIC (Standard Industrial Classification) codes\(^{57}\). As stated in chapter II, it can be argued that SIC codes within a particular digit-level (i.e. with the same preceding digits) describe activities that are most likely vertically related. The number of SIC industry sectors with the same two preceding digits that a media conglomerate is involved in shall serve as the initial proxy for the extent of vertical integration. For each conglomerate, a vertical integration ranking can be compiled by first subtracting the number of stand-alone SIC sector activities from the total number of activities. The result is then divided by the number of SIC sectors that display the same first two digits and therefore signify vertical relatedness. The number of SIC sectors with equal two-digit SIC codes implies those sectors where the conglomerate in question is present in several related sub-sectors. This quotient produces the average number of related operations that a conglomerate has in one two-digit SIC sector (see Appendix for detailed industry classifications of each conglomerate), and thus shows the extent of vertical integration of the conglomerates within individual segments of the media value chain. The table below summarizes the results of this analysis. News Corporation and Viacom show the highest number of average related activities within a single SIC sector, with 10 and 5 vertically integrated activities for each two-digit SIC sector. News Corporation’s high extent of vertical integration within media segments is especially noteworthy because of the large difference to the number two position Viacom. The overall differences in the number of vertically related activities between Viacom and the remaining four conglomerates is a maximum of 2.5

\(^{57}\) SIC codes are assigned according to each type of product which is mainly produced in one industry (Central Statistical Office 1979, pp. 17ff.). Beyond this, the assignment of the codes takes into account the following criteria: The nature of the process of the work done, the main raw material used, the type or intended use of goods produced or handled, or the type of service rendered.
activities. After Viacom, Sony has an average of 4.6 related activities within one media sector, followed by Disney with 3.3, Bertelsmann with 3, and lastly, Time Warner with 2.5. The fact that Time Warner occupies the fifth and last position means only that the conglomerate is the least vertically integrated within single segments of the media industry.

<table>
<thead>
<tr>
<th>Time Warner</th>
<th>Disney</th>
<th>News Corp</th>
<th>Viacom</th>
<th>Sony</th>
<th>Bertelsmann</th>
</tr>
</thead>
<tbody>
<tr>
<td>Movies and Entertainment (SIC Sector 78)</td>
<td>4</td>
<td>6</td>
<td>9</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Publishing (SIC Sector 27)</td>
<td>2</td>
<td>2</td>
<td>6</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Broadcasting, Cable &amp; Pay TV, and Radio (SIC Code 48)</td>
<td>2</td>
<td>5</td>
<td>14</td>
<td>7</td>
<td>1</td>
</tr>
<tr>
<td>Information Technology, Software and Business Services (SIC Sector 73)</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>Music Publishing, Recording &amp; Audio/Video equipment (SIC Sector 36)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>Hotels, Restaurants &amp; Leisure Services (SIC Sector 79)</td>
<td></td>
<td>3</td>
<td>1</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Retailing (SIC Sector 59)</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer Electronics (SIC Sector 50)</td>
<td></td>
<td></td>
<td></td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>General Management Services (SIC Sector 87)</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Holding Company (SIC Code 67)</td>
<td></td>
<td></td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial Services &amp; Insurance (SIC Sector 63)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall Number of Activities</td>
<td>11</td>
<td>20</td>
<td>30</td>
<td>17</td>
<td>25</td>
</tr>
<tr>
<td>Stand-alone Presence in SIC Sector</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Presence in SIC Sector with Related Activities</td>
<td>4</td>
<td>6</td>
<td>3</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>Vertical Integration Ranking by Average Number of Related Activities in SIC Subsectors with the same two preceding digits$^{58}$</td>
<td>2.5</td>
<td>3.3</td>
<td>10</td>
<td>5</td>
<td>4.6</td>
</tr>
</tbody>
</table>

Table 14: Comparison of SIC Sector Presence of the Selected Media Conglomerates

$^{58}$ The ranking is based on the following calculation: Extent of vertical integration within media industry SIC sectors = (Overall no. of activities – no. of stand-alone SIC sector presences)/No. of SIC sectors with related activities.
However, the above analysis of the extent of vertical integration of the selected media conglomerates within the individual two-digit SIC sectors includes the presence in industry segments that are not part of the media industry, like the Financial Service and Insurance sector. Therefore, to determine the true extent of vertical integration for the media conglomerates between segments of the media value chain, further analysis needs to be undertaken. The SIC sector results can be further complemented by a detailed analysis of the activity profile of each media conglomerate along the media value chain. The table below lists all current segments of the media value chain in a vertical order from content production over aggregation to distribution, and the conglomerates' presence in the respective segments. If the conglomerates are only marginally present in one segment, the activity has been counted with the factor 0.5 in order to incorporate a weighting of a full against a marginal segment presence.

According to the table presented on the following page, News Corporation can be classified as the most extensively vertically integrated media conglomerate with a presence in 12 out of 17 media value chain sectors and a weighted vertical integration ranking of 11. Time Warner and Viacom follow with operations in 11 sectors out of the 17 profiled and a weighted vertical integration ranking of 10.5. Bertelsmann and Disney jointly occupy the third position with 10 out of 17 activity sectors and a weighted vertical integration ranking of 9. The least extensively vertically integrated firm is Sony with 8 operations out of the total 17, and a weighted vertical integration ranking of only 6.5.
<table>
<thead>
<tr>
<th></th>
<th>Time Warner</th>
<th>News Corp.</th>
<th>Disney</th>
<th>Viacom</th>
<th>Sony</th>
<th>Bertelsmann</th>
</tr>
</thead>
<tbody>
<tr>
<td>Theatrical Content</td>
<td>√</td>
<td></td>
<td>√</td>
<td>√</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>Television Content</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Film Library</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td></td>
</tr>
<tr>
<td>Movie Theaters</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TV Network</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pay networks/cable channels</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√ (marginal)</td>
<td>√</td>
</tr>
<tr>
<td>Cable Distribution Systems</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Satellite Broadcast Platform</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Print Content</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Publishing</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recorded Music</td>
<td></td>
<td>√ (marginal)</td>
<td>√</td>
<td>√</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Radio</td>
<td></td>
<td>√ (marginal)</td>
<td>√</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Multimedia &amp; Internet</td>
<td>√</td>
<td>√</td>
<td>√ (marginal)</td>
<td>√</td>
<td>√ (marginal)</td>
<td>√ (marginal)</td>
</tr>
<tr>
<td>Internet Access Provider</td>
<td>√</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hardware &amp; Navigation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Media-related Business Services</td>
<td>√ (marginal): (outdoor advertising)</td>
<td>√ (general &amp; outdoor advertising )</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Theme Parks</td>
<td>√ (marginal)</td>
<td>√</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Overall presence in sectors</td>
<td>11/17</td>
<td>12/17</td>
<td>10/17</td>
<td>11/17</td>
<td>8/17</td>
<td>10/17</td>
</tr>
<tr>
<td>Weighted Vertical Integration Ranking</td>
<td>10.5</td>
<td>11</td>
<td>9</td>
<td>10.5</td>
<td>6.5</td>
<td>9</td>
</tr>
</tbody>
</table>

Table 15: Activity Profile of the Selected Media Conglomerates
Source: Own Compilation, Company Annual Reports

Regarding the content part of the media value chain, with theatrical, television, music and print content, all six selected media conglomerates occupy strong positions in this segment, albeit with different foci. Bertelsmann is the only firm without any presence in the theatrical content segment, and has only a marginal presence in television content production. The company has traditionally focused more on print and music content. In general, the analysis shows that all of the selected companies display a high degree of vertical integration not only within but also between media value chain segments, and that the difference in the overall
extent of vertical integration is relatively minor. Accordingly, the individual vertical integration strategies of the conglomerates need to be analyzed further, especially with regard to which segments of the value chain they have chosen to vertically integrate into. In order to determine which conglomerate dominated which media industry segment, the revenue contributions of all industry sectors will be analyzed for each firm in the following paragraphs.

5.2.2. Analysis of Revenue Contribution Per Media Value Chain Segment

As explained above, an examination of the conglomerates’ revenue contributions per sector should provide useful information about the selected firms’ individual vertical integration choices.

5.2.2.1. News Corporation

62 per cent of News Corporation’s 2006 revenues are originated by content products (16 per cent from newspapers, 4 per cent from magazines, 5 per cent from publishing, 24 per cent from filmed entertainment, and 13 per cent from cable network programming). News Corporation’s main distribution activities are its television network Fox Television, which generates 21 per cent of total revenues, and direct satellite broadcasting, which generated 10 per cent of 2006 revenues. It has to be noted though, that the last figure does not include the BSkyB and SkyGlobal satellite broadcasting operations, as those are separate corporate entities. This means that the percentage of content-originated revenues is likely distorted and that the actual split between content and distribution revenues is about 50:50 (News Corporation Annual Report, 2006; BSkyB Annual Report, 2006).

Regarding the historic evolution of News Corporation’s segmental revenue contribution, a clear shift away from publishing to broadcasting distribution can be observed. The recent Internet acquisitions have also established News Corporation as one of the top ten Internet players\(^59\) and have thus opened up important new online distribution channels.

\(^59\) MySpace.com has grown from collecting 1.9 per cent of page visits to nearly 4.5 per cent by mid 2006 (http://www.cbsnews.com/stories/2006/07/12/tech/main1797109.shtml)
5.2.2.2. Viacom

An analysis of Viacom’s total revenue split into content and distribution revenues, reveals that distribution revenues dominate content revenues with a ratio of 60 to 40 per cent. Viacom’s entertainment unit provides 23 per cent of content revenues, of which 5 per cent...
come from the publishing operations, plus the content production share of Viacom’s television unit of 17 per cent (the total revenue contribution of the television unit is 35 per cent, which includes both content and distribution revenues for the CBS and UPN networks), thus taking the total content revenues to 40 per cent (Viacom Annual Report, 2004). In consequence, 60 per cent of overall revenues rely on Viacom’s distribution outlets, with 17 per cent being generated by its television broadcast networks, 27 per cent by the cable networks, and radio and outdoor account for a further 16 per cent. Historically, the entertainment division contributed 82 per cent of Viacom’s revenues, which has over the last decade declined to 23 per cent. The decline in content operations has been offset by a marked increase in Viacom’s distribution-related revenues, particularly in its television and cable network divisions. Radio and outdoor revenues have stayed largely unchanged and constitute a relatively minor revenue contributor with 8 per cent in 2004. The disposal of the video division in 2004, provides a good illustration how certain media industry segments are affected by technological change: In 2000, the Blockbuster video rental operations still contributed one quarter of Viacom’s revenues, and only four years later this figure had fallen to almost zero as the unit faced a saturated video rental market with negative growth rates due to the rise of video-on-demand and pay-per-view services.

![Figure 15: Viacom Total Revenues by Business Segment (1992-2004)](image)

Source: Company Annual Reports
Disney generated 24 per cent of its total 2005 revenues from its media content business, and relies on its television broadcasting operations as the main revenue contributor with 41 per cent of total revenues. Theme parks and consumer products as further content distribution channels follow with 28 and 7 per cent respectively.

Historically, Disney used to be much more dependent on its content revenues, as they contributed half of total revenues in 1995. This percentage has since decreased to 24 per cent, with a disproportionate increase in distribution-related revenues from its broadcasting operations. On Eisner’s initiative, Disney changed its focus from a primarily content creator to being a vertically integrated content producer and distributor. He moved the company further along the value chain to capture more profit, taking control of the channels through which Disney products were distributed. With Buena Vista, he bought one of the primary distribution channels of Disney’s films and products, and purchased ABC/Capital Cities in an attempt to re-use Disney’s assets in the most possible ways. Eisner also decided to take Disney into the retailing industry with the launch of 630 retail stores worldwide. These moves were mutually reinforcing, and allowed Disney to move closer to the end-consumer.

---

60 Since Viacom was split up into two separate entities at the end of 2005, only 2004 figures can be used for comparative purposes in this study.

61 nya = not yet acquired.
5.2.2.4. Time Warner

Time Warner can be classified as the most balanced vertically integrated conglomerate, with 40 per cent of its total 2005 revenues coming from its content businesses (27 per cent from filmed entertainment, and 13 per cent from publishing), and the remaining 60 per cent being generated by three distinct distribution networks: 22 per cent each from cable system and television network operations, and 19 per cent from the AOL Internet segment. In fact, the table below shows clearly that AOL’s operations today constitute one of the main revenue contributors of the combined entity’s operations, after Time Warner’s filmed entertainment
operations which contributed 23 per cent. Historically, Time Warner’s publishing units have suffered the most pronounced decrease in overall revenue contribution with a decrease from 24 per cent to 13 per cent. Between 1995 and 2005, Time Warner has through its two major vertical acquisitions/mergers added two of the current main revenue drivers with the cable operations and AOL, who now jointly contribute almost half of the conglomerate’s total revenues. This finding underlines the strategic importance of extending the revenue potential of the content operations by vertically integrating the downstream distribution revenue sources.

![Figure 17: Time Warner Total Revenues by Business Segment (1991-2005)](image)

Source: Company Annual Reports

<table>
<thead>
<tr>
<th>Time Warner</th>
<th>1995</th>
<th>2000</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Publishing</td>
<td>24%</td>
<td>13%</td>
<td>13%</td>
</tr>
<tr>
<td>Music</td>
<td>24%</td>
<td>12%</td>
<td>disposal</td>
</tr>
<tr>
<td>Cable</td>
<td>1%</td>
<td>15%</td>
<td>22%</td>
</tr>
<tr>
<td>Filmed Entertainment</td>
<td>29%</td>
<td>23%</td>
<td>27%</td>
</tr>
<tr>
<td>Networks</td>
<td>27%</td>
<td>19%</td>
<td>22%</td>
</tr>
<tr>
<td>Digital Media/AOL</td>
<td>Nya</td>
<td>22%</td>
<td>19%</td>
</tr>
<tr>
<td>Theme Parks</td>
<td>1%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Table 19: Time Warner Development Revenue Contribution per Business Segment

Source: Own Analysis; Company Annual Reports
5.2.2.5. Sony Corporation

Both of the non-U.S. based conglomerates Sony Corporation and Bertelsmann AG have from the beginning exhibited a strong presence in distribution, rather than starting with a strong position in content and then gradually shifting their focus down the media value chain like their American counterparts. For Bertelsmann, the majority of revenues come from its television broadcasting and printing operations, and Sony Corporation is still primarily a consumer electronics concern.

Although Sony is present in the theatrical and music content segments, 70 per cent of its revenues still come from the sale of consumer electronics. Sony’s theatrical and music content businesses each contribute only 8 per cent to overall revenues. Over the last decade, however, Sony has built up an additional content position in the gaming content segment, which in 2005 already contributed 13 per cent of overall revenues. The strength of the gaming content division, coupled with the Sony’s successful gaming hardware – the PlayStation – show that Sony’s strategy of vertically integrating hardware with software can work well if executed in the right manner. The success of the vertical integration of software and hardware seems to depend on the hardware product achieving a dominant market share or high user penetration, as can be illustrated by the market share commanded by Sony’s PlayStations.

Currently, the only operations that exhibit satisfactory performance variables are Sony’s financial services operations. The revenue from this unit provide the necessary cash flows for the maintenance of the consumer electronics division, as the latter segment has been experiencing declining profit margins due to intensified competition and disappointing new product developments.
For Bertelsmann, all distribution outlets together account for 66 per cent of 2005 revenues (broadcasting with the RTL Group contributes 29 per cent, printing 24 per cent, and other media-related business services contribute 13 per cent). Bertelsmann’ strongest content segment is magazines with 15 per cent of total revenues, followed by music with 12 per cent and book publishing with 10 per cent. The publishing operations have witnessed the most significant decrease, which was again compensated by an increase in the business printing and broadcasting units’ share of revenues.
Overall, based on the review of media sector presence and revenue contributions, it can be concluded that all conglomerates have vertically integrated the content and distribution segments of the media value chain. The distribution segment seems to have gained in importance relative to the content segment. A summarizing historical analysis of the revenue contributions for each conglomerate will show by how much the focus has shifted between the two segments over the last decade. The table below lists the revenues for the content and
distribution sectors for the years 1995, 2000 and 2005 for each conglomerate, and shows that the relative importance of the content segment has indeed diminished for each firm except for Sony, where a slight increase can be observed. In 2005, for all selected companies, at least 60 per cent of revenues came from their distribution operations.

<table>
<thead>
<tr>
<th></th>
<th>1995</th>
<th>2000</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Time Warner</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- content</td>
<td>77%</td>
<td>48%</td>
<td>40%</td>
</tr>
<tr>
<td>- distribution</td>
<td>28%</td>
<td>55%</td>
<td>63%</td>
</tr>
<tr>
<td><strong>Disney</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- content</td>
<td>50%</td>
<td>24%</td>
<td>24%</td>
</tr>
<tr>
<td>- distribution</td>
<td>51%</td>
<td>77%</td>
<td>76%</td>
</tr>
<tr>
<td><strong>News Corp.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- content</td>
<td>70% (1996 figures)</td>
<td>70%</td>
<td>62%</td>
</tr>
<tr>
<td>- distribution</td>
<td>30% (1996 figures)</td>
<td>30%</td>
<td>31%*</td>
</tr>
<tr>
<td><strong>Viacom</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- content</td>
<td>82%</td>
<td>14%</td>
<td>40% (2004 figures)</td>
</tr>
<tr>
<td>- distribution</td>
<td>19%</td>
<td>86%</td>
<td>60% (2004 figures)</td>
</tr>
<tr>
<td><strong>Sony</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- content</td>
<td>22%</td>
<td>25%</td>
<td>29%</td>
</tr>
<tr>
<td>- distribution (mainly electronics sales)</td>
<td>78%</td>
<td>75%</td>
<td>70%</td>
</tr>
<tr>
<td><strong>Bertelsmann AG</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- content</td>
<td>86% (1996 figures)</td>
<td>43%</td>
<td>34%</td>
</tr>
<tr>
<td>- distribution</td>
<td>14% (1996 figures)</td>
<td>57%</td>
<td>66%</td>
</tr>
</tbody>
</table>

Table 23: Shifts in Content and Distribution Revenue Contributions
Source: Own Analysis; Company Annual Reports

5.3. Analysis of Each Conglomerate’s Financial Performance Variables

The table below presents an overview of the selected performance variables for the chosen conglomerates. Starting with the total revenue figures, which serve as a proxy for overall company size, Time Warner has the highest total revenues, making it the largest global media conglomerate. Disney follows, and News Corporation and Viacom each generate about half

---

62 Valid for all companies in this table: Total percentages of content and distribution operations may add up to more than 100 per cent since inter-company revenue eliminations are not accounted for in the percentage revenue contributions.

63 6 per cent of News Corporation’s revenues are bundled under “Other revenues”, and are therefore attributed neither to the content nor the distribution sector.
the revenues of Time Warner. Bertelsmann and Sony (excluding its electronics sales) are the smallest of the media conglomerates with revenues under US$20 billion.

The cumulated annual growth rates for all companies show strong revenue growth rates for the years 1995-2000, followed by a significant decrease for the period 2000-2005. Most severely affected are Sony and Bertelsmann, with the latter showing negative growth and the former with almost zero growth for the five year period. The only exception to this general decline of growth rates is News Corporation, which shows a stable cumulated annual growth rate for a decade.

<table>
<thead>
<tr>
<th>Multiple Performance Measures</th>
<th>Time Warner</th>
<th>News Corp.</th>
<th>Disney</th>
<th>Viacom</th>
<th>Sony</th>
<th>Bertelsmann</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total sales</td>
<td>$US43.6bn</td>
<td>US$23.8bn</td>
<td>US$31.9bn</td>
<td>US$22.5bn</td>
<td>US$63.9bn</td>
<td>€17.9bn</td>
</tr>
<tr>
<td>EBITDA</td>
<td>US$7.8bn</td>
<td>US$4.3bn</td>
<td>US$4.1bn</td>
<td>US$5.8bn</td>
<td>US$6.8bn</td>
<td>€2.3bn</td>
</tr>
<tr>
<td>Net Income</td>
<td>US$2.9bn</td>
<td>US$2.1bn</td>
<td>US$2.5bn</td>
<td>US$1.8bn</td>
<td>US$1bn</td>
<td>€1.0bn</td>
</tr>
<tr>
<td>ROA</td>
<td>4%</td>
<td>7%</td>
<td>8%</td>
<td>7%</td>
<td>3%</td>
<td>5%</td>
</tr>
<tr>
<td>ROE</td>
<td>7%</td>
<td>12%</td>
<td>15%</td>
<td>12%</td>
<td>9%</td>
<td>11%</td>
</tr>
<tr>
<td>ROS</td>
<td>11%</td>
<td>15%</td>
<td>12%</td>
<td>22%</td>
<td>4%</td>
<td>6%</td>
</tr>
<tr>
<td>Average ROS 2000-2005</td>
<td>11.7%</td>
<td>13.5%</td>
<td>11.3%</td>
<td>16%</td>
<td>6%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Leverage</td>
<td>49%</td>
<td>46%</td>
<td>51%</td>
<td>38%</td>
<td>70%</td>
<td>58%</td>
</tr>
</tbody>
</table>

Table 24: Analysis of Financial Performance Variables of the Selected Media Conglomerates

Source: Own Analysis; Company Annual Reports

Notes.
(1) ROE, ROA and ROS are calculated with the companies’ EBIT to exclude the effect of different tax regimes.
(2) All Sales, EBITDA and Net Income figures are 2005 figures; except for Viacom, where 2004 figures were chosen for comparability reasons since the company was split up into two separate entities during the course of 2005.
(3) Net income/loss for Viacom is -US$16.1 when the one-off impairment charge of US$18bn is included. The table shows the pro forma net income for 2004 without the charge in order to allow comparability.
With regard to each conglomerate’s overall profitability for the time period under study, i.e. 1995-2005, the following observations can be made: News Corporation has been the most profitable conglomerate with an average return on sales of 13.3 per cent, closely followed by Viacom with an average ROS 13 per cent. The third most profitable company has been Time Warner with an average ROS of 11.9 per cent. The second profitability tier is made up of Disney with an average ROS of 9.8 per cent, followed by Bertelsmann with an average profitability of 5 per cent, and finally, Sony, with the lowest profitability and a corresponding average ROS of just 3.7 per cent.

The analysis of the historical evolution of the average ROS will illustrate the profitability development of each conglomerate in greater detail.

5.3.1. News Corporation

The examination of the historical ROS development for each of News Corporation’s business segments reveals that all units show increasing average ROS figures for the period 2000-2005, with especially significant margin improvements in the filmed entertainment, cable network programming, and book publishing operations. Direct broadcast satellite television, which encompasses only the U.S. DirecTV business, shows negative profitability due to immediate post-merger integration costs. In comparison, the ROS of BSkyB has increased from minus 39.5 per cent in 2002 to a positive margin of 22.4 per cent in 2005 (BSkyB Annual Report, 2002, 2005). A similar development can most probably be expected for the DirecTV operations.

---

64 The 2006 figures already show a positive ROS of 1.5 per cent (see Appendix: News Corporation Financial Analysis).
News Corporation's film studio claims the highest margins of the major studios, and shows the strongest cumulated annual growth in profitability as represented by return on sales, with 42.2 per cent. Equally profitable are its cable network operations, with an average ROS of 14 per cent and a growth rate of 34.4 per cent. News Corporation’s television unit has suffered from a slight decrease in profitability growth between 2000 and 2005, but still displays a higher average ROS for the period 2000-2005 than for the period 1995-1999. The most challenged of News Corporation's divisions is its newspaper business, which currently contributes one-fifth of operating income, and displays decreasing return on sales growth of minus 1.5 per cent. This division might be most threatened by the shift of readers and thus of advertising revenues away from newspapers to the Internet. No other media conglomerate owns newspapers in any significant number.

5.3.2. Viacom

Viacom’s weak spot regarding profitability is the filmed entertainment division, i.e. the Paramount film studios. ROS of this segment has been an average 5.1 per cent over the last five years. Operating income has risen only 2 per cent since 2001, while the entertainment divisions of the other media conglomerates show far higher growth and profitability rates. It
has to be stated, though, that the entertainment divisions of the selected firms are extremely
difficult to compare directly, since they are made up of different entertainment units and
different types of libraries. Regarding the size of its content library, Viacom is at a
competitive disadvantage to the other media conglomerates that own one of the major content
studios, since Viacom has a relatively small content library, which numbers about 1,100 titles,
compared to more than 4,000 at MGM and 6,600 for Time Warner. With increasing
digitization, Viacom, however, will need more content to satisfy the increasing demand for
DVDs and video-on-demand. In addition, an improvement of the profitability of Viacom’s
entertainment content operations would help the conglomerate to better counterbalance its
heavy dependency on advertising revenues for its cable, television and radio networks.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Television</td>
<td>22.9%</td>
<td>12.4%</td>
<td>29.5%</td>
</tr>
<tr>
<td>Cable Networks</td>
<td>28.2%</td>
<td>34.1%</td>
<td>9.0%</td>
</tr>
<tr>
<td>Entertainment</td>
<td>3.8%</td>
<td>5.1%</td>
<td>17.9%</td>
</tr>
<tr>
<td>Radio &amp; Outdoor</td>
<td>nya%</td>
<td>23.2%</td>
<td>13.0%</td>
</tr>
</tbody>
</table>

Table 27: Viacom’s Average ROS Per Business Segment – Historical Evolution
Source: Own Analysis; Company Annual Reports

Notes:
(1) Figure shows 2000-2003 average ROS since 2004 ROS is not representative of the true financial
development due to heavy one-off impairment charges.
(2) Denotes CAGR 2000-2003 since ROS 2004 has been excluded: see note (1)

An analysis of the historical ROS of each segment should show the long-term trends more of
each of Viacom’s business units more clearly. The table above shows that all segments have
seen relatively slight increases in ROS, except for Viacom’s television operations where ROS
decreased from a high of 26.5 per cent in 1995 to a low of 6.1 per cent in 2000, and
rebounding slowly between 2001 and 2004 to 18.7 per cent (see Viacom Analysis
spreadsheet in Appendix). Viacom’s television business revenues, which comprise the CBS
and UPN networks, and all of Viacom’s television production and syndication operations,
were impacted by the decrease in advertising expenditures after 2000, when a weak economy
and the terrorist attacks of 2001 took a severe toll on the advertising and media industry.
The fact that the two most vertically integrated conglomerates are also the ones showing the highest profitability and management efficiency, leads to the question of whether the two companies’ performance is due to the benefits of an extensive vertical integration strategy, or to an overall more efficient management style, or both. Both Viacom and News Corporation are run as strictly centralized firms with two extraordinary business personalities as their leaders who have had an exceptional eye for undervalued assets and the evolution of their industries. This suggests that the extraordinary business acumen of the respective CEOs of the two conglomerates has actually induced them to follow a strategy of vertical integration from the start, and the effective management of this strategy has led to a superior performance of these two firms.

5.3.3. Time Warner

Time Warner is the third most profitable media conglomerate with a total return on sales of 11.7 per cent for the period 2000-2005, after News Corporation and Viacom. For Time Warner, the profitability drivers come mainly from its distribution operations, with its broadcasting networks showing the highest profitability with an average ROS of 24.6 per cent for the period 2000-2005. The broadcasting networks segment also exhibits the highest cumulative annual ROS growth rate for the period 2000-2005. Time Warner’s network business presents a convincing argument for the benefits of vertical integration between content and distribution, as broadcasting continues to be an extremely profitable outlet for the produced content.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Publishing</td>
<td>7.8%</td>
<td>13.0%</td>
<td>14.9%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Music</td>
<td>8.8%</td>
<td>12.2%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cable</td>
<td>Nye</td>
<td>30.2%</td>
<td>24.1%</td>
<td>-5.4%</td>
</tr>
<tr>
<td>Filmed Entertainment</td>
<td>6.0%</td>
<td>8.3%</td>
<td>10.9%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Networks</td>
<td>16.2%</td>
<td>20.9%</td>
<td>24.6%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Digital Media/AOL</td>
<td>Nye</td>
<td>nye/nya</td>
<td>17.8%</td>
<td>-8.7%</td>
</tr>
</tbody>
</table>

Table 28: Time Warner’s Average ROS Per Business Segment – Historical Evolution
Source: Own Analysis; Company Annual Reports
Time Warner’s cable operations, which have just been bundled in a separately listed subsidiary, Time Warner Cable Inc., show the second highest average ROS with 24.1 per cent. Interestingly, AOL has also emerged as one of the strong profitability drivers, with a ROS of 17.8 per cent, underlining the importance of a presence of the traditional media conglomerates in the new Internet distribution networks. An analysis of the cumulated annual growth rate for the segments’ ROS shows, however, that both the cable segment and AOL are experiencing diminishing returns on sales since 2000, even though their overall average is still quite high. Within the cable segment, high-speed data services have been a key driver of this segment’s profitability. Intensifying competition in this industry, however, has already, and is likely to continue to do so, negatively impacted both subscriber and revenue growth. The same is true for AOL, where competition in the Internet access and service provision segments has also effected severe decreases in subscriber numbers.

The two content operations - filmed entertainment and publishing - exhibit the lowest average ROS for the period 2000-2005, but it should be noted that their return on sales has increased steadily since 1991, and thus presents a more reliable profitability driver than the cable and Internet operations. Considering the volatile character of media content operations, Time Warner’s steady improvement in profitability constitutes one of the major strengths of the company.

5.3.4. Disney

Disney shows the most profitable operations of the second profitability tier, which is constituted by Disney, Bertelsmann and Sony. The total profitability as represented by the average total ROS between 2000 and 2005 is 11.3 per cent, which is slightly lower than Time Warner’s 11.7 per cent.

Overall, Disney’s earnings before interest and tax are lower in 2005 than they were in 1999, a development that is also reflected in the decline of the cumulated annual growth rate from 16 per cent for the period 1995-2000 to 5 per cent for the period 2000-2005. Since the value and profitability of Disney’s business units depends on its ability to leverage its entertainment brands down the entire media value chain, if revenues of its content units are disappointing, all other divisions will likely suffer the consequences of unsuccessful content products as well.
An analysis of each segment’s return on sales (ROS) provides further insights into which operations constitute Disney’s profitability drivers:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Studio Entertainment</td>
<td>15.8%</td>
<td>17.1%</td>
<td>4.9%</td>
<td>5.4%</td>
</tr>
<tr>
<td>Media Networks</td>
<td>nya</td>
<td>15.3%</td>
<td>16.5%</td>
<td>-11.3%</td>
</tr>
<tr>
<td>Theme Parks</td>
<td>20.1%</td>
<td>24.4%</td>
<td>17.8%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>26.7%</td>
<td>21.1%</td>
<td>18.0%</td>
<td>11.8%</td>
</tr>
</tbody>
</table>

Table 29: Disney’s Average ROS Per Business Segment – Historical Evolution  
Source: Own Analysis; Company Annual Reports

The above table shows clearly that the studio entertainment segment has, for the last five years, constituted the least profitable operation. However, all segments apart from media networks show decreasing profitability margins, with the entertainment unit only showing the most pronounced decline. Since the entertainment segment’s performance depends on the success of the content produced, the declining margin could be explained by a series of unsuccessful movie launches. Indeed, entertainment revenues decreased by 5 per cent between 2004 and 2005, however, for the period 2000-2004 revenues for this segment showed steady growth. The decline in revenues between 2004 and 2005 is due to the petering out of revenues from the highly successful animated film “Finding Nemo”, which was largely responsible for the unit’s revenue growth in 2002 and 2003. This illustrates the problematic Disney currently faces for its content operations: For the last five years, the success of Disney’s content operations has entirely depended on its output deal with Pixar Animated Entertainment, making the company dangerously vulnerable by relying on a partnership instead of successful in-house developments for its important content operations. This precarious situation has been remedied in part by Disney’s 2006 acquisition of Pixar Animated Entertainment.

Disney’s distribution segments as constituted by its broadcasting, theme park, and consumer product operations, all show a satisfying profitability ratio for the period 2000-2005, which underlines the importance of an extensive vertically integrated distribution network for the conglomerate. When a successful content product is launched by the entertainment segment, revenues can rise exponentially when the content product is exploited through the profitable distribution segments.
A closer inspection of the cumulated annual growth rates for Disney’s distribution segments, however, show a more problematic development: The negative cumulated annual growth rate for Disney’s broadcasting division points to difficulties that the ABC network has been experiencing over the last five years. Its ratings have decreased significantly, and the network’s poor performance is in stark contrast to the other media conglomerates’ increasingly profitable broadcasting operations. The above table shows further margin depression in the theme parks and consumer products segments, with the former showing almost zero cumulated annual growth in ROS for the period 2000-2005.

5.3.5. Bertelsmann AG

Bertelsmann has, since 2002, due to significant bottom-line losses from its main divisions and from earlier online ventures, concentrated mainly on increasing the efficiency and profitability of its operations. The decentralized company structure has always made it difficult to control costs and enforce cooperation between the different business units in order to realize economies of scale and scope.

<table>
<thead>
<tr>
<th>Bertelsmann AG</th>
<th>Average ROS 2002-2005 (^{1,2})</th>
<th>CAGR ROS 2002-2005 (^{1,2})</th>
</tr>
</thead>
<tbody>
<tr>
<td>Television (RTL Group)</td>
<td>8.9%</td>
<td>68.0%</td>
</tr>
<tr>
<td>Book Publishing (Random House)</td>
<td>6.5%</td>
<td>23.6%</td>
</tr>
<tr>
<td>Magazines (Gruner + Jahr)</td>
<td>6.3%</td>
<td>68.3%</td>
</tr>
<tr>
<td>Music (BMG)</td>
<td>5.0%</td>
<td>nm</td>
</tr>
<tr>
<td>Printing (Arvato)</td>
<td>6.6%</td>
<td>22.7%</td>
</tr>
<tr>
<td>Business Services (Direct Group)</td>
<td>Nm</td>
<td>147.2%</td>
</tr>
</tbody>
</table>

**Table 30:** Bertelsmann’s Average ROS Per Business Segment – Historical Evolution

Source: Own Analysis; Company Annual Reports

Notes:
(1) Detailed segment EBIT information is only publicly available from 2002 onwards.
(2) Since Bertelsmann changed its accounting to year-end in 2001, the Average ROS and its CAGR can only be compiled for the period 2002-2005 in order to ensure reliability.

In general, Bertelsmann’s ROS figures fall short of the other media conglomerates, except for Sony, which displays even lower profit margins. However, as can be seen from the astonishingly high cumulated annual growth rates of the average return on sales per segment,
Bertelsmann has been successfully improving its operations’ profitability since the departure of former CEO Thomas Middelhoff in 2002.

The above table shows that Bertelsmann’s profitability depends mainly on two business units: the RTL television group and its professional printing and book publishing operations. As has been observed in section 6.6., the RTL Group not only contributes one third of Bertelsmann’s revenues, but also constitutes the main profitability driver with an average ROS of 8.9 per cent. This conclusion is corroborated by the cumulated annual growth rate of the RTL Group’s ROS of 68 per cent.

Bertelsmann’s professional printing services, magazines, and book publishing operations all have a low average ROS of around six per cent, with the Gruner + Jahr magazine unit showing the highest cumulated annual growth rate for its average ROS.

The Direct Group has exhibited a negative ROS for the years 2002 and 2003, which has turned positive in 2005 with a ROS of 2.2 per cent.

### 5.3.6. Sony Corporation

Sony Corporation represents the worst performer among the selected media conglomerates.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Electronics</td>
<td>4.6%</td>
<td>0.7%</td>
<td>-44.5%</td>
</tr>
<tr>
<td>Game</td>
<td>10.9%</td>
<td>4.6%</td>
<td>-42.6%</td>
</tr>
<tr>
<td>Music</td>
<td>6.3%</td>
<td>sep. entity</td>
<td>sep. entity</td>
</tr>
<tr>
<td>Filmed Entertainment</td>
<td>7.0%</td>
<td>5.0%</td>
<td>36%</td>
</tr>
<tr>
<td>Financial Services</td>
<td>5.9%</td>
<td>9.4%</td>
<td>47%</td>
</tr>
</tbody>
</table>

**Table 31:** Sony’s Average ROS Per Business Segment – Historical Evolution  
Source: Own Analysis; Company Annual Reports

Its electronics division has been subject to severe operating margin decreases, as can be seen from the negative cumulated annual growth rate of the average ROS. An operating margin decrease can also be observed for the game division, which had constituted Sony’s highest margin business until 2000. With the two main revenue contributors (both segments together constituted 83 per cent of Sony’s 2005 revenues) showing diminishing profitability coupled with significant market share losses, Sony’s shareholders have put pressure on the management to improve profitability and spin off businesses that do not fit into the core
strategy of integrating its electronics hardware with its film, music, and game software. This means that business lines without clear cross-selling potential may be sold or taken public as separate entities. This decision most affects the financial services division, which for the moment constitutes Sony’s major profitability driver, and a disposal would thus lead to further decreases in Sony’s overall operating margins and profitability. On the other hand, proceedings from an IPO or disposal could be invested in the development of new products or in the financing of acquisitions that are more related to Sony’s core hard- and software businesses. Another issue is that despite its contribution to earnings, Sony Financial’s asset base, which represents one-third of the Sony group’s total, has pulled down the company’s return on assets which in turn has negative implications for the share price performance.

5.4. Comparison of Common Segment Profitability for the Selected Media Conglomerates

<table>
<thead>
<tr>
<th></th>
<th>Time Warner</th>
<th>News Corp.</th>
<th>Disney</th>
<th>Viacom</th>
<th>Sony</th>
<th>Bertelsmann</th>
</tr>
</thead>
<tbody>
<tr>
<td>Filmed Entertainment</td>
<td>10.9%</td>
<td>12.1%</td>
<td>4.9%</td>
<td>5.1%</td>
<td>5.0%</td>
<td></td>
</tr>
<tr>
<td>Television</td>
<td>24.6%</td>
<td>16.5%</td>
<td>16.5%</td>
<td>12.4%</td>
<td></td>
<td>8.9%</td>
</tr>
<tr>
<td>Cable Networks</td>
<td>24.1%</td>
<td>14%</td>
<td>16.5%</td>
<td>34.1%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Print &amp; Publishing¹</td>
<td>14.9%</td>
<td>17.4%</td>
<td></td>
<td></td>
<td></td>
<td>6.4%</td>
</tr>
</tbody>
</table>

Table 32: Comparison of Average ROS 2000-2005 Per Segment for All Conglomerates
Source: Own Analysis; Company Annual Reports

Notes:
(1) Print & Publishing shows the average ROS of the segments Book Publishing, Newspapers, and Magazines taken together. For News Corp. the average ROS 2000-2005 is 7.4 per cent for Book Publishing, 17.7 per cent for Newspapers, and 27.7 per cent for Magazines. For Bertelsmann, the average ROS 2000-2005 for Book Publishing is 6.5 per cent, and for Magazines 6.3 per cent.

The above table provides a comparison of the profitability as represented by the return on sales ratio for all businesses where the selected media conglomerates have common operations. Interestingly, this table shows that the selected firms’ presence in the various segments of the media value chain is still quite fragmented, with no more than five companies present in the four major segments of entertainment and television content, television and cable broadcasting, and print and publishing.
The only two companies that are present in all of the four major sectors are Time Warner and News Corporation, which incidentally command the highest return on sales figures in three out of four segments. The exception is the cable networks segment, where Viacom dominates with a ROS of 34.1 per cent, followed by Time Warner with a ROS of 24.1 per cent. It has to be noted though, that both Time Warner and Viacom include not only their cable content networks, but also their profitable cable system operation business in this segment, which likely distorts their ROS figures.

The analysis of the profitability margins suggests that for the media conglomerates studied in this dissertation, the combination of a presence in the major segments of the media value chain is coupled with high respective ROS margins. These findings thus provide the empirical confirmation of theoretically valid conclusion that vertical integration constitutes the natural strategic response to the characteristics of the media industry, by providing the vertical structure that is necessary to reap the economies of scale and scope present in the media industry. In consequence, the research hypothesis H2.1. is confirmed.

5.5. Analysis of Share Price Developments of the Selected Media Conglomerates

The analyses undertaken in the preceding paragraphs show that five out the six selected media conglomerates (with the exception of Sony) have been reporting respectable and, for some business divisions, even extraordinary growth rates. Nevertheless, this growth has not been rewarded with share price increases on the international capital markets.

The purpose of this section is therefore to provide a detailed analysis of the share price movements for each case study company, with the exception of Bertelsmann, which is a private company and therefore not listed on any stock market. The determination of the influence factors on the share prices of the conglomerates will allow a conclusion on whether a share price underperformance is due to the choice of corporate strategy, i.e. vertical integration, or whether the differential performance is caused by other internal or external factors.
5.5.1. Analysis of Viacom’s Share Price Performance

Of the companies analyzed in this study, Viacom is the media conglomerate with the highest dependency on advertising revenues. Since the Blockbuster spin-off in 2004, Viacom’s revenues depend to 60 per cent on advertising. With such exposure to advertising’s cyclicalitity, Viacom could find itself increasingly vulnerable. That single dominant stream of revenue has also been the reason why Viacom’s share price has been underperforming the other media conglomerates for the last years.

Between 1992 and 2001, Viacom showed strong share price growth, although it consistently underperformed the growth rates of the Dow Jones 1800 Media Stoxx Index. Since 2001, Viacom’s shares have decreased from an all-time high of US$92 to US$40, which is just marginally higher than Viacom’s share price in the early 1990s. This share price development goes against overall company performance, which has posted increasing revenues since 2002.

Other reasons for the underperforming share price might have been the disagreements between Viacom’s CEO Mel Karmazin and majority owner Sumner Redstone. But even with the disputes solved by Karmazin’s departure in 2004, Viacom’s share price did not improve. In general, under Karmazin, Viacom became financially healthier, but also more risk-averse.
Karmazin introduced several cost-cutting programmes and refused to engage in risky Internet acquisitions. This strategy has, in the short term, repaired Viacom’s balance sheet, but the conglomerate is still missing a coherent growth strategy for the digital age.

Since Karmazin’s departure, Redstone has increasingly centralized the conglomerate’s management structure in order to extract more synergies between its businesses. So far, this strategy has remained unsuccessful, and Viacom’s earnings have fallen behind the other media conglomerates since 2004. Viacom’s cable networks are continuing to be strong revenue drivers, but Viacom’s radio unit, Infinity Broadcasting Corporation, is facing an increasingly competitive market environment, especially from new digital radio providers.

In order to increase its consistently depressed share price, Viacom initially increased its initiatives to adapt to the digital era, which is especially important for Viacom’s youth-oriented cable networks MTV and Nickelodeon, in order to secure future growth in this segment. In 2005, Viacom also acquired several smaller gaming and Internet video websites and has been trying to develop its own broadband sites. Investors, however, remained unconvinced that this would prove to form a coherent strategy to adapt the conglomerate to the transformation affecting the media value chain.

As a final share price remedy, Viacom reasoned that a de-integration would help to unlock the value of its individual operations. At the end of 2005, the conglomerate therefore decided to de-integrate by essentially dismantling the 2000 merger of Viacom and CBS Corporation. Under one umbrella, a company retaining the Viacom name was formed, comprising MTV Networks, Black Entertainment Television, and Paramount Pictures. The other spinoff included the CBS and UPN broadcast-television networks, Viacom’s television stations, the cable network Showtime, its radio and outdoor properties, and its books publishing operations. So far, the share price of the two entities has not witnessed significant increases.
5.5.2. Analysis of Time Warner’s Share Price Performance

Since the announcement of the AOL Time Warner merger, the conglomerate has witnessed its share price decline by 70 per cent. In 2005, Time Warner’s share price has rebounded slightly, but this was largely due to the increased interest generated by the proxy fight between the company and one of its major shareholders, who was pushing for a break-up of the conglomerate in order to release the value of individual high-performing units. Since the merger of AOL and Time Warner, the share price has reflected concerns about the prospects for most of Time Warner’s businesses. The falling share price is mainly due to uncertainty about the growth and revenue prospects of the AOL Internet division, whereas Time Warner’s old-media operations like the Warner Brothers movie and television studios and the cable television networks were posting robust growth.

The problems of AOL stem largely from a combination of the following factors: in the 1990s, during the early days of the Internet, AOL had flourished by providing the juncture of three online businesses: advertising, access (as an online-service provider with monthly subscribers) and e-commerce (through its affiliated merchants). AOL failed to recognize early enough that consumers would move to broadband-internet access, which they could buy straight from the
firms that owned the broadband network. As a consequence, AOL has continually lost subscribers and the respective revenues, thus dragging down Time Warner’s overall results.

AOL's belated response has been to try to increase its revenues from internet advertising. To attract users, it has abandoned its “walled garden” strategy and now offers free content to everyone, not just to AOL subscribers. Thus, gains from the advertising business are believed to offset the decline of revenue from the access business. To advance AOL’s strategy further, it acquired Advertising.com in 2004, a company that buys space on web pages and resells it to advertisers looking to reach a specific customer category. In 2005, Advertising.com had already become the main driver of AOL's online advertising business, and the growth in AOL's advertising sales has been one of the positive catalysts for Time Warner's share price performance.

However, although the AOL division has been quite successful in attracting people to its content, the unit is still not realizing the synergies available from using the traditional Time Warner content brands. So far, Time Warner's divisions are mostly developing digital strategies independently of AOL.

The disappointing share price performance also represents concerns about the effect digital technology will have on some of Time Warner's old-media businesses. Its magazine divisions have suffered from a shift in advertising revenues to the Internet, and have only in 2005 started to develop their own digital offerings. Regarding Time Warner’s cable networks, uncertainty also prevails over the ability to respond to growing consumer use of the Internet. In order to offer television content on the web, the networks need to own the Internet copyrights. Since Time Warner’s networks rely heavily on re-runs to fill their schedules, their ability to shift content to the Web is limited.

In contrast, the Internet is helping drive growth at Time Warner Cable, which accounts for more than one-third of the company's operating profit before depreciation and amortization (EBITDA). Subscriber numbers have been increasing due to the unit’s attractive triple-play offerings. In order to increase Time Warner’s financial means for further acquisitions in the currently highly profitable cable industry, Time Warner will spin-off part of its cable

---

65 Online advertising is the fastest-growing segment of the media business, with quarterly growth rates topping 30 per cent (van Duyn, 2007).
operations in the separately listed entity Time Warner Cable, in which it will nonetheless hold a 84 per cent stake (Time Warner Press Release, February 16, 2007).

5.5.3. Analysis of News Corporation’s Share Price Performance

After relatively subdued increases between 1992 and 1997, News Corporation saw strong share price growth for the period from 1998 to 2001. In 1999, News Corporation entered into a share swap with Liberty Media Corporation in order to acquire the majority of shares in its Fox Television Network. This has made Liberty News Corporation’s second biggest individual shareholder after the Murdoch family. News Corporation’s share price continued to rise until 2001, after which it decreased to 1996 levels. This decrease was mainly due to uncertainty over News Corporation’s planned satellite television acquisitions in Italy and the U.S., which dragged on for years in lengthy negotiations with the acquisition targets and regulators. DirecTV was finally acquired in 2003 and allowed News Corporation to gain control over a significant distribution platform, which provided the company with manifold opportunities to further exploit its television and cable content. In 2005, however, the growth of new subscribers to its U.S. satellite broadcasting services has slowed by a third (News Corporation Annual Report, 2005), due to increasing competition from cable operators who
have invested heavily in their infrastructure and started winning back customers with all-inclusive monthly subscriptions that offer television, broadband, and Internet phone service. In addition, regulatory obstacles in the U.S. make it difficult to adapt the one-way satellite technology to include broadband Internet and telephone connections. Nevertheless, News Corporation has started to develop a new US$1 billion wireless data and voice network in order to be able to offer the same bundle of services that cable companies and, increasingly, telecommunications companies have been using to attract customers.

After the successful acquisitions of what is now Sky Italia and DirecTV’s satellite broadcasting operations in the U.S., News Corporation’s shares have increased by about 25 per cent since 2003, and revenues and profits have been growing at a double-digit rate, faster than those of comparable media enterprises.

Nonetheless, in 2005, News Corporation still traded at a discount to the media sector, in spite of superior revenue and profit growth figures. The reasons for this relative underperformance are threefold: First, there is, as mentioned above, general uncertainty about the future of the traditional media businesses. Second, the control exercised by Rupert Murdoch over the company has continually made investors uneasy about the future of News Corporation once Murdoch decides to hand over control of his company. Third, there is further uncertainty about how the company will adapt to the Internet and the rise of digital media. One of the biggest problems for the media conglomerates’ content businesses is digital piracy. At the moment Hollywood film studios wait for five months after releasing a film in cinemas before selling it on DVD, which leaves their content highly vulnerable to piracy. News Corporation attempts to bridge this gap by offering video-on-demand, which has led to a cannibalization of its television-based advertising revenues. For example, to maintain the attractiveness of satellite television, News Corporation has subsidized digital video recorders (DVRs) for its customers, in order to increase the uptake of video-on-demand. Yet the increase in the use of DVRs has adversely impacted News Corporation’s advertising-funded television operations, as the DVR technology decreases overall live television viewing time, and, in addition, allows customers to skip advertisements.

Nevertheless, the relatively positive share price development since 2003 seems to be a sign of investor confidence in News Corporation’s ability to adapt to the technological changes that are transforming the media industry and to establish a coherent strategy for the creation of strong market positions in the digital and online media markets.
5.5.4. Analysis of Disney’s Share Price Performance

Between 1992 and 1998, Disney’s share price performance was characterized by steady growth, until, in 1997, Disney’s earnings declined due to the increasingly disappointing performance of its ABC television network. This decrease in earnings was only the beginning of what would be an earnings downward slide for the next five years. Disney’s share price fell from about US$40 to around US$25 in one single year (1998). Disney rightly warned investors that its earnings would not rebound before 2000, after it had become clear that Disney would incur further losses from its early Internet ventures.

Revenue growth returned in 2000, due to the regained strength of the company's broadcast and cable operations and its theme park division. Disney’s share price had accordingly recovered in 2001, before all operations were severely negatively impacted by the terrorist attacks of September 11, 2001. Disney's theme parks segment, which makes up nearly a quarter of total revenues, suffered the most pronounced losses. Because of the subsequent economic weakness, Disney’s share price continued to lose value and traded below its 1992 level at the beginning of 2003.
2004 finally saw an improvement in Disney’s overall financial results after six years of mostly declining earnings, which was reflected in a steep increase in its share price. The other reason for the sudden increase was a hostile takeover bid for Disney by Comcast, which was supported by the financial markets. Combining Comcast with Disney would unite distribution power and technology know-how with Disney's valuable content businesses. A merger between Comcast and Disney would also have created the by far the biggest vertically-integrated entertainment conglomerate with a market capitalization of over US$120 billion (as compared to a market capitalization of around US$80 billion of Time Warner).

Under Disney's current management, the firm's profits are still a third lower than they were in 1998, and its share price is at its 1997 level. Generally unfavourable macroeconomic conditions have certainly contributed to the overall disappointing share price performance, but the depressed share price may also stem from internal problems Disney faces in its television network and content operations. The revenue-generating films have in recent years almost exclusively been provided by the now acquired animation studio Pixar, with which Disney has had a long-term content output deal. However, the share price has dropped significantly since the announcement of the Pixar acquisition, due to fears that Pixar's creativity will be stifled once the company has been integrated into the Disney conglomerate.
5.5.5. Analysis of Sony’s Share Price Performance

Sony Corporation’s share price development between 1992 and 1998 was characterized by steady increases until 1998. This development was in line with steady revenue growth and high profitability margins for Sony’s core electronics operations. In 1999, however, the share price experienced a significant drop due to a severe decrease in company earnings despite growing overall revenues. In response, Sony announced a bold restructuring programme in order to implement cost-cutting measures and thus boost earnings. As a response to the restructuring initiatives, Sony’s share price recovered to the 1998 level, and even increased to an all-time high in 2000, caused by anticipation over the launch of the PlayStation2.

Between 2000 and 2002, Sony witnessed the same share price decline the other media conglomerates experienced, which was caused by difficult global macroeconomic conditions, and the burst of the Internet bubble. In Sony’s case, the negative effects were exacerbated by the investors’ realization that the restructuring programme which had been decided upon in 1998, had been implemented only half-heartedly and had not produced the envisaged efficiency increases. This consequently led to the “Sony shock” of 2003, where the company announced a quarterly loss of US$1 billion. This triggered a share sell-off, and the share price fell by 25 per cent in two days and has languished since.
Overall, since 2000, Sony’s share price has decreased by 60 per cent. Apart from the above-mentioned one-off influences and the management of Sony’s CEO Nobuku Idei, which was perceived as inefficient by investors, the disappointing share price performance is in large part due to the erosion of profit margins in the consumer electronics industry, which have decreased to around 1 per cent, down from 10 per cent a decade ago.

Consequences were taken in 2005, as Sony finally made the long-overdue changes to its top management and appointed the CEO of Sony America as Sony’s global chairman and chief executive. Since then, the group has made progress on much-needed restructuring.

However, Sony’s key problem in recent years has been its internal conflict between its strategy to distribute its media content with a range of networked household electronic devices and its intention to enforce copyright protection for all its content products. Sony is essentially torn between protecting its copyright and making electronic devices that allow music and other entertainment content to be copied and swapped. For example, Sony once dominated the portable-music market with its Walkman, but since the onset of digital music it has handed control of the market to Apple by refusing to support the MP3 format in its players, and unsuccessfully pushing its own proprietary format instead. As high-speed internet technology spreads, piracy will threaten the film business just as it has the music industry. Sony's biggest success story, its games division, faces similar piracy threats. The firm's PlayStation is the world's most popular console, and games sales contributed over half of Sony's operating profit of US$1.3 billion in 2004. The division shows that a profitable combination of content and hardware is possible, if managed properly. This conclusion is supported by the fact that Sony’ share price has increased sharply since the successful, if not somewhat delayed, launch of the PlayStation3.

5.5.6. Comparison of the Selected Media Conglomerates Share Price Development

The following two figures show the share price development of all selected media conglomerates for the period 1992 to 2006. Time Warner is shown in a separate graph as the company’s share price has risen by more than 70,000 basis points in comparison with the other media conglomerates, and is therefore easier depicted on a stand-alone basis.
Comparison Share Price Development
(all share prices rebased to 100)

Figure 24: Comparison of the Selected Media Conglomerates’ Share Price Development (1992-2006)
Source: Datastream, Company Annual Reports

Time Warner Share Price Development (Rebased to 100)

Figure 25: Time Warner Share Price Development; Rebased to 100 (1992-2006)
Source: Datastream, Company Annual Reports
Between 2000 and 2002, weak advertising markets saw the share prices of all media conglomerates decrease severely, as they are all heavily dependent on advertising revenues. Since 2002, general uncertainty about the value of the conglomerates’ traditional media businesses has prevailed, coupled with doubts about the conglomerates’ ability to adapt their complex enterprises to the challenges of the new digital and online industries.

The above figures show that notwithstanding all recent negative publicity about Time Warner, the company displays by far the biggest overall share price increase of all selected media conglomerates. In relation to the rebased starting point of 100 in 1992, Time Warner’s stock still stands at 18,000 basis points at the beginning of 2006. In comparison, the second best performer is News Corporation, which has seen its share price increase more than four-fold, to 443 basis points. The remaining three media conglomerates show strongly correlated share price developments, all with increases between 200 and 250 basis points. The weakest share price performance is demonstrated by Viacom, with an increase of only 110 basis points. Since Viacom is the second most extensively vertically integrated conglomerate after News Corporation, the unusually small share price gain cannot be attributed to the chosen corporate strategy, but might rather be due to the firm’s disproportionately strong dependence on traditional media advertising revenues, coupled with a relatively small content library, and no coherent new media strategy.

5.5.7. Conclusion: Relationship between Vertical Integration and Share Price Performance

In conclusion, the main reason for the general underperformance of the selected media conglomerates’ share prices cannot be found in their adoption of extensive vertical integration strategies, but is rather due to an increasing uncertainty about long-term growth prospects for their traditional and emerging businesses. The dramatic decline in DVD sales, the shift in advertisement spending to the Internet, and the increasing fragmentation of mass audiences are among the paradigm shifts that affects media companies today. This means that, on the one hand, managers are under pressure to meet investors’ short-term expectations of shareholder value creation. On the other hand, they are challenged with boldly investing in unqualified, unprecedented long-term growth opportunities in the new media sectors.

In fact, media companies are cautiously embarking on new strategies and moves that collectively provide an interesting illustration of the ways that the major media conglomerates are repositioning themselves in order to capitalize on the recent and coming
changes in technology, competition and leadership. But because none of these initiatives are yet generating meaningful revenue or profits, they have not been rewarded by the capital markets.

Therein lies the key problem for publicly listed media companies today. Their business environment is rapidly transforming into an end-consumer-centered, interactive, on-demand marketplace in which the values of content, services and distribution are being redrafted. Without historical experience to guide them, media companies must invest in emerging digital platforms knowing they will be important, and accordingly redefine their business models while trying to satisfy investors' short-term expectations at the same time.

In conclusion, the research hypothesis H2.2. has to be rejected.

5.6. Probable Link between Performance and Organizational Structure

Organizational structure institutionalizes how communication flows and power relationships are defined in an organization (Hall, 1987). The choice of organizational structure therefore determines the modes of interaction and communication concerning the coordination and control of the organization's activities.

Organizational structure takes many forms, ranging from highly centralized to highly decentralized. Centralized organizations are generally characterized by highly structured information flows and all decision-making is based on formal lines of management position. In most cases, sophisticated control systems are in place. In decentralized organizations decision-making is delegated to the level of the individual business units, and relies solely on their individual expertise.

As has been outlined in chapter IV, one of the main strategic motives for vertical integration is the potential to reduce transaction costs, and realize synergies through economies of scale and scope. It follows that a corporation’s ability to realize the potential benefits of a vertical integration depends to a high degree on whether its organizational structure and corporate culture facilitate internal cooperation and synergy management.

Existing literature suggests that synergy management in media conglomerates should be triggered and implemented in a centralized manner by the top management and staff departments (Eisenmann & Bower, 2000; Gershon, 2000; Gershon & Kanayama, 2002). Specific reasons for this centralized approach are the need for rapid decision-making in
highly volatile environments, and the disproportionate risks for divisional managers often associated with large-scale upfront costs that will likely deter them from making investment decisions if left to act independently.

While decentralization has been shown to increase returns in companies with unrelated diversification, in firms with vertical integration it reduces benefits when compared with a more centralized structure (Hoskisson, 1987; Eisenmann, 2000). In addition, the industry's high degree of uncertainty makes "corporate strategies built on the setting of financial targets for otherwise independent business units“ not the appropriate type of action to establish a dominant position in the market (Porter, 1996, p. 179). The setting of financial targets for each unit also raises competition between the divisions and thus makes it increasingly difficult to realize synergies through inter-divisional initiatives and cross-promotion.

Regarding the media conglomerates selected for this dissertation, the comparison of their performance with their selected organizational structure should provide further insights on whether the reason for poor performance lies in the adoption of a strategy of vertical integration, or whether this strategy could not be implemented efficiently due to the unsuitability of the company’s organizational structure.

The figure below presents a matrix depicting the position of each media conglomerate along the organizational structure axis. This position is then put in relation to the degree of international revenues. The extent of international operations was chosen as the comparative variable, since it will have a significant effect on organizational complexity and thus the choice of company structure. The extent of vertical integration as a comparative variable would not have produced sufficiently clear results as all selected conglomerates show an extremely high degree of vertical integration.
The figure shows that four out of the six media conglomerates were originally characterized by a decentralized management structure. Only News Corporation and Disney have centralized operations, where Disney is the only conglomerate that has a “pure-play” centralized structure with a dedicated central synergy management department which controls and enforces cooperation and cross-promotion between all divisions. News Corporation displays an interesting hybrid structure, which is nevertheless characterized by high centralization: it is a strict hierarchy where Murdoch stays in control over every single decision, but displays an informal structure for every position below CEO level.

However, of the four decentralized conglomerates, Time Warner, Viacom and Sony are all in the process of transforming their corporate culture.

In Viacom’s case, doubts about the benefits of decentralized decision-making have been voiced for a long time, and since 2004, after several hesitant attempts to introduce a greater degree of centralization, its chairman and majority shareholder Sumner Redstone has chosen to adopt a more autocratic leadership style as a further remedy against Viacom’s ailing share price performance.
Time Warner has also since its beginnings been characterized by decentralization, and in addition, a corporate culture of fierce independence of its various business units. Cooperation was never enforced after the merger between Time, Inc. and Warner Communications and the subsequent merger of Time Warner and TBS. However, since the acquisition of Time Warner by AOL, AOL’s management has been pushing for greater cooperation between the two companies, and the highly decentralized structure has been somewhat modified to allow for coordinated marketing and cross-promotion efforts.

Sony Corporation has also recently abolished its system of networked companies, which essentially denoted a network of independent profit centers that were only linked through the Sony brand name, but did not cooperate with each other. In order to be able to reap the benefits of Sony’s vertical integration of hardware and software, in 2005 a centralized management style was introduced, with rigorous horizontal coordination in the key areas of product planning, technology, procurement, manufacturing, and sales and marketing.

The only media conglomerate who is still characterized by a fully decentralized organizational structure is Bertelsmann. The company even chose to return to its decentralized structure, abolishing all efforts of former CEO Thomas Middelhoff, who had introduced a centralized management style with a clear focus on synergy realization.

Regarding hypothesis H2.3., that the choice of organizational form has an impact on the success of vertical integration, i.e. has a profitability-enhancing effect, no definite conclusion can yet be drawn. News Corporation, which shows the highest overall profitability (see section 7.2.2.), is characterized by a hybrid but highly autocratic leadership culture, while the second most profitable conglomerate Time Warner has during most of its corporate history, operated under a decentralized structure. Viacom, in contrast, is decentralized, but is nevertheless controlled by an autocratic leader like News Corporation. In the second, lower profitability tier Disney displays a centralized structure, while the two bottom-performers Bertelsmann and Sony Corporation have also been characterized by decentralized organizational structures. However, in Disney’s case, lower profitability has also been due to uncontrollable external factors: Disney faced decreasing synergies from cross-promotion in 1999, even though all functions to reap the full benefits of potential synergies had been implemented and were centrally coordinated across all divisions, due to the external macroeconomic factor of decreasing royalty and license fees for its merchandising products.
In conclusion, it seems that the above contradictory results do not lend support to the assumption that organizational structure and performance are related. However, the difficulty of controlling external influence factors allows no definite conclusion in this matter. The recent change in corporate structure from decentralized to centralized operations for three out of the four decentralized conglomerates nonetheless presents a strong indicator that also in the view of the conglomerates’ management a centralized organizational structure allows for a more efficient and thus successful implementation of vertical integration.
6. CONCLUSION

6.1. Summary of Findings

All media conglomerates that were selected for this study show extensive vertical integration between as well as within the media industry value chain segments. The following vertical integration ranking has been derived from the analysis of the activity profiles of each media conglomerate. News Corporation is the most vertically integrated company of the case study sample, followed by Viacom and Time Warner, which jointly occupy the position of second most extensively vertically integrated conglomerate. Disney and Bertelsmann constitute the third most vertically integrated media firms; overall, they exhibit the same extent of vertical integration, but differ in their choice of media industry segments for the establishment of their vertical links. Disney has strong distribution linkages through its broadcasting operations with the ABC television network, while Bertelsmann still exhibits a strong focus on the traditional publishing and printing businesses. Sony is the least vertically integrated media conglomerate, with only one major vertical linkage, between consumer electronics and content production. Sony has no broadcasting distribution operations to speak of, which constitutes the one major factor which sets the company apart from the other selected media conglomerates.

The review of media sector revenue contributions shows that all selected conglomerates have established vertical links between content production and distribution. The historical analysis
of the revenue contribution of the two segments for each media conglomerate shows a shift of focus away from the content segment to the distribution sector, with a clear emphasis on broadcasting operations. This shift can be observed for all conglomerates with the exception of Sony Corporation, which has, in contrast to the other media conglomerates, traditionally had a strong presence in the distribution of hardware or customer interface segment of the media value chain with its consumer electronics units. With the acquisition of Columbia Tristar Pictures, Sony has sought to balance its distribution focus by establishing a position in the content production segment. In 2005, for all case studies, at least 60 per cent of revenues came from their distribution operations.

Regarding the overall financial performance of the case study companies the following results have been obtained from the analysis of key financial data for each conglomerate. The cumulated annual growth rates for all companies show strong revenue growth for the years 1995-1999, followed by a significant decrease for the period 2000-2005. Most severely affected are Sony Corporation and Bertelsmann AG, with the latter showing negative growth and the former almost zero growth for the five-year period. The only exception to this general decline in growth rates is News Corporation, which shows a stable cumulated annual growth rate for the whole decade under study.

The table below presents a useful profitability overview in the form of a summary of the average return on sales (ROS) development for each conglomerate, differentiating between average ROS before and after 2000, and total average ROS for the period 1995-2005.

<table>
<thead>
<tr>
<th></th>
<th>Average Total ROS 1995-1999</th>
<th>Average Total ROS 2000-2005</th>
<th>Average Total ROS 1995-2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>News Corporation</td>
<td>12.7%</td>
<td>13.5%</td>
<td>13.3%</td>
</tr>
<tr>
<td>Viacom</td>
<td>9%</td>
<td>16%</td>
<td>13%</td>
</tr>
<tr>
<td>Time Warner</td>
<td>12.1%</td>
<td>11.7%</td>
<td>11.9%</td>
</tr>
<tr>
<td>Disney</td>
<td>8%</td>
<td>11.3%</td>
<td>9.8%</td>
</tr>
<tr>
<td>Bertelsmann</td>
<td>5%</td>
<td>6%</td>
<td>5%</td>
</tr>
<tr>
<td>Sony Corporation</td>
<td>4.9%</td>
<td>2.7%</td>
<td>3.7%</td>
</tr>
</tbody>
</table>

Table 33: Average Total ROS for all Selected Media Conglomerates
Source: Own Analysis; Company Annual Reports
The performance results are illustrated graphically in the figure below, and put in relation with total media revenues, representing the size of the respective conglomerate, and share price performance, representing the evaluation of the conglomerates’ development by their shareholders.

**Financial Performance**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Time Warner (1)</td>
<td>News Corporation (1)</td>
<td>Viacom (1)</td>
<td>News Corporation (1)</td>
<td>Time Warner (1)</td>
</tr>
<tr>
<td>Disney (2)</td>
<td>Time Warner (2)</td>
<td>News Corporation (2)</td>
<td>Viacom (2)</td>
<td>News Corporation (2)</td>
</tr>
<tr>
<td>News Corporation (3)</td>
<td>Viacom (3)</td>
<td>Time Warner (3)</td>
<td>Time Warner (3)</td>
<td>Disney (3)</td>
</tr>
<tr>
<td>Viacom (4)</td>
<td>Disney (4)</td>
<td>Disney (4)</td>
<td>Disney (4)</td>
<td>Viacom (4)</td>
</tr>
<tr>
<td>Bertelsmann (5)</td>
<td>Bertelsmann (5)</td>
<td>Bertelsmann (5)</td>
<td>Bertelsmann (5)</td>
<td>Sony (5)</td>
</tr>
<tr>
<td>Sony Corporation (6)</td>
<td>Sony Corporation (6)</td>
<td>Sony Corporation (6)</td>
<td>Sony Corporation (6)</td>
<td></td>
</tr>
</tbody>
</table>

**Figure 28: Financial Performance Overview in Relation to Company Size and Share Price Performance**

Source: Own Illustration

Regarding overall financial performance, the top three positions have been occupied by the same three media conglomerates over the last decade. These three companies are News Corporation, Time Warner, and Viacom. For the two time periods selected, Viacom has improved its average ROS after 2000, in contrast to News Corporation and Time Warner, who experienced a slight decline in average ROS when the world economy went into recession after 2000\(^66\). The reason why heavily-advertising dependent Viacom was unaffected by this general decline and instead managed to increase its average ROS from 9 to 16 per cent between 2000 and 2004, lies in the extraordinary profitability margins the

\(^{66}\) For Time Warner, the largest revenue decreases incurred at its AOL unit, where subscriber and advertising revenues were being eradicated by the increasing competition from other ISPs in particular, and a weak economy in general.
company obtains in its cable networks operations (Average ROS for 2000-2004 is 34.1 per cent), which, due to their adaptation to highly specific target groups like children and young adults, have suffered less from the general decline in advertising expenditures as a consequence of a weakened gross domestic product (GDP).

The most consistent financial performance is nonetheless exhibited by News Corporation, with the highest average ROS for the total time frame of this study, 1995-2005. As stated above, News Corporation displays, in addition, the highest and most consistent cumulated annual growth rate for its return on sales.

The fact that the three most vertically integrated case study companies also display the highest profitability and an accordingly positive financial performance provides a strong indicator that the extent of vertical integration is positively correlated with high profitability for the selected media conglomerates. Whether this conclusion can be generalized for the media industry as a whole, needs to be determined by further research with a broader sample base.

The comparison of the common segment profitability (compare section 7.4) further corroborates the positive correlation between vertical integration and company performance. Time Warner and News Corporation, which constitute the two conglomerates that are present in all of the four major sectors of the media value chain (entertainment content, television, cable networks, and publishing), command the highest return-on-sales figures in three out of the four segments. The exception is the cable networks segment, where Viacom displays the highest profitability. These figures strongly support the notion that the combination of a presence in the major segments of the media value chain is coupled with high divisional as well as high total profitability margins.

The question that remains to be answered is whether a correlation can be established between the media conglomerates’ extent of vertical integration and their respective share price performance. This analysis, however, will only be valid for five of the six selected conglomerates, as Bertelsmann is not a publicly listed company.

During the selected timeframe, Time Warner shows the best overall share price performance, even though the company experienced an enormous destruction of shareholder value after its acquisition by AOL. Nevertheless, Time Warner’s share price has increased by 70,000 basis points during the time period studied. News Corporation displays the second-highest overall share price increase, with a four-fold increase for the period 1992-2006. The share price
developments of the remaining three media conglomerates Viacom, Disney and Sony Corporation closely mirror each other and show only minor overall gains in the fourteen-year period, although Viacom represents the worst overall share price performer.

Since all studied media conglomerates have witnessed extraordinary growth in their share prices up to the year 2000, followed by significant share prices decreases in the period from 2000/2001 to the present day, and due to the fact that they have consistently increased their extent of vertical integration between 1992 and 2006, it can be deducted that the negative share price movements of the last years are unrelated to the strategic vertical integration decisions. This reasoning is further supported by the reaction of the financial markets to the announcement of the split of Viacom into two separate entities, since the resulting de-integration has so far not been rewarded by significant share price increases of the now separately listed corporations. It seems more likely that this discrepancy is due to a general uncertainty over the future of the traditional media streams than the degree of vertical integration.

As stated in section 7.6., no definite conclusion can be drawn about the correlation of organizational structure and financial performance. However, some further thought shall be given to the correlation between a successful vertical integration strategy and the choice of organizational structure and resulting corporate culture. In general, the selected leading global media conglomerates face an unusually demanding management task when they seek to expand through vertical integration, for three reasons: First, coordinating the strategies of multiple divisions can create internal conflicts over transfer prices. Second, vertical integration efforts usually confront a high level of environmental turbulence, since in the media industry such efforts typically follow some discontinuity in technology or regulation. Third, expansion through vertical integration in most cases involves large, irreversible up-front investments. The size of the investments tends to require long-term forecasts, but such forecasts are likely to be rendered obsolete in an environment characterized by rapid, discontinuous, and unpredictable change. In the absence of predictable information, the firm may end up over-investing in certain markets or technologies. On the other hand, delaying investments in order to resolve uncertainties bears the risk of missing first-mover advantages (Lieberman & Montgomery, 1988).

The initial evidence from the case studies shows that the companies that are organized in a centralized manner with a single individual as chief architect of strategy, i.e. News Corporation, Disney, and Viacom, are better suited to adapt to the high turbulence
environment and highly asset-specific investments that characterize the media industry. However, further research from a larger sample base is needed to validate this deductive conclusion.

As stated in chapters III and IV, the external environment shapes the strategic behaviour of a firm. These environmental factors also directly impact the attractiveness of each media industry segment. Therefore, a media conglomerate’s decision to enter a specific industry is likely to be determined by its chosen industry’s basic characteristics such as market size, growth rate, profitability, and competition, as well as the factors of product relatedness and content-distribution alignment possibilities.

In addition, going back to the resource-based view of vertical integration, many internal resource determinants such as financial performance, complimentary assets, management teams, marketing systems, and existing vertical alliances also affect the media conglomerate’s vertical integration decision. Many other firm-specific resources and capabilities relevant to the existing content products and distribution platforms are likely to shape a conglomerate’s preferences concerning the direction and extent of vertical integration as well. Knowledge-based resources such as access to creative talent for content production purposes, and the capability of transferring or repurposing content products for different distribution platforms as well as the availability of a multi-channel revenues system will also determine the strategic vertical integration decisions. In summary, the media-specific characteristics such as the complementary nature of content and distribution and the windowing process for content products play a significant role in shaping the conglomerate’s vertical integration decisions. As the global media markets have since 2000 entered into a turbulent period characterized by high uncertainty and rapid technological change, media firms are faced with an increasing need to be less reliant on traditional advertising revenues and to develop additional revenue opportunities in the new media value chain segments. The trend towards increasing vertical and global integration is therefore likely to continue. The global media conglomerates as they are structured at present are clearly occupying better competitive positions than the non-integrated media firms, because the former have the resources to exploit content products in multiple distribution platforms under different advertising and fee structures, to perform extensive vertical and horizontal cross-promotion of content products as well as distribution outlets, and to be well positioned in the online and digital industries by leveraging their existing market power through their diverse holdings and partnerships.
6.2. Concluding Summary of the Benefits of Vertical Integration for Media Conglomerates

The next sections provide a conclusive summary of the overall strategic advantages of a vertical integration strategy in the characteristic business environments of the media industry, followed by recommendations on how the studied media conglomerates can best react to the further changes that will be affecting the traditional media value chain. Lastly, areas of further research will be outlined.

From the point of view of individual media corporations, the benefits associated with expansion through concentration and vertical integration can be summarized as follows:

1. Increased size offers substantial opportunities to realize economies of scale. As the marginal costs of reproduction of media products and services are typically low, and approach zero in industries such as broadcasting, the capacity to increase profitability through the expansion of market share is substantial;

2. the size of media institutions, and a vertical integration of multiple media, enables economies of scope to be realized, as diversification of output allows for a greater degree of product differentiation, which is necessary in order to satisfy increasingly diverse audience tastes;

3. the advantages of critical mass in providing leverage in deals with suppliers, buyers and advertisers, particularly if this is seen as having the potential to be linked to future expansion;

4. increased opportunities for cost reduction through vertical integration in particular, as it offers the opportunity to reduce transaction costs through the “internalization” of information about market requirements and product development strategies, and reduces the time and cost associated with contract negotiation and content acquisition; the national and international agglomerations of television, satellite, cable broadcasting and radio operations, can be understood as a cost reduction strategy along these lines;

5. increased opportunities for risk reduction, as the uncertainty of consumer demand for individual content products can be minimized through the devotion of greater resources to market research, and through the capacity to operate across multiple media, thereby “covering all bases” in case of significant changes in consumer preferences (e.g. a switch from cinema to television, as occurred in the United
States in the 1950s, or a switch towards home-based entertainment, or accessing content through the Internet);

6. vertical integration provides ready access to content streams over time, by securing a link between the content production, content packaging and content distribution elements of the media supply chain;

7. finally, media conglomeration has offered the opportunity for cross-promotion of media content and the realization of economic rents across multiple media.

6.3. Recommendations Regarding the Conglomerates’ Strategic Reactions to the Value Shift in the Media Value Chain

The results of this study show that vertical integration has been a successful tool for today's leading media conglomerates to achieve dominant positions in the industry, which has, as an additional benefit, allowed them to control the transformation of the media industry to some extent. However, due to the growing complexity of the market, value shifts can be expected in the industry as traditional media companies and new participants fight for relevance and prominence. Competing and maintaining value in the media marketplace will therefore depend on the conglomerates’ continued ability to adapt to the changes and accordingly reformulate their strategies. When planning for future competitiveness, today’s media conglomerates need to undertake in-depth analysis of the array of differentiated capabilities needed in order to respond to the changes brought about by convergence and digitalization. The media conglomerates' leaders or top management need to reassess all aspects of their businesses according to whether they constitute a coherent part of a vertical integration strategy adapted to the transformed media value chain. The next paragraphs will introduce the changes that affect the media value chain and outline possible strategic responses for the media conglomerates.

Extension of the media value chain. The increasing digitization of information services and media content, and the subsequent convergence of the technologies transporting the digitized products, has led to an extension of the traditional media value chain. The results of this dissertation support the assumption that vertical integration should again be an effective strategy to secure access to the new distribution media and to exploit the benefits of the now possible direct access to consumers. As has been shown in this study, the instigator behind the changes in the information-based media and communications industries, the Internet, still
proves to be a volatile medium regarding profits and strategic advantages for the profiled media conglomerates, with the possible exception of News Corporation which has recently managed to secure itself a dominant position in the online media segment through an aggressive downstream vertical acquisition strategy.

Vertically integrating a firm’s core product range with the Internet and its related technologies may create a sustainable competitive advantage. Porter states that “it is the tailoring of the Internet to the firm’s unique strategy that will be the real opportunity for advantage” (Byrne, 2001). Considering that the Internet and associated broadband distribution channels can transfer most if not all of the value of information services to customers while leaving traditional media conglomerates vulnerable, it must become the stated imperative of these firms to own as much of the Internet access networks as possible. In summary, the importance of establishing firm vertical links not only between the traditional content and distribution sectors, but also between new online and digital content products and distribution platforms, will increase further and in the author's view, become one of the main sources of sustainable competitive advantage in the new extended media value chain.

**Importance of a dual strategy in the intermediate future.** The move of users to new screens such as computers and mobile telephones, and away from traditional broadcast schedules and advertising, will likely weaken the position of the traditional content aggregators (broadcasters). Instead, online packaging and content providers will extend their position with users by adding television and video offerings. In doing so, they will increasingly cannibalize the traditional advertising and service revenue streams. At the moment, only advanced and technology-savvy users are already extensively using the new platforms, so for the next five years a dual strategy would be advisable for both traditional and new media enterprises to protect both current and future revenues. From a purely financial resource perspective, media company management will have to achieve significant cost savings from the traditional value chain in order to be able to invest in new distribution channels and platforms.

**Increasing personalization of services.** In order to sustain their current dominant positions and competitive advantages, the selected media conglomerates need to be able to customize services to such an extent that their existing customers will remain locked in and new customers continue to be attracted. Time Warner is trying to reach this stage. Through a unique mix of premium content and a presence on all distribution platforms, the firm is
building a competitive advantage of locking in customers who receive Time Warner content through Time Warner’s traditional print, television and cable broadcasting operations, as well as through AOL’s online distribution services. As the product and service development is reoriented by audience or customer segment, the increasingly fragmented demand can only be met by providing highly differentiated product bundles that are marketed directly to specific target groups. The distribution channels also have to be adapted to an increasingly interactive mode between provider and consumer. In order to guarantee efficient and rapid strategic responses to changes in customer demands, a seamless cooperation has to be established between the traditional and new content production and distribution business segments, where the latter pass on the collected customer data to the content creators for an immediate adaptation of the content product to the changed preferences. It follows that equally fast adapted marketing messages have to come from an ideally centralized marketing department. Again, a vertically integrated corporate structure with centralized super-departmental functions like marketing, public relations, and customer data management, seems best suited for this purpose. In summary, when consumer demand for technologically advanced media and communications services is sufficiently high, the firms that are present in as many segments of the converged media value chain will retain the most competitive advantages. In this respect, it should also be noted that the slump in performance of the traditional media firms since 2001 was caused by wrong timing, as the media conglomerates had already started to react to the changes in the media value chain, but had overestimated the speed and extent of the transformation in their expansion strategies.

Customer Data Acquisition Capabilities. Another critical area of future competitive advantage for the media conglomerates that are the subject of this study are customer data acquisition capabilities. In order to be able to discriminate between the “traditional media users” and the “high-tech users”, sophisticated customer data collection methods will be crucial in order to differentiate the various user groups on pricing, bundles, technology integration, content form and function, release windows and advertising formats. Again, the strategy that will most efficiently address this issue is further forward or downstream vertical integration into customer relationship management. The data gathered on the different user groups can additionally be used to create new innovative content and content forms. These will in turn allow the conglomerates to exploit new revenue streams, and pricing strategies should be reassessed in order to gain maximum revenues from the new content sources. To secure customer loyalty, a combination of free and paid content should work best: Paid
content will provide secure subscription-based or pay-per-view revenue streams that have the additional advantage of being independent of advertising, and free content will extend audience reach, and thus the number of potential paid content users.

**Standard setting.** In addition, vertical integration – both upstream and downstream – will allow media conglomerates to set standardized distribution platforms based on their chosen standard. Standard setting will provide the firms with a sustainable competitive advantage and allow efficient content protection as well as the ability to upgrade systems more or less in real time with market changes. By establishing such optimized distribution platforms, the conglomerates should witness a significant improvement in performance: faster time-to-market with new products, improved agility in reacting to production needs, reduced cost structure, improved asset use, and improved bargaining leverage vis-à-vis remaining non-integrated suppliers.

**Creation of sustainable competitive advantages through full vertical integration.** During the next decade, the media industry will most certainly be marked by further concurrent disaggregation and reaggregation due to the described shifts in the media value chain. In order to keep their status quo, the media conglomerates analyzed in this dissertation must consider full ownership as the most viable method of vertically integrating their services in a way that allows them to get instant access to industry- or operations-specific knowledge and keep abreast with the pace of technological change. Partial vertical integration through partnerships, alliances, and joint ventures provide benefits to such firms only in the short term: the current partnerships among media, Internet technology and broadband distribution firms are transitory steps meant to test business viability in the newly developed media industry segments. It can already be observed that these partnerships are increasingly being replaced by the acquisition of full ownership as the true value of the shared asset becomes clearer to the business partners. Therefore, in the long-term a shared asset ownership will hinder the implementation of a consistent corporate strategy and full integration remains the sole means of creating a future sustainable and non-imitable competitive advantage.

6.4. **Recommendations for Further Media Research**

In contrast to earlier research on media conglomerates, this study provides an unprecedented depth of information on the importance of vertical integration as a corporate strategy to achieve a dominant position in the global media industry, and all aspects related to the
successful implementation of this strategy. The results from the empirical part confirm that
the selected media conglomerates are characterized by extensive vertical integration between
as well as within the media industry value chain segments. The study finds also that the
direction of vertical integration has been mostly downstream, i.e. content producers vertically
integrated into distribution. Most importantly, the results of the inter-case study analysis
confirm that the extent of vertical integration is positively correlated with firm performance.
Concerning a correlation between the extent of vertical integration and share price
performance, no correlation was found. In contrast, the empirical results provide convincing
anecdotal evidence that the successful implementation of a vertical integration strategy might
be correlated with the choice of organizational form, however, the small case-study sample
size does not allow a definite conclusion in this matter.

In summary, the presented study’s research approach has been of an exploratory nature, and
each of the three chapters of the empirical results part provide important contributions to
foster a better understanding of academia and practitioners of the industry- and firm-specific
dynamics that characterize today’s media conglomerates, with a particular emphasis of the
important role vertical integration has played in the shaping of these conglomerates.

As a consequence, related work on vertical integration in the media industry can be
reclassified and discussed in light of the results of this study. In addition, the new
opportunities for vertical integration in the increasingly converging segments of the media
value chain might become a special matter of researchers’ interest.

It would also be useful to undertake similar research for a broader sample base, in order to
determine whether this study’s findings are valid not only for the six major international
media conglomerates, but for media companies in general.

Furthermore, aiming to ex ante evaluate economic consequences, subsequent research might
result in the development of a generic model that supports media companies to make
equitable decisions regarding the benefits and risks associated with an envisaged vertical
integration strategy. The model will ideally develop clear external and internal determinants
which indicate when vertical integration would be advisable and to what extent it should be
undertaken. More detailed research is also needed on the question of whether the positive
effect of vertical integration on performance has an optimum, and beyond which positive
effects would decline due to increased managerial complexity and cost of coordination.
7. APPENDIX

EXHIBIT 1: Existing Empirical Research on Vertical Integration and Performance ..........................................................141
EXHIBIT 2: Detailed Media Value Chain Activity Profile for the Selected Media Conglomerates ..................................................141
EXHIBIT 3: Viacom SIC Business Sectors: .........................................................................................................................141
EXHIBIT 4: Disney SIC Business Sectors: ..........................................................................................................................141
EXHIBIT 5: News Corporation SIC Business Sectors: ............................................................................................................141
EXHIBIT 6: BSkyB SIC Business Sectors: .............................................................................................................................141
EXHIBIT 7: Fox Entertainment Group SIC Business Sectors: ..................................................................................................141
EXHIBIT 8: Bertelsmann AG SIC Business Sectors: ................................................................................................................141
EXHIBIT 9: Time Warner SIC Business Sectors: .......................................................................................................................141
EXHIBIT 10: Sony Corporation SIC Business Sectors: ............................................................................................................141
EXHIBIT 11: Time Warner Inc. Key Financial Data ..................................................................................................................141
EXHIBIT 12: Analysis: Time Warner Inc .................................................................................................................................141
EXHIBIT 13: News Corporation: Key Financial Data ................................................................................................................141
EXHIBIT 14: Analysis of Financial Performance: News Corporation ..........................................................................................141
EXHIBIT 15: Sony Corporation: Key Financial Data ..................................................................................................................141
EXHIBIT 16: Analysis of Financial Performance: Sony Corporation ..........................................................................................141
EXHIBIT 17: Key Financial Data: The Walt Disney Company .................................................................................................141
EXHIBIT 18: Analysis of Financial Performance: The Walt Disney Company ..............................................................................141
EXHIBIT 19: Key Financial Data: Bertelsmann AG .................................................................................................................141
EXHIBIT 20: Analysis of Financial Performance: Bertelsmann AG ..........................................................................................141
EXHIBIT 21: Viacom Inc. Key Financial Data ..........................................................................................................................141
EXHIBIT 22: Analysis of Financial Performance: Viacom ..........................................................................................................141
### EXHIBIT 1: Existing Empirical Research on Vertical Integration and Performance

<table>
<thead>
<tr>
<th>Author</th>
<th>Measurement of Vertical Integration</th>
<th>Measurement of Performance</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bowman (1978)</td>
<td>Value Added/Sales</td>
<td>ROI</td>
<td>Vertical integration is profitable in the extremes, i.e. with a either very low or very high degree of vertical integration</td>
</tr>
<tr>
<td>Buzzell (1983)</td>
<td>Value Added/Sales</td>
<td>ROI</td>
<td>V-shaped curve of vertical-integration related profitability implying that extremely high vertical integration is most profitable</td>
</tr>
<tr>
<td>Levy (1985)</td>
<td>Value Added/Sales</td>
<td>Number of firms in the industry and R&amp;D expenditures</td>
<td>Sales volume uncertainty, farness of firms, and research intensity increased the likelihood of vertical integration</td>
</tr>
<tr>
<td>Maddigan &amp; Zaima (1985)</td>
<td>Interconnections between suppliers and producers</td>
<td>ROI</td>
<td>Moderate vertical integration produces highest firm profitability</td>
</tr>
<tr>
<td>MacDonald (1985)</td>
<td>Measurement of shipments from manufacturing industries that are made to affiliated units</td>
<td>Industry concentration and capital intensity (measured by ratio of fixed assets to shipments)</td>
<td>The use of vertical integration is more prevalent in capital intensive industries and in highly concentrated industries</td>
</tr>
<tr>
<td>Bonnano &amp; Vickers (1985)</td>
<td></td>
<td>Sales growth</td>
<td>When downstream firms compete on price, a degree of vertical separation between the upstream and downstream softens price competition and can lead to higher profits</td>
</tr>
<tr>
<td>Rumelt (1986)</td>
<td>Related diversification as an indicator for vertical integration</td>
<td>Return on Assets (ROA)</td>
<td>Vertically-integrated firms poorest performers of all the diversification types in the sample</td>
</tr>
<tr>
<td>Hoskisson (1987)</td>
<td>Measure of related and unrelated diversification</td>
<td>ROI</td>
<td>Vertical integration reduces rentability</td>
</tr>
<tr>
<td>Jones &amp; Hill (1988)</td>
<td>Increase or reduction in transaction costs</td>
<td>Decrease in marginal costs/Increase in marginal benefits</td>
<td>Vertical integration reduces transaction costs</td>
</tr>
<tr>
<td>Caves &amp; Bradburd (1988)</td>
<td>Input-output measure on the distribution of each industry's shipments among other industries</td>
<td>Industry concentration and capital intensity that is specific to the industry</td>
<td>Small numbers bargaining and firm-specific sunk capital lead to vertical integration</td>
</tr>
<tr>
<td>Reed &amp; Fronmueller (1990)</td>
<td>Matched pairs analysis of integrated versus non-integrated companies in the same industry</td>
<td>Sales and EBIT growth ROA Gross Profit Margin</td>
<td>Vertical integration is performance and risk neutral</td>
</tr>
<tr>
<td>Thomas, O'Hara &amp; Musgrave (1990)</td>
<td>Franchises versus wholly-owned business</td>
<td>Sales</td>
<td>Franchise system produces better</td>
</tr>
</tbody>
</table>
### Table 34: Empirical Research on Vertical Integration and Performance

<table>
<thead>
<tr>
<th>Author</th>
<th>Measurement of Vertical Integration</th>
<th>Measurement of Performance</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>D’Aveni &amp; Ravenscraft (1994)</td>
<td>Harrigan’s &quot;Degree of Integration&quot; (ratio of total sales to internal transfers)</td>
<td>Sales Cost variables Gross Profit Margin</td>
<td>Vertical integration reduces bureaucratic and transaction costs</td>
</tr>
<tr>
<td>Chipty (2001)</td>
<td>Percentage of content acquired from nonintegrated cable system operators vs. percentage acquired internally</td>
<td></td>
<td>Vertically integrated cable system operators tend to exclude rival programming</td>
</tr>
<tr>
<td>Ferrari et al. (2003)</td>
<td>Classification of acquisition target as upstream or downstream vertical integration</td>
<td>Share price development</td>
<td>Upstream vertical integration creates shareholder value for media corporations</td>
</tr>
<tr>
<td>Kolo &amp; Vogt (2003)</td>
<td>Number of activities in distinct media industry segments</td>
<td>Sales Operating cash flow margin</td>
<td>No clear correlation between diversification and improvement in performance in the communications industry</td>
</tr>
<tr>
<td>Mployi &amp; Bullington (2004)</td>
<td>Number of vertically integrated business segments as index for Vertical Integration</td>
<td>Inventory and production costs</td>
<td>Vertical integration reduces production costs, but has no influence on inventory costs</td>
</tr>
<tr>
<td>Jung &amp; Chan-Olmsted (2005)</td>
<td>Number of four-digit SIC codes</td>
<td>EBITDA ROS ROA EPS</td>
<td>Related diversification improves financial performance, unrelated diversification decreases performance</td>
</tr>
</tbody>
</table>

Source: Own Compilation, adapted in part from Whinston (2001)
EXHIBIT 2: Detailed Media Value Chain Activity Profile for the Selected Media Conglomerates

<table>
<thead>
<tr>
<th>Activity</th>
<th>Time Warner</th>
<th>News Corporation</th>
<th>Disney</th>
<th>Viacom</th>
<th>Sony</th>
<th>Bertelsmann</th>
</tr>
</thead>
<tbody>
<tr>
<td>Theatrical Exhibition</td>
<td>UCI (50%), WF Cinema Holdings (50%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TV Network</td>
<td>WB Network</td>
<td>Fox Broadcast Company</td>
<td>ABC Network</td>
<td>CBS (acquired 1999)</td>
<td></td>
<td>RTL Group</td>
</tr>
<tr>
<td>TV Stations</td>
<td>32</td>
<td>10</td>
<td>39</td>
<td>8 (partial)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pay networks/channels (distribution via cable &amp; satellite platforms)</td>
<td>HBO, Cinemax, TW Sports, CNN, Comedy Central, TBS, TNT, TCM, Cartoon Network, Turner Classic Movies</td>
<td>Fox News, Fox Kids, Fox Sports, Fox Movies, FX, National Geographic (50%)</td>
<td>ABC Family, Disney Channel, Toon Disney, ESPN, Soap Net, A&amp;E, Lifetime, Lifetime Movie Network, History Channel, E! Entertainment</td>
<td>MTV, Nickolodeon, UPN, Nick at Nite, CMT, BET, TNN, VH1, Showtime, Comedy Channel, The Movie Channel, Flick, The Sundance Channel</td>
<td>Telemundo (34%), Soap City, Game Show Network (50%)</td>
<td></td>
</tr>
<tr>
<td>Cable Network Platform</td>
<td>Time Warner Cable</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Satellite Broadcast Platform</td>
<td>DirectTV, BSkyB, Sky Italia, Sky Brazil, Innova, PErfectTV Japan, Phoenix, Star TV</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Print Content</td>
<td>Time Warner</td>
<td>News Corporation</td>
<td>Disney</td>
<td>Viacom</td>
<td>Sony</td>
<td>Bertelsmann</td>
</tr>
<tr>
<td>---------------</td>
<td>-------------</td>
<td>------------------</td>
<td>--------</td>
<td>--------</td>
<td>------</td>
<td>-------------</td>
</tr>
<tr>
<td>Radio</td>
<td></td>
<td></td>
<td>50 Stations, ABC Radio Network, Radio Disney, ESPN Radio (80%)</td>
<td>184 Infinity radio stations, CBS Radio Network, Westwood One (18%), and Sportsline Radio (20%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recorded Music</td>
<td>Atlantic, Elektra, Maverick, Rhino, WEA, Columbia House (50%), Quincy Jones Entertainment Co. (37.5%)</td>
<td></td>
<td></td>
<td>All music operations bundled in Sony BMG Music Group (50%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Multimedia &amp; Internet</td>
<td>AOL, Netscape, CompuServe, ICQ</td>
<td>Gemstar-TV Guide, MySpace.com, Neopets.com</td>
<td></td>
<td>All music operations bundled in Sony BMG Music Group (50%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hardware &amp; Navigation</td>
<td>Set-top boxes, NDS (digital pay-TV technology)</td>
<td></td>
<td></td>
<td>Lycos Europe (18%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time Warner</td>
<td>News Corporation</td>
<td>Disney</td>
<td>Viacom</td>
<td>Sony</td>
<td>Bertelsmann</td>
<td></td>
</tr>
<tr>
<td>-------------</td>
<td>------------------</td>
<td>--------</td>
<td>--------</td>
<td>------</td>
<td>--------------</td>
<td></td>
</tr>
<tr>
<td>Theme Parks</td>
<td>Warner Brothers theme park in Australia</td>
<td>Disney World, Disneyland, Disney Cruise Line, Disney Vacation Club, Disneyland Paris, Hong Kong Disneyland, ESPN Zone,</td>
<td>Paramount theme parks in the US and Canada</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outdoor Advertising</td>
<td>News Outdoor (Russia and Eastern Europe)</td>
<td></td>
<td>Infinity Outdoor</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Interests</td>
<td>Sports teams</td>
<td>Sports teams</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
EXHIBIT 3: Viacom SIC Business Sectors:

<table>
<thead>
<tr>
<th>Industry Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Cable and Other Pay Television Content and Programming</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Cable Broadcasting</td>
</tr>
<tr>
<td>- Consumer Discretionary → Consumer Services → Hotels, Restaurants and Leisure → Leisure Facilities → Amusement And Recreation Services → Amusement Operations, Parks and Services → Amusement Parks</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television → Television Content and Programming</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Radio → Radio Content and Programming</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Radio → Radio Networks</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Radio → Radio Content and Programming</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television → Television Networks</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Animation Production</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Radio Production Companies</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Television Production Companies</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Services → Motion Picture Distribution And Allied Services</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Services → Music Services</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Publishing → Music Publishing</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Book Publishing</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Newspaper and Magazine Publishing → Magazine Publishing</td>
</tr>
<tr>
<td>- Services → Business Services → Advertising → Outdoor Advertising Services</td>
</tr>
</tbody>
</table>
**EXHIBIT 4: Disney SIC Business Sectors:**

<table>
<thead>
<tr>
<th>Industry Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Consumer Discretionary → Consumer Services → Hotels, Restaurants and Leisure → Hotels, Resorts and Cruise Lines</td>
</tr>
<tr>
<td>→ Lodging → Hotels And Motels → Hotels</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Consumer Services → Hotels, Restaurants and Leisure → Hotels, Resorts and Cruise Lines</td>
</tr>
<tr>
<td>→ Lodging → Hotels And Motels → Resorts</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Consumer Services → Hotels, Restaurants and Leisure → Leisure Facilities → Amusement And Recreation Services → Amusement Operations, Parks and Services → Amusement Parks</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Cable</td>
</tr>
<tr>
<td>and Other Pay Television Content and Programming</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Radio → Radio Content and Programming</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Radio → Radio Networks</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television → Television Content and Programming</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television Networks</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Animation Production</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Radio Production Companies</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Television Production Companies</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Services → Motion Picture Distribution And Allied Services</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Services → Music Services</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Services → Stage and Theater Services</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Book Publishing</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Newspaper and Magazine Publishing → Magazine Publishing</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Retailing → Internet and Catalog Retail → Internet Retail → Online Specialty Retail</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Retailing → Specialty Retail → Specialty Stores</td>
</tr>
<tr>
<td>▪ Information Technology → Software and Services → Internet Software and Services → Internet Software and Services → Online Services</td>
</tr>
<tr>
<td>▪ Information Technology → Software and Services → Software → Home Entertainment Software → Entertainment Software</td>
</tr>
</tbody>
</table>
### EXHIBIT 5: News Corporation SIC Business Sectors:

<table>
<thead>
<tr>
<th>Industry Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Cable Networks</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television → Television Broadcasting Stations</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television → Television Content and Programming</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Motion Picture and Video Production Companies</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Television Production Companies</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Book Publishing → Educational Book Publishing</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Newspaper and Magazine Publishing → Magazine Publishing</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Newspaper and Magazine Publishing → Newspaper Publishing</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Promotional Material and Business Publishing</td>
</tr>
<tr>
<td>- Financials → Diversified Financials → Diversified Financial Services → Multi-Sector Holdings → Investment Services and Holding Companies → Holding Companies</td>
</tr>
</tbody>
</table>
EXHIBIT 6: BSkyB SIC Business Sectors:

<table>
<thead>
<tr>
<th>Industry Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Cable and Other Pay Television Content and Programming</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Cable Broadcasting</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Cable Networks</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Digital Cable Television</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Venues → Online Entertainment</td>
</tr>
</tbody>
</table>
### EXHIBIT 7: Fox Entertainment Group SIC Business Sectors:

<table>
<thead>
<tr>
<th>Industry Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Cable Broadcasting</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Cable Networks</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Digital Cable Television</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television → Digital Television</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television → Television Broadcasting Stations</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television → Television Networks</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Web Broadcasts And Cybercasts</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Motion Picture and Video Production Companies</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Television Production Companies</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Services → Motion Picture Distribution And Allied Services → Motion Picture And Video Tape Distribution</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Services → Motion Picture Post-Production Services</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Services → Sports Services</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Services → Television and Video Post-Production Services</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Book Publishing</td>
</tr>
<tr>
<td>- Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Newspaper and Magazine Publishing → Newspaper Publishing</td>
</tr>
</tbody>
</table>
EXHIBIT 8: Bertelsmann AG SIC Business Sectors:

<table>
<thead>
<tr>
<th>Industry Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Industrials → Commercial Services and Supplies → Commercial Services and Supplies → Commercial Printing → Printing Services</td>
</tr>
<tr>
<td>▪ Industrials → Commercial Services and Supplies → Commercial Services and Supplies → Office Services and Supplies → Outsourced Business Services → Outsourced Client Support and Customer Services</td>
</tr>
<tr>
<td>▪ Industrials → Transportation → Air Freight and Logistics</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Consumer Services → Hotels, Restaurants and Leisure → Leisure Facilities → Amusement And Recreation Services → Recreation Clubs</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Radio → Radio Broadcasting Stations</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television → Television Broadcasting Stations</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television → Television Content and Programming</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Publishing → Music Publishing</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Book Publishing</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Newspaper and Magazine Publishing → Magazine Publishing</td>
</tr>
<tr>
<td>▪ Consumer Discretionary → Media → Media → Publishing → Published Electronic Materials → Electronic Directory Publishing</td>
</tr>
</tbody>
</table>
EXHIBIT 9: Time Warner SIC Business Sectors:

<table>
<thead>
<tr>
<th>Industry Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Discretionary → Media → Media → Advertising → Broadcast Advertising → Internet Advertising</td>
</tr>
<tr>
<td>Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Cable And Other Pay Television → Cable And Other Pay Television Content and Programming</td>
</tr>
<tr>
<td>Consumer Discretionary → Media → Media → Broadcasting and Cable TV → Television → Television Broadcasting Stations</td>
</tr>
<tr>
<td>Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Animation Production</td>
</tr>
<tr>
<td>Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Motion Picture and Video Production Companies</td>
</tr>
<tr>
<td>Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Production Companies → Television Production Companies</td>
</tr>
<tr>
<td>Consumer Discretionary → Media → Media → Movies and Entertainment → Entertainment Services → Motion Picture Distribution And Allied Services → Motion Picture And Video Tape Distribution</td>
</tr>
<tr>
<td>Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Book Publishing</td>
</tr>
<tr>
<td>Consumer Discretionary → Media → Media → Publishing → Printed Media Publishing → Newspaper And Magazine Publishing → Magazine Publishing</td>
</tr>
<tr>
<td>Information Technology → Software And Services → Internet Software And Services → Online Services → Internet Service Providers</td>
</tr>
</tbody>
</table>
## EXHIBIT 10: Sony Corporation SIC Business Sectors:

### Industry Classification

- **Consumer Discretionary** → **Consumer Durables and Apparel** → **Household Durables** → **Consumer Electronics** → **Audio Equipment** → **Compact Disc Players**

- **Consumer Discretionary** → **Consumer Durables and Apparel** → **Household Durables** → **Consumer Electronics** → **Audio Equipment** → **Digital Music Recorders** → **MP3 Players**

- **Consumer Discretionary** → **Consumer Durables and Apparel** → **Household Durables** → **Consumer Electronics** → **Consumer Electronics Accessories**

- **Consumer Discretionary** → **Consumer Durables and Apparel** → **Household Durables** → **Consumer Electronics** → **Video Equipment** → **Digital Versatile Disc Player (DVD)**

- **Consumer Discretionary** → **Consumer Durables and Apparel** → **Household Durables** → **Consumer Electronics** → **Video Equipment** → **Televisions**

- **Consumer Discretionary** → **Consumer Durables and Apparel** → **Leisure Equipment and Products** → **Photographic Products** → **Cameras** → **Digital Cameras**

- **Consumer Discretionary** → **Media** → **Media** → **Advertising**

- **Consumer Discretionary** → **Media** → **Media** → **Broadcasting and Cable TV** → **Television** → **Television Broadcasting Stations**

- **Consumer Discretionary** → **Media** → **Media** → **Movies and Entertainment** → **Entertainment Production Companies** → **Animation Production**

- **Consumer Discretionary** → **Media** → **Media** → **Movies and Entertainment** → **Entertainment Production Companies** → **Motion Picture and Video Production Companies**

- **Consumer Discretionary** → **Media** → **Media** → **Movies and Entertainment** → **Entertainment Production Companies** → **Television Production Companies**

- **Consumer Discretionary** → **Media** → **Media** → **Movies and Entertainment** → **Entertainment Services** → **Music Services**

- **Financials** → **Diversified Financials** → **Diversified Financial Services** → **Specialized Finance** → **Credit Agencies** → **Business Credit Agencies** → **Finance Leasing**

- **Financials** → **Insurance** → **Life and Health Insurance**

- **Information Technology** → **Semiconductors and Semiconductor Equipment** → **Semiconductors**

- **Information Technology** → **Software and Services** → **Internet Software and Services** → **Online Services** → **Personal Applications** → **Online Financial Services**

- **Information Technology** → **Software and Services** → **Software** → **Application Software** → **Multimedia Software** → **Audio Software**

- **Information Technology** → **Software and Services** → **Software** → **Application Software** → **Multimedia Software** → **Video Software**

- **Information Technology** → **Software and Services** → **Software** → **Home Entertainment Software** → **Entertainment Software** → **Computer Games**

- **Information Technology** → **Software and Services** → **Software** → **Home Entertainment Software** → **Entertainment Software** → **Console Platforms**

- **Information Technology** → **Technology Hardware and Equipment** → **Computers and Peripherals** → **Computer Hardware**
→ Personal Computers and Accessories → Printers
**EXHIBIT 11: Time Warner Inc. Key Financial Data**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>12021</td>
<td>13070</td>
<td>14567</td>
<td>15905</td>
<td>17742</td>
<td>20925</td>
<td>24622</td>
<td>26838</td>
<td>26244</td>
<td>27333</td>
<td>35324</td>
<td>37166</td>
<td>38234</td>
<td>37060</td>
<td>39563</td>
<td>42089</td>
<td>43652</td>
</tr>
<tr>
<td>Publishing</td>
<td>2960</td>
<td>3214</td>
<td>3334</td>
<td>3986</td>
<td>4196</td>
<td>3949</td>
<td>3691</td>
<td>4025</td>
<td>3834</td>
<td>4663</td>
<td>4525</td>
<td>4689</td>
<td>4689</td>
<td>4810</td>
<td>5422</td>
<td>5533</td>
<td>5846</td>
</tr>
<tr>
<td>Music</td>
<td>2960</td>
<td>3214</td>
<td>3334</td>
<td>3986</td>
<td>4196</td>
<td>3949</td>
<td>3691</td>
<td>4025</td>
<td>3834</td>
<td>4663</td>
<td>4525</td>
<td>4689</td>
<td>4689</td>
<td>4810</td>
<td>5422</td>
<td>5533</td>
<td>5846</td>
</tr>
<tr>
<td>Cable</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>172</td>
<td>1598</td>
<td>3897</td>
<td>5374</td>
<td>5247</td>
<td>6028</td>
<td>6992</td>
<td>7035</td>
<td>7699</td>
<td>8484</td>
<td>9498</td>
<td>11924</td>
</tr>
<tr>
<td>Filmed Entertainment</td>
<td>3065</td>
<td>3945</td>
<td>4032</td>
<td>4484</td>
<td>5078</td>
<td>6103</td>
<td>7003</td>
<td>7978</td>
<td>8075</td>
<td>8119</td>
<td>8759</td>
<td>8759</td>
<td>8759</td>
<td>8759</td>
<td>10040</td>
<td>11853</td>
<td>11924</td>
</tr>
<tr>
<td>Networks</td>
<td>3301</td>
<td>3535</td>
<td>3649</td>
<td>3755</td>
<td>4734</td>
<td>5701</td>
<td>6302</td>
<td>6690</td>
<td>6495</td>
<td>6802</td>
<td>7050</td>
<td>7050</td>
<td>7050</td>
<td>7655</td>
<td>8434</td>
<td>9054</td>
<td>9611</td>
</tr>
<tr>
<td>Digital Media/AOL</td>
<td>3301</td>
<td>3535</td>
<td>3649</td>
<td>3755</td>
<td>4734</td>
<td>5701</td>
<td>6302</td>
<td>6690</td>
<td>6495</td>
<td>6802</td>
<td>7050</td>
<td>7050</td>
<td>7050</td>
<td>7655</td>
<td>8434</td>
<td>9054</td>
<td>9611</td>
</tr>
<tr>
<td>Total Operating Expenses</td>
<td>7769</td>
<td>8439</td>
<td>9459</td>
<td>10283</td>
<td>11279</td>
<td>13363</td>
<td>14948</td>
<td>16406</td>
<td>14820</td>
<td>14940</td>
<td>19887</td>
<td>20533</td>
<td>22291</td>
<td>23422</td>
<td>24449</td>
<td>25046</td>
<td></td>
</tr>
<tr>
<td>Theme Parks</td>
<td>533</td>
<td>557</td>
<td>227</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1</td>
<td>7605</td>
<td>8165</td>
<td>8718</td>
<td>8860</td>
<td>8598</td>
<td>8692</td>
<td>8283</td>
<td></td>
</tr>
<tr>
<td>Total Costs</td>
<td>10867</td>
<td>11727</td>
<td>13053</td>
<td>14295</td>
<td>15927</td>
<td>18872</td>
<td>21897</td>
<td>23613</td>
<td>21890</td>
<td>22453</td>
<td>29437</td>
<td>30129</td>
<td>31085</td>
<td>33256</td>
<td>34749</td>
<td>35524</td>
<td></td>
</tr>
<tr>
<td>EBITDA</td>
<td>2263</td>
<td>2625</td>
<td>2707</td>
<td>2826</td>
<td>3248</td>
<td>4903</td>
<td>6214</td>
<td>6386</td>
<td>8574</td>
<td>8237</td>
<td>9684</td>
<td>9465</td>
<td>-34197</td>
<td>8410</td>
<td>9394</td>
<td>7823</td>
<td></td>
</tr>
<tr>
<td>Selling, general &amp; admin costs</td>
<td>3098</td>
<td>3288</td>
<td>3594</td>
<td>4012</td>
<td>4648</td>
<td>5509</td>
<td>6949</td>
<td>7207</td>
<td>7070</td>
<td>7513</td>
<td>9550</td>
<td>9596</td>
<td>8794</td>
<td>9834</td>
<td>10300</td>
<td>10478</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>1109</td>
<td>1241</td>
<td>1333</td>
<td>867</td>
<td>956</td>
<td>992</td>
<td>1768</td>
<td>1305</td>
<td>1305</td>
<td>1231</td>
<td>1600</td>
<td>1731</td>
<td>2299</td>
<td>2465</td>
<td>2538</td>
<td>2627</td>
<td></td>
</tr>
<tr>
<td>Corporate</td>
<td>-424</td>
<td>-1020</td>
<td>-3295</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-424</td>
<td>-1020</td>
<td>-3295</td>
</tr>
</tbody>
</table>

| Degreciation      | 72       | 74       | 77       | 83       | 59       | 71       | 79       | 80       | 80            | 81       | 64       | 70       | 97        | 116            | 122  | 132  |        |
| Music             | 304      | 310      | 347      | 354      | 274      | 91       | 83       | 72       | 72            | 74       | 83       | 97       | 121       |                |      |      |        |
| Cable             | 27       | 20       | 213      | 220      | 864      | 786      | 857      | 893      | 1206          | 1403     | 1438     | 1588     | 86        | 104            | 121  |      |        |
| Filmed Entertainment | 183   | 266     | 263     | 76       | 113      | 169      | 327      | 172      | 172           | 156      | 99       | 90       | 79        |                |      |      |        |
| Networks          | 550      | 591      | 646      | 354      | 483      | 641      | 1066     | 761      | 117           | 133      | 153      | 159      | 172       |                |      |      |        |
|-----------------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| Subscriptions   | 14733| 15657| 18059| 20448| 21605| 22222|
| Advertising & Commerce | 8744 | 8260 | 7680 | 6180 | 6995 | 7612 |
| Content & Other | 12736 | 13249 | 14322 | 12935 | 13529 | 13818 |
| Total           | 36213| 37166| 40961| 39563| 42089| 43652|

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>17043</td>
<td>16892</td>
<td>16716</td>
<td>22132</td>
<td>35064</td>
<td>34163</td>
<td>47951</td>
<td>51239</td>
<td>216047</td>
<td>208539</td>
<td>115450</td>
<td>115450</td>
<td>121780</td>
<td>123149</td>
<td>122476</td>
<td></td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>8876</td>
<td>15522</td>
<td>15568</td>
<td>18465</td>
<td>25562</td>
<td>24807</td>
<td>39099</td>
<td>41526</td>
<td>58420</td>
<td>56488</td>
<td>62633</td>
<td>62633</td>
<td>61009</td>
<td>62430</td>
<td>59797</td>
<td></td>
</tr>
<tr>
<td>Shareholder's Equity</td>
<td>8167</td>
<td>1370</td>
<td>1148</td>
<td>3667</td>
<td>9502</td>
<td>9356</td>
<td>8852</td>
<td>9713</td>
<td>157627</td>
<td>152071</td>
<td>52817</td>
<td>52817</td>
<td>60771</td>
<td>60719</td>
<td>62679</td>
<td></td>
</tr>
</tbody>
</table>
EXHIBIT 12: Analysis: Time Warner Inc.


<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Publishing</td>
<td>25%</td>
<td>24%</td>
<td>13%</td>
<td>13%</td>
</tr>
<tr>
<td>Music</td>
<td>25%</td>
<td>24%</td>
<td>12%</td>
<td>0%</td>
</tr>
<tr>
<td>Cable</td>
<td>0%</td>
<td>1%</td>
<td>15%</td>
<td>22%</td>
</tr>
<tr>
<td>Filmed Entertainment</td>
<td>25%</td>
<td>29%</td>
<td>23%</td>
<td>27%</td>
</tr>
<tr>
<td>Networks</td>
<td>27%</td>
<td>27%</td>
<td>19%</td>
<td>22%</td>
</tr>
<tr>
<td>Digital</td>
<td>0%</td>
<td>0%</td>
<td>22%</td>
<td>19%</td>
</tr>
<tr>
<td>Theme Parks</td>
<td>0%</td>
<td>1%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Return on Sales per Segment (Operating income (EBITA)/sales)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Publishing</td>
<td>5.9%</td>
<td>7.9%</td>
<td>8.8%</td>
<td>8.7%</td>
<td>9.1%</td>
<td>11.7%</td>
<td>14.3%</td>
<td>15.1%</td>
<td>14.6%</td>
<td>15.1%</td>
<td>17.9%</td>
<td>22.0%</td>
<td>15.2%</td>
<td>19.3%</td>
<td>19.3%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Music</td>
<td>8.6%</td>
<td>8.6%</td>
<td>8.9%</td>
<td>9.2%</td>
<td>7.7%</td>
<td>16.5%</td>
<td>12.7%</td>
<td>12.2%</td>
<td>11.8%</td>
<td>10.2%</td>
<td>8.0%</td>
<td>9.2%</td>
<td>disposal</td>
<td>disposal</td>
<td>disposal</td>
<td>disposal</td>
</tr>
<tr>
<td>Cable</td>
<td>nye</td>
<td>nye</td>
<td>nye</td>
<td>nye</td>
<td>-2.9%</td>
<td>31.2%</td>
<td>25.7%</td>
<td>24.0%</td>
<td>73.1%</td>
<td>28.9%</td>
<td>28.8%</td>
<td>22.3%</td>
<td>20.6%</td>
<td>21.7%</td>
<td>21.9%</td>
<td>-5.4%</td>
</tr>
<tr>
<td>Filmed Entertainment</td>
<td>6.8%</td>
<td>6.4%</td>
<td>5.8%</td>
<td>4.9%</td>
<td>5.0%</td>
<td>6.7%</td>
<td>8.6%</td>
<td>8.7%</td>
<td>12.3%</td>
<td>8.6%</td>
<td>10.6%</td>
<td>13.2%</td>
<td>11.6%</td>
<td>11.6%</td>
<td>9.8%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Networks</td>
<td>15.7%</td>
<td>17.0%</td>
<td>17.0%</td>
<td>15.4%</td>
<td>15.0%</td>
<td>20.1%</td>
<td>23.6%</td>
<td>25.9%</td>
<td>20.1%</td>
<td>19.8%</td>
<td>23.2%</td>
<td>26.4%</td>
<td>21.8%</td>
<td>27.4%</td>
<td>28.7%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Digital Media/AOL</td>
<td>nye</td>
<td>nye</td>
<td>nye</td>
<td>nye</td>
<td>nye</td>
<td>nye</td>
<td>nye</td>
<td>nye</td>
<td>negative</td>
<td>25.7%</td>
<td>28.9%</td>
<td>13.5%</td>
<td>9.7%</td>
<td>12.8%</td>
<td>16.3%</td>
<td>-8.7%</td>
</tr>
</tbody>
</table>

Historical ROS Development Per Business Segment

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Publishing</td>
<td>7.8%</td>
<td>13.0%</td>
<td>14.9%</td>
</tr>
<tr>
<td>Music</td>
<td>8.8%</td>
<td>12.2%</td>
<td>disposal</td>
</tr>
<tr>
<td>Cable</td>
<td>nye</td>
<td>30.2%</td>
<td>24.1%</td>
</tr>
<tr>
<td>Filmed Entertainment</td>
<td>6.0%</td>
<td>8.3%</td>
<td>10.9%</td>
</tr>
<tr>
<td>Networks</td>
<td>16.2%</td>
<td>20.9%</td>
<td>24.6%</td>
</tr>
<tr>
<td>Digital Media/AOL</td>
<td>nye</td>
<td>nye</td>
<td>17.8%</td>
</tr>
</tbody>
</table>

Key Performance Ratios

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Equity (EBIT/Equity)</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>82%</td>
<td>28%</td>
<td>21%</td>
<td>29%</td>
<td>37%</td>
<td>62%</td>
<td>negative</td>
<td>1%</td>
<td>12%</td>
<td>9%</td>
<td>10%</td>
</tr>
<tr>
<td>Return on Assets (EBIT/Total Assets)</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>6%</td>
<td>5%</td>
<td>6%</td>
<td>8%</td>
<td>7%</td>
<td>12%</td>
<td>negative</td>
<td>1%</td>
<td>6%</td>
<td>4%</td>
<td>5%</td>
</tr>
<tr>
<td>Return on Sales (EBIT/Sales)</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>6%</td>
<td>6%</td>
<td>9%</td>
<td>11%</td>
<td>12%</td>
<td>22%</td>
<td>negative</td>
<td>3%</td>
<td>17%</td>
<td>13%</td>
<td>15%</td>
</tr>
<tr>
<td>Gross Profit Margin (EBITDA/Sales)</td>
<td>19%</td>
<td>20%</td>
<td>19%</td>
<td>18%</td>
<td>18%</td>
<td>23%</td>
<td>25%</td>
<td>24%</td>
<td>31%</td>
<td>23%</td>
<td>26%</td>
<td>25%</td>
<td>21%</td>
<td>22%</td>
<td>18%</td>
</tr>
<tr>
<td>Leverage (Total debt/total assets)</td>
<td>na</td>
<td>52%</td>
<td>92%</td>
<td>93%</td>
<td>83%</td>
<td>73%</td>
<td>73%</td>
<td>82%</td>
<td>81%</td>
<td>27%</td>
<td>27%</td>
<td>54%</td>
<td>50%</td>
<td>51%</td>
<td>49%</td>
</tr>
</tbody>
</table>

Cumulated Annual Revenue Growth

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulated</td>
<td>14%</td>
<td>4%</td>
</tr>
</tbody>
</table>
EXHIBIT 13: News Corporation: Key Financial Data

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td>7609</td>
<td>8360</td>
<td>11010</td>
<td>12651</td>
<td>13040</td>
<td>14861</td>
<td>16858</td>
<td>17380</td>
<td>20802</td>
<td>23859</td>
<td>25327</td>
</tr>
<tr>
<td>Newspapers</td>
<td>1767</td>
<td>1835</td>
<td>2192</td>
<td>2402</td>
<td>2584</td>
<td>2673</td>
<td>2675</td>
<td>2718</td>
<td>3425</td>
<td>4083</td>
<td>4095</td>
</tr>
<tr>
<td>Magazines &amp; Inserts</td>
<td>982</td>
<td>895</td>
<td>1448</td>
<td>1295</td>
<td>921</td>
<td>973</td>
<td>959</td>
<td>923</td>
<td>979</td>
<td>1068</td>
<td>1090</td>
</tr>
<tr>
<td>Television</td>
<td>1946</td>
<td>2150</td>
<td>2827</td>
<td>3580</td>
<td>3395</td>
<td>4072</td>
<td>4741</td>
<td>4763</td>
<td>5027</td>
<td>5338</td>
<td>5334</td>
</tr>
<tr>
<td>Cable network programming</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1165</td>
<td>1566</td>
<td>2074</td>
<td>2145</td>
<td>2409</td>
<td>2688</td>
<td>3358</td>
</tr>
<tr>
<td>Direct Broadcast Satellite Television</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2313</td>
<td>2542</td>
</tr>
<tr>
<td>Filmed entertainment</td>
<td>1879</td>
<td>2451</td>
<td>3426</td>
<td>4112</td>
<td>3553</td>
<td>3849</td>
<td>4482</td>
<td>4486</td>
<td>5187</td>
<td>5919</td>
<td>6199</td>
</tr>
<tr>
<td>Book Publishing</td>
<td>717</td>
<td>550</td>
<td>632</td>
<td>711</td>
<td>949</td>
<td>1108</td>
<td>1196</td>
<td>1162</td>
<td>1276</td>
<td>1327</td>
<td>1312</td>
</tr>
<tr>
<td>Other</td>
<td>314</td>
<td>479</td>
<td>485</td>
<td>551</td>
<td>472</td>
<td>620</td>
<td>731</td>
<td>963</td>
<td>834</td>
<td>1123</td>
<td>1397</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>6461</td>
<td>7352</td>
<td>14547</td>
<td>14487</td>
<td>17306</td>
<td>19598</td>
<td>20684</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>9324</td>
<td>10250</td>
<td>0</td>
<td>11894</td>
<td>13942</td>
<td>15901</td>
<td>16593</td>
</tr>
<tr>
<td>Selling, gen &amp; admin expenses</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1797</td>
<td>2404</td>
<td>0</td>
<td>2692</td>
<td>3364</td>
<td>3697</td>
<td>4091</td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td>1091</td>
<td>1411</td>
<td>1778</td>
<td>1895</td>
<td>1920</td>
<td>2207</td>
<td>2493</td>
<td>2919</td>
<td>3625</td>
<td>4329</td>
<td>4746</td>
</tr>
<tr>
<td>Newspapers</td>
<td>368</td>
<td>436</td>
<td>489</td>
<td>621</td>
<td>654</td>
<td>608</td>
<td>531</td>
<td>722</td>
<td>962</td>
<td>780</td>
<td>314</td>
</tr>
<tr>
<td>Magazines &amp; Inserts</td>
<td>194</td>
<td>231</td>
<td>351</td>
<td>246</td>
<td>264</td>
<td>268</td>
<td>263</td>
<td>276</td>
<td>304</td>
<td>314</td>
<td>314</td>
</tr>
<tr>
<td>Television</td>
<td>353</td>
<td>381</td>
<td>610</td>
<td>732</td>
<td>673</td>
<td>619</td>
<td>955</td>
<td>1043</td>
<td>1044</td>
<td>1120</td>
<td>1120</td>
</tr>
<tr>
<td>Cable network programming</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>102</td>
<td>160</td>
<td>268</td>
<td>472</td>
<td>658</td>
<td>858</td>
<td>1018</td>
<td>1018</td>
</tr>
<tr>
<td>Direct Broadcast Satellite Television</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>17</td>
<td>211</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Filmed entertainment</td>
<td>109</td>
<td>105</td>
<td>252</td>
<td>166</td>
<td>371</td>
<td>601</td>
<td>716</td>
<td>959</td>
<td>1109</td>
<td>1177</td>
<td>1177</td>
</tr>
<tr>
<td>Book Publishing</td>
<td>55</td>
<td>13</td>
<td>36</td>
<td>87</td>
<td>127</td>
<td>139</td>
<td>136</td>
<td>163</td>
<td>170</td>
<td>174</td>
<td>174</td>
</tr>
<tr>
<td>Other</td>
<td>12</td>
<td>8</td>
<td>41</td>
<td>-33</td>
<td>-43</td>
<td>-11</td>
<td>-98</td>
<td>-71</td>
<td>-101</td>
<td>-48</td>
<td>-48</td>
</tr>
<tr>
<td><strong>Depreciation &amp; Amortization</strong></td>
<td>166</td>
<td>186</td>
<td>241</td>
<td>296</td>
<td>327</td>
<td>410</td>
<td>435</td>
<td>539</td>
<td>694</td>
<td>765</td>
<td>775</td>
</tr>
<tr>
<td>Newspapers</td>
<td>77</td>
<td>81</td>
<td>100</td>
<td>115</td>
<td>129</td>
<td>131</td>
<td>130</td>
<td>157</td>
<td>222</td>
<td>263</td>
<td></td>
</tr>
<tr>
<td>Magazines &amp; Inserts</td>
<td>6</td>
<td>6</td>
<td>10</td>
<td>7</td>
<td>10</td>
<td>8</td>
<td>6</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Television</td>
<td>34</td>
<td>48</td>
<td>70</td>
<td>81</td>
<td>98</td>
<td>112</td>
<td>96</td>
<td>93</td>
<td>92</td>
<td>88</td>
<td></td>
</tr>
<tr>
<td>Cable network programming</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>33</td>
<td>46</td>
<td>48</td>
<td>172</td>
<td>170</td>
<td>156</td>
<td>864</td>
<td></td>
</tr>
<tr>
<td>Direct Broadcast Satellite Television</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>25</td>
</tr>
<tr>
<td>Filmed entertainment</td>
<td>25</td>
<td>27</td>
<td>34</td>
<td>56</td>
<td>79</td>
<td>76</td>
<td>55</td>
<td>54</td>
<td>51</td>
<td>85</td>
<td>85</td>
</tr>
<tr>
<td>Book Publishing</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>8</td>
<td>9</td>
<td>5</td>
<td>6</td>
<td>6</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Other</td>
<td>21</td>
<td>20</td>
<td>23</td>
<td>30</td>
<td>41</td>
<td>52</td>
<td>50</td>
<td>57</td>
<td>76</td>
<td>102</td>
<td>102</td>
</tr>
<tr>
<td>Depreciation (Fixed + leased assets)</td>
<td>146</td>
<td>167</td>
<td>221</td>
<td>303</td>
<td>379</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Amortization (=Goodwill)</td>
<td>19</td>
<td>19</td>
<td>20</td>
<td>24</td>
<td>31</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>103</td>
<td>103</td>
</tr>
<tr>
<td><strong>Operating income (=EBIT)</strong></td>
<td>926</td>
<td>988</td>
<td>1537</td>
<td>1599</td>
<td>1593</td>
<td>1797</td>
<td>2058</td>
<td>2380</td>
<td>2931</td>
<td>3564</td>
<td>3868</td>
</tr>
</tbody>
</table>
### Appendix

#### (in US$ millions)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Newspapers</td>
<td>291</td>
<td>354</td>
<td>389</td>
<td>400</td>
<td>505</td>
<td>525</td>
<td>478</td>
<td>401</td>
<td>565</td>
<td>740</td>
<td>517</td>
</tr>
<tr>
<td>Magazines &amp; Inserts</td>
<td>188</td>
<td>225</td>
<td>340</td>
<td>315</td>
<td>239</td>
<td>254</td>
<td>260</td>
<td>257</td>
<td>271</td>
<td>298</td>
<td>307</td>
</tr>
<tr>
<td>Television</td>
<td>319</td>
<td>333</td>
<td>540</td>
<td>511</td>
<td>651</td>
<td>576</td>
<td>507</td>
<td>859</td>
<td>950</td>
<td>952</td>
<td>1032</td>
</tr>
<tr>
<td>Cable network programming</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>70</td>
<td>114</td>
<td>221</td>
<td>300</td>
<td>488</td>
<td>702</td>
<td>864</td>
</tr>
<tr>
<td>Direct Broadcast Satellite Television</td>
<td>-173</td>
<td>39</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Filmed entertainment</td>
<td>84</td>
<td>77</td>
<td>218</td>
<td>321</td>
<td>109</td>
<td>292</td>
<td>525</td>
<td>661</td>
<td>905</td>
<td>1058</td>
<td>1092</td>
</tr>
<tr>
<td>Book Publishing</td>
<td>52</td>
<td>9</td>
<td>32</td>
<td>45</td>
<td>82</td>
<td>119</td>
<td>130</td>
<td>131</td>
<td>157</td>
<td>164</td>
<td>167</td>
</tr>
<tr>
<td>Other</td>
<td>-9</td>
<td>-12</td>
<td>18</td>
<td>6</td>
<td>-63</td>
<td>-84</td>
<td>-63</td>
<td>-148</td>
<td>-128</td>
<td>-177</td>
<td>-150</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>734</td>
<td>756</td>
<td>1050</td>
<td>898</td>
<td>770</td>
<td>808</td>
<td>-7691</td>
<td>822</td>
<td>1533</td>
<td>2128</td>
<td>2314</td>
</tr>
</tbody>
</table>

#### Financial Position

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>0</td>
<td>24030</td>
<td>31656</td>
<td>31359</td>
<td>38106</td>
<td>36898</td>
<td>42149</td>
<td>48343</td>
<td>54692</td>
<td>56649</td>
<td></td>
</tr>
<tr>
<td>Total Debt</td>
<td>0</td>
<td>11111</td>
<td>15846</td>
<td>15608</td>
<td>19130</td>
<td>10809</td>
<td>9840</td>
<td>10003</td>
<td>10590</td>
<td>25315</td>
<td>26775</td>
</tr>
<tr>
<td>Total Equity</td>
<td>0</td>
<td>12918</td>
<td>15810</td>
<td>15751</td>
<td>18976</td>
<td>28876</td>
<td>27058</td>
<td>32146</td>
<td>37834</td>
<td>29377</td>
<td>29874</td>
</tr>
</tbody>
</table>

#### Revenues by geographic area

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>5262</td>
<td>5842</td>
<td>8135</td>
<td>9412</td>
<td>9683</td>
<td>11094</td>
<td>12980</td>
<td>11150</td>
<td>12022</td>
<td>12884</td>
<td>14106</td>
</tr>
<tr>
<td>Australasia</td>
<td>986</td>
<td>970</td>
<td>1076</td>
<td>1166</td>
<td>1265</td>
<td>1336</td>
<td>1349</td>
<td>2384</td>
<td>2765</td>
<td>3464</td>
<td>3673</td>
</tr>
<tr>
<td>Europe</td>
<td>1357</td>
<td>1548</td>
<td>1798</td>
<td>2074</td>
<td>2092</td>
<td>2432</td>
<td>2529</td>
<td>3846</td>
<td>6015</td>
<td>7511</td>
<td>7552</td>
</tr>
</tbody>
</table>
## EXHIBIT 14: Analysis of Financial Performance: News Corporation

### Revenue contribution of media sectors

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Newspapers</td>
<td>5243%</td>
<td>3177%</td>
<td>4653%</td>
<td></td>
</tr>
<tr>
<td>Magazines &amp; Inserts</td>
<td>2914%</td>
<td>1132%</td>
<td>1239%</td>
<td></td>
</tr>
<tr>
<td>Television</td>
<td>5774%</td>
<td>4174%</td>
<td>6061%</td>
<td></td>
</tr>
<tr>
<td>Cable network programming</td>
<td>0%</td>
<td>1432%</td>
<td>3816%</td>
<td></td>
</tr>
<tr>
<td>Direct Broadcast Satellite Television</td>
<td>0%</td>
<td>0%</td>
<td>2889%</td>
<td></td>
</tr>
<tr>
<td>Filmed entertainment</td>
<td>5576%</td>
<td>4368%</td>
<td>7044%</td>
<td></td>
</tr>
<tr>
<td>Book Publishing</td>
<td>2128%</td>
<td>1167%</td>
<td>1491%</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>931%</td>
<td>581%</td>
<td>1588%</td>
<td></td>
</tr>
</tbody>
</table>

### Return on Sales per Segment (Operating income/sales)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Newspapers</td>
<td>16.5%</td>
<td>19.3%</td>
<td>17.7%</td>
<td>16.7%</td>
</tr>
<tr>
<td>Magazines &amp; Inserts</td>
<td>19.2%</td>
<td>25.2%</td>
<td>23.5%</td>
<td>24.4%</td>
</tr>
<tr>
<td>Television</td>
<td>16.4%</td>
<td>15.5%</td>
<td>19.1%</td>
<td>14.3%</td>
</tr>
<tr>
<td>Cable network programming</td>
<td>4.5%</td>
<td>3.2%</td>
<td>6.4%</td>
<td>7.8%</td>
</tr>
<tr>
<td>Direct Broadcast Satellite Television</td>
<td>nya</td>
<td>14.0%</td>
<td>-7.5%</td>
<td></td>
</tr>
<tr>
<td>Filmed entertainment</td>
<td>5.5%</td>
<td>12.1%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Book Publishing</td>
<td>7.3%</td>
<td>1.7%</td>
<td>5.1%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Other</td>
<td>-3.0%</td>
<td>-2.4%</td>
<td>3.7%</td>
<td>1.2%</td>
</tr>
</tbody>
</table>

### Development of Average ROS per Segment

<table>
<thead>
<tr>
<th></th>
<th>1996-1999</th>
<th>2000-2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Newspapers</td>
<td>17.5%</td>
<td>17.7%</td>
</tr>
<tr>
<td>Magazines &amp; Inserts</td>
<td>23.1%</td>
<td>27.1%</td>
</tr>
<tr>
<td>Television</td>
<td>16.3%</td>
<td>16.5%</td>
</tr>
<tr>
<td>Cable network programming</td>
<td>nya</td>
<td>14.0%</td>
</tr>
<tr>
<td>Direct Broadcast Satellite Television</td>
<td>nya</td>
<td>-7.5%</td>
</tr>
<tr>
<td>Filmed entertainment</td>
<td>5.5%</td>
<td>12.1%</td>
</tr>
<tr>
<td>Book Publishing</td>
<td>5.1%</td>
<td>11.0%</td>
</tr>
<tr>
<td>Other</td>
<td>-0.1%</td>
<td>-13.7%</td>
</tr>
</tbody>
</table>

### Return on Equity (EBIT/Equity)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Equity (EBIT/Equity)</td>
<td>#DIV/0!</td>
<td>8%</td>
<td>10%</td>
<td>10%</td>
</tr>
</tbody>
</table>

### Return on Assets (EBIT/Total Assets)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Assets (EBIT/Total Assets)</td>
<td>#DIV/0!</td>
<td>4%</td>
<td>5%</td>
<td>5%</td>
</tr>
</tbody>
</table>

### Return on Sales (EBIT/Sales)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Sales (EBIT/Sales)</td>
<td>12%</td>
<td>12%</td>
<td>14%</td>
<td>13%</td>
</tr>
</tbody>
</table>

### Gross Profit Margin (EBITDA/Sales)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Profit Margin (EBITDA/Sales)</td>
<td>14%</td>
<td>17%</td>
<td>16%</td>
<td>15%</td>
</tr>
</tbody>
</table>

### Leverage (Total debt/total assets)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Leverage (Total debt/total assets)</td>
<td>#DIV/0!</td>
<td>46%</td>
<td>50%</td>
<td>50%</td>
</tr>
</tbody>
</table>

### Averaged total revenue growth

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Averaged total revenue growth</td>
<td>14%</td>
<td>13%</td>
</tr>
</tbody>
</table>
## EXHIBIT 15: Sony Corporation: Key Financial Data

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Electronics</td>
<td>32,201</td>
<td>34,895</td>
<td>41,140</td>
<td>48,343</td>
<td>50,564</td>
<td>55,418</td>
<td>53,576</td>
<td>58,655</td>
<td>66,498</td>
<td>61,115</td>
<td>61,766</td>
<td>66,932</td>
<td>66,912</td>
<td>63,893</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Game</td>
<td>6,734</td>
<td>7,424</td>
<td>8,057</td>
<td>11,140</td>
<td>11,960</td>
<td>13,743</td>
<td>13,576</td>
<td>14,855</td>
<td>16,148</td>
<td>17,880</td>
<td>17,936</td>
<td>18,766</td>
<td>18,512</td>
<td>16,932</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Music</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>5,451</td>
<td>5,286</td>
<td>5,678</td>
<td>5,974</td>
<td>6,201</td>
<td>5,565</td>
<td>4,839</td>
<td>3,854</td>
<td>3,931</td>
<td>2,328</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pictures</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>3,343</td>
<td>3,916</td>
<td>5,284</td>
<td>4,297</td>
<td>4,340</td>
<td>5,048</td>
<td>5,128</td>
<td>6,634</td>
<td>6,753</td>
<td>6,857</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Operating expenses</strong></td>
<td>17,897</td>
<td>20,274</td>
<td>23,620</td>
<td>25,756</td>
<td>30,067</td>
<td>33,861</td>
<td>35,090</td>
<td>37,860</td>
<td>40,308</td>
<td>45,879</td>
<td>42,255</td>
<td>46,152</td>
<td>46,163</td>
<td>46,730</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling, general &amp; admin costs</td>
<td>6,341</td>
<td>6,008</td>
<td>6,845</td>
<td>7,281</td>
<td>8,688</td>
<td>9,662</td>
<td>10,302</td>
<td>11,029</td>
<td>11,989</td>
<td>12,971</td>
<td>14,664</td>
<td>13,677</td>
<td>14,346</td>
<td>16,056</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td>1,735</td>
<td>1,858</td>
<td>2,385</td>
<td>4,820</td>
<td>5,171</td>
<td>5,628</td>
<td>5,192</td>
<td>5,376</td>
<td>5,955</td>
<td>5,184</td>
<td>5,883</td>
<td>5,714</td>
<td>5,836</td>
<td>6,812</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Depreciation &amp; Amortization</strong></td>
<td>1,529</td>
<td>1,894</td>
<td>2,223</td>
<td>2,266</td>
<td>2,340</td>
<td>2,393</td>
<td>2,380</td>
<td>2,473</td>
<td>2,419</td>
<td>2,689</td>
<td>3,166</td>
<td>2,856</td>
<td>2,908</td>
<td>3,270</td>
<td>3,485</td>
<td></td>
</tr>
<tr>
<td>Electronics</td>
<td>1,203</td>
<td>1,567</td>
<td>1,836</td>
<td>1,679</td>
<td>1,700</td>
<td>1,711</td>
<td>1,678</td>
<td>1,618</td>
<td>1,721</td>
<td>1,861</td>
<td>1,906</td>
<td>1,709</td>
<td>1,681</td>
<td>1,883</td>
<td>2,577</td>
<td></td>
</tr>
<tr>
<td>Game</td>
<td>315</td>
<td>318</td>
<td>362</td>
<td>404</td>
<td>391</td>
<td>23</td>
<td>33</td>
<td>103</td>
<td>31</td>
<td>118</td>
<td>341</td>
<td>400</td>
<td>442</td>
<td>511</td>
<td>154</td>
<td></td>
</tr>
<tr>
<td>Music</td>
<td>235</td>
<td>256</td>
<td>254</td>
<td>272</td>
<td>288</td>
<td>315</td>
<td>269</td>
<td>165</td>
<td>86</td>
<td>92</td>
<td>90</td>
<td>90</td>
<td>90</td>
<td>90</td>
<td>90</td>
<td></td>
</tr>
<tr>
<td>Pictures</td>
<td>112</td>
<td>119</td>
<td>137</td>
<td>90</td>
<td>93</td>
<td>108</td>
<td>86</td>
<td>71</td>
<td>70</td>
<td>52</td>
<td>52</td>
<td>52</td>
<td>52</td>
<td>52</td>
<td>52</td>
<td></td>
</tr>
<tr>
<td><strong>Operating Income</strong></td>
<td>1,020</td>
<td>931</td>
<td>(1,718)</td>
<td>2,477</td>
<td>3,307</td>
<td>4,309</td>
<td>4,724</td>
<td>1,958</td>
<td>2,049</td>
<td>1,086</td>
<td>1,533</td>
<td>883</td>
<td>1,065</td>
<td>1,065</td>
<td>1,065</td>
<td></td>
</tr>
<tr>
<td>Electronics</td>
<td>646</td>
<td>848</td>
<td>1,254</td>
<td>2,035</td>
<td>2,137</td>
<td>2,601</td>
<td>1,032</td>
<td>865</td>
<td>2,283</td>
<td>9</td>
<td>545</td>
<td>61</td>
<td>(293)</td>
<td>(289)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Game</td>
<td>484</td>
<td>234</td>
<td>(2,817)</td>
<td>-94</td>
<td>509</td>
<td>958</td>
<td>1,075</td>
<td>675</td>
<td>669</td>
<td>931</td>
<td>603</td>
<td>403</td>
<td>74</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Music</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>422</td>
<td>404</td>
<td>427</td>
<td>288</td>
<td>248</td>
<td>186</td>
<td>178</td>
<td>(234)</td>
<td>(54)</td>
<td>(54)</td>
<td>(54)</td>
<td>(54)</td>
<td></td>
</tr>
<tr>
<td>Pictures</td>
<td>0</td>
<td>0</td>
<td>251</td>
<td>258</td>
<td>303</td>
<td>338</td>
<td>315</td>
<td>29</td>
<td>252</td>
<td>487</td>
<td>315</td>
<td>597</td>
<td>234</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Elimination</td>
<td>-111</td>
<td>-151</td>
<td>(216)</td>
<td>-148</td>
<td>(159)</td>
<td>(90)</td>
<td>(98)</td>
<td>(265)</td>
<td>(29)</td>
<td>(33)</td>
<td>(151)</td>
<td>(305)</td>
<td>(178)</td>
<td>(158)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Income before taxes (EBT)</strong></td>
<td>1,393</td>
<td>2,746</td>
<td>3,764</td>
<td>2,974</td>
<td>2,319</td>
<td>2,417</td>
<td>748</td>
<td>2,046</td>
<td>1,286</td>
<td>1,469</td>
<td>2,447</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>835</td>
<td>858</td>
<td>292</td>
<td>143</td>
<td>(3,024)</td>
<td>571</td>
<td>1,245</td>
<td>1,820</td>
<td>1,409</td>
<td>1,069</td>
<td>152</td>
<td>123</td>
<td>955</td>
<td>790</td>
<td>1,531</td>
<td>1,057</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>32,875</td>
<td>35,079</td>
<td>36,531</td>
<td>39,905</td>
<td>43,546</td>
<td>53,113</td>
<td>50,716</td>
<td>52,484</td>
<td>49,599</td>
<td>59,712</td>
<td>71,163</td>
<td>66,014</td>
<td>69,178</td>
<td>81,167</td>
<td>88,777</td>
<td>90,665</td>
</tr>
<tr>
<td>-----------------------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
<td>----------</td>
</tr>
<tr>
<td>Electronics</td>
<td>19,052</td>
<td>21,002</td>
<td>21,561</td>
<td>20,940</td>
<td>25,461</td>
<td>29,457</td>
<td>26,917</td>
<td>26,672</td>
<td>24,082</td>
<td>26,911</td>
<td>31,106</td>
<td>24,918</td>
<td>24,578</td>
<td>26,744</td>
<td>32,095</td>
<td></td>
</tr>
<tr>
<td>Game</td>
<td>11,206</td>
<td>11,681</td>
<td>12,419</td>
<td>12,896</td>
<td>10,389</td>
<td>800</td>
<td>1,143</td>
<td>1,620</td>
<td>1,487</td>
<td>3,912</td>
<td>6,279</td>
<td>5,823</td>
<td>5,564</td>
<td>6,109</td>
<td>4,505</td>
<td></td>
</tr>
<tr>
<td>Music</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6,263</td>
<td>6,382</td>
<td>6,852</td>
<td>5,951</td>
<td>6,515</td>
<td>6,794</td>
<td>5,445</td>
<td>4,137</td>
<td>4,321</td>
<td>3,046</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pictures</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6,687</td>
<td>7,116</td>
<td>7,504</td>
<td>6,587</td>
<td>7,079</td>
<td>8,071</td>
<td>7,744</td>
<td>7,177</td>
<td>7,647</td>
<td>8,066</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial Services</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>4,287</td>
<td>5,446</td>
<td>5,935</td>
<td>6,400</td>
<td>7,369</td>
<td>8,890</td>
<td>14,639</td>
<td>18,857</td>
<td>20,020</td>
<td>23,943</td>
<td>31,027</td>
<td>36,313</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3,349</td>
<td>2,463</td>
<td>2,534</td>
<td>3,056</td>
<td>1,325</td>
<td>2,323</td>
<td>2,548</td>
<td>2,756</td>
<td>3,319</td>
<td>3,251</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Elimination</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-2,396</td>
<td>1,821</td>
<td>1,182</td>
<td>1,699</td>
<td>2,013</td>
<td>3,976</td>
<td>2,165</td>
<td>2,200</td>
<td>2,850</td>
<td>(4,107)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate assets and elimination</td>
<td>2,617</td>
<td>2,397</td>
<td>2,550</td>
<td>1,782</td>
<td>2,250</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(in US$ millions)

| Equity   | 12307   | 13030   | 14882   | 14360   | 19148   | 21050   | 19116   | 18850   | 21232   | 26826   | 27383   |
| Debt     | 40806   | 37687   | 37602   | 35239   | 40564   | 50114   | 46898   | 50328   | 59934   | 61951   | 63281   |
## EXHIBIT 16: Analysis of Financial Performance: Sony Corporation

### Revenue contribution of media sectors

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Electronics</td>
<td>na</td>
<td>75%</td>
<td>75%</td>
<td>70%</td>
</tr>
<tr>
<td>Game</td>
<td>na</td>
<td>4%</td>
<td>9%</td>
<td>13%</td>
</tr>
<tr>
<td>Music</td>
<td>na</td>
<td>11%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Filmed Entertainment</td>
<td>na</td>
<td>7%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Financial Services</td>
<td>na</td>
<td>5%</td>
<td>7%</td>
<td>7%</td>
</tr>
</tbody>
</table>

### Return on Sales per Segment (Operating income/sales)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Electronics</td>
<td>5.6%</td>
<td>5.8%</td>
<td>6.8%</td>
<td>2.8%</td>
<td>2.1%</td>
<td>4.6%</td>
<td>0.0%</td>
<td>1.3%</td>
<td>-0.1%</td>
<td>-0.6%</td>
<td>-0.7%</td>
<td>44.5%</td>
</tr>
<tr>
<td>Game</td>
<td>-4.4%</td>
<td>13.6%</td>
<td>16.2%</td>
<td>17.4%</td>
<td>11.8%</td>
<td>-7.7%</td>
<td>8.3%</td>
<td>11.8%</td>
<td>8.7%</td>
<td>5.9%</td>
<td>0.9%</td>
<td>39.6%</td>
</tr>
<tr>
<td>Music</td>
<td>7.7%</td>
<td>7.6%</td>
<td>7.5%</td>
<td>4.8%</td>
<td>4.0%</td>
<td>3.3%</td>
<td>3.7%</td>
<td>-6.1%</td>
<td>-1.4%</td>
<td>3.5%</td>
<td>sep. entity</td>
<td>sep. entity</td>
</tr>
<tr>
<td>Filmed Entertainment</td>
<td>7.5%</td>
<td>6.6%</td>
<td>5.7%</td>
<td>7.9%</td>
<td>7.3%</td>
<td>0.8%</td>
<td>4.9%</td>
<td>7.3%</td>
<td>4.7%</td>
<td>8.7%</td>
<td>3.7%</td>
<td>36%</td>
</tr>
<tr>
<td>Financial Services</td>
<td>3.4%</td>
<td>8.4%</td>
<td>7.0%</td>
<td>5.3%</td>
<td>5.3%</td>
<td>3.6%</td>
<td>4.3%</td>
<td>4.2%</td>
<td>9.3%</td>
<td>9.9%</td>
<td>25.3%</td>
<td>47%</td>
</tr>
</tbody>
</table>

### Historical Average ROS Development Per Segment

<table>
<thead>
<tr>
<th></th>
<th>1995-1999</th>
<th>2000-2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electronics</td>
<td>4.6%</td>
<td>0.7%</td>
</tr>
<tr>
<td>Game</td>
<td>10.9%</td>
<td>4.6%</td>
</tr>
<tr>
<td>Music</td>
<td>6.3%</td>
<td>sep. entity</td>
</tr>
<tr>
<td>Filmed Entertainment</td>
<td>7.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Financial Services</td>
<td>5.9%</td>
<td>9.4%</td>
</tr>
</tbody>
</table>

### Key Profitability Variables

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Equity (EBIT/Equity)</td>
<td>11%</td>
<td>21%</td>
<td>25%</td>
<td>21%</td>
<td>12%</td>
<td>11%</td>
<td>4%</td>
<td>11%</td>
<td>6%</td>
<td>5%</td>
<td>9%</td>
</tr>
<tr>
<td>Return on Assets (EBIT/Total Assets)</td>
<td>3%</td>
<td>5%</td>
<td>7%</td>
<td>6%</td>
<td>4%</td>
<td>3%</td>
<td>1%</td>
<td>3%</td>
<td>2%</td>
<td>2%</td>
<td>3%</td>
</tr>
<tr>
<td>Return on Sales (EBIT/Sales)</td>
<td>3%</td>
<td>5%</td>
<td>7%</td>
<td>6%</td>
<td>4%</td>
<td>4%</td>
<td>1%</td>
<td>3%</td>
<td>2%</td>
<td>2%</td>
<td>4%</td>
</tr>
<tr>
<td>Gross Profit Margin (EBITDA/Sales)</td>
<td>10%</td>
<td>10%</td>
<td>12%</td>
<td>10%</td>
<td>9%</td>
<td>9%</td>
<td>8%</td>
<td>10%</td>
<td>9%</td>
<td>9%</td>
<td>11%</td>
</tr>
<tr>
<td>Leverage (Total debt/total assets)</td>
<td>77%</td>
<td>74%</td>
<td>72%</td>
<td>71%</td>
<td>68%</td>
<td>70%</td>
<td>71%</td>
<td>73%</td>
<td>74%</td>
<td>70%</td>
<td>70%</td>
</tr>
</tbody>
</table>

### Cumulated annual revenue growth rate

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulated annual revenue</td>
<td>7%</td>
<td>0.2%</td>
</tr>
</tbody>
</table>
EXHIBIT 17: Key Financial Data: The Walt Disney Company

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>6112</td>
<td>7504</td>
<td>8529</td>
<td>10055</td>
<td>12112</td>
<td>18739</td>
<td>22473</td>
<td>22976</td>
<td>23455</td>
<td>25418</td>
<td>25269</td>
<td>25329</td>
<td>27061</td>
<td>30752</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Studio Entertainment</td>
<td>2593.7</td>
<td>3115.2</td>
<td>3673.4</td>
<td>4793.3</td>
<td>6001.5</td>
<td>7641</td>
<td>7861</td>
<td>6850</td>
<td>6176</td>
<td>6011</td>
<td>6106</td>
<td>6691</td>
<td>7364</td>
<td>8713</td>
<td>7587</td>
<td></td>
</tr>
<tr>
<td>Studio entertainment: Theatrical</td>
<td>1776.9</td>
<td>2251.7</td>
<td>2764.4</td>
<td>3734.2</td>
<td>4452.5</td>
<td>5472</td>
<td>5595</td>
<td>5085</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Studio entertainment: Other</td>
<td>816.8</td>
<td>863.5</td>
<td>909</td>
<td>1059.1</td>
<td>1549</td>
<td>2169</td>
<td>2266</td>
<td>1765</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Media Networks a</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Media Networks: Advertising</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Theme parks</td>
<td>2794.3</td>
<td>3306.9</td>
<td>3440.7</td>
<td>3463.6</td>
<td>3959.8</td>
<td>4502</td>
<td>5014</td>
<td>5532</td>
<td>6141</td>
<td>6809</td>
<td>7004</td>
<td>6465</td>
<td>7750</td>
<td>9023</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer Products</td>
<td>724</td>
<td>1081.9</td>
<td>1415.1</td>
<td>1798.2</td>
<td>2150.8</td>
<td>2518</td>
<td>3076</td>
<td>3452</td>
<td>3126</td>
<td>2762</td>
<td>2590</td>
<td>2590</td>
<td>2440</td>
<td>2127</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Studio Entertainment</td>
<td>2275.6</td>
<td>2606.9</td>
<td>3051.2</td>
<td>3937.2</td>
<td>4927.1</td>
<td>6080</td>
<td>5979</td>
<td>5447</td>
<td>6014</td>
<td>5885</td>
<td>5846</td>
<td>6418</td>
<td>7629</td>
<td>8713</td>
<td>9287</td>
<td>9728</td>
</tr>
<tr>
<td>Theme parks</td>
<td>2247.7</td>
<td>2662.9</td>
<td>2693.8</td>
<td>2779.5</td>
<td>3099</td>
<td>3512</td>
<td>3788</td>
<td>3801</td>
<td>4647</td>
<td>5194</td>
<td>5418</td>
<td>5296</td>
<td>5455</td>
<td>6627</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Media Networks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer Products</td>
<td>494.2</td>
<td>798.9</td>
<td>1059.7</td>
<td>1372.7</td>
<td>1640.3</td>
<td>3296</td>
<td>5228</td>
<td>5817</td>
<td>6500</td>
<td>7851</td>
<td>8711</td>
<td>9747</td>
<td>9287</td>
<td>9728</td>
<td>9287</td>
<td>9728</td>
</tr>
<tr>
<td>Selling &amp; administrative expenses</td>
<td>160.8</td>
<td>148.2</td>
<td>164.2</td>
<td>162.2</td>
<td>183.6</td>
<td>309</td>
<td>367</td>
<td>236</td>
<td>335</td>
<td>354</td>
<td>406</td>
<td>417</td>
<td>443</td>
<td>428</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total expenses</td>
<td>5178.3</td>
<td>6216.9</td>
<td>6969.9</td>
<td>8251.6</td>
<td>9850</td>
<td>16315</td>
<td>18393</td>
<td>19197</td>
<td>20030</td>
<td>21660</td>
<td>21670</td>
<td>22924</td>
<td>24330</td>
<td>26692</td>
<td>27837</td>
<td></td>
</tr>
<tr>
<td><strong>Operating income =EBITA)</strong></td>
<td>1094.5</td>
<td>1435.3</td>
<td>1724.5</td>
<td>1965.7</td>
<td>2445.7</td>
<td>3033</td>
<td>4447</td>
<td>4015</td>
<td>3760</td>
<td>4112</td>
<td>4005</td>
<td>2822</td>
<td>3174</td>
<td>4488</td>
<td>4654</td>
<td></td>
</tr>
<tr>
<td>Studio Entertainment</td>
<td>318.1</td>
<td>508.3</td>
<td>622.2</td>
<td>856.1</td>
<td>1074.4</td>
<td>1561</td>
<td>1882</td>
<td>1403</td>
<td>162</td>
<td>126</td>
<td>260</td>
<td>273</td>
<td>620</td>
<td>662</td>
<td>207</td>
<td></td>
</tr>
<tr>
<td>Theme parks</td>
<td>546.6</td>
<td>644</td>
<td>746.9</td>
<td>684.1</td>
<td>860.8</td>
<td>990</td>
<td>1136</td>
<td>1731</td>
<td>1494</td>
<td>1615</td>
<td>1586</td>
<td>1169</td>
<td>957</td>
<td>1123</td>
<td>1178</td>
<td></td>
</tr>
<tr>
<td>Media Networks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer Products</td>
<td>782</td>
<td>1294</td>
<td>1325</td>
<td>1512</td>
<td>1985</td>
<td>386</td>
<td>401</td>
<td>384</td>
<td>534</td>
<td>520</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Operating margin</strong></td>
<td>18%</td>
<td>19%</td>
<td>20%</td>
<td>20%</td>
<td>16%</td>
<td>16%</td>
<td>16%</td>
<td>16%</td>
<td>16%</td>
<td>16%</td>
<td>12%</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>Studio entertainment</td>
<td>12%</td>
<td>16%</td>
<td>17%</td>
<td>18%</td>
<td>18%</td>
<td>20%</td>
<td>24%</td>
<td>20%</td>
<td>3%</td>
<td>2%</td>
<td>4%</td>
<td>4%</td>
<td>8%</td>
<td>8%</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>Theme parks</td>
<td>20%</td>
<td>19%</td>
<td>22%</td>
<td>20%</td>
<td>22%</td>
<td>22%</td>
<td>23%</td>
<td>31%</td>
<td>24%</td>
<td>24%</td>
<td>23%</td>
<td>18%</td>
<td>15%</td>
<td>14%</td>
<td>13%</td>
<td></td>
</tr>
<tr>
<td>Media Networks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer Products</td>
<td>32%</td>
<td>26%</td>
<td>25%</td>
<td>24%</td>
<td>24%</td>
<td>24%</td>
<td>21%</td>
<td>18%</td>
<td>19%</td>
<td>14%</td>
<td>15%</td>
<td>16%</td>
<td>16%</td>
<td>21%</td>
<td>24%</td>
<td></td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td>1358</td>
<td>1752.6</td>
<td>2088.7</td>
<td>2375.4</td>
<td>2915.9</td>
<td>3705</td>
<td>5185</td>
<td>4824</td>
<td>4585</td>
<td>5026</td>
<td>4922</td>
<td>3843</td>
<td>4233</td>
<td>5686</td>
<td>4107</td>
<td></td>
</tr>
<tr>
<td>Studio Entertainment</td>
<td></td>
<td>226</td>
<td>180</td>
<td>307</td>
<td>319</td>
<td>659</td>
<td>684</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Parks &amp; Resorts</td>
<td></td>
<td>1992</td>
<td>2197</td>
<td>2190</td>
<td>1817</td>
<td>1638</td>
<td>1928</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Media Networks</td>
<td></td>
<td>1647</td>
<td>2154</td>
<td>1934</td>
<td>1166</td>
<td>1382</td>
<td>2341</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer Products</td>
<td></td>
<td>720</td>
<td>495</td>
<td>491</td>
<td>452</td>
<td>447</td>
<td>578</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## Appendix

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expenses</td>
<td>263.5</td>
<td>317.3</td>
<td>364.2</td>
<td>409.7</td>
<td>470.2</td>
<td>672</td>
<td>738</td>
<td>809</td>
<td>851</td>
<td>962</td>
<td>987</td>
<td>1021</td>
<td>1059</td>
<td>1198</td>
<td>1328</td>
<td></td>
</tr>
<tr>
<td>Studio entertainment</td>
<td>23.9</td>
<td>29.5</td>
<td>38.5</td>
<td>49.1</td>
<td>61.6</td>
<td>163</td>
<td>187</td>
<td>209</td>
<td>64</td>
<td>54</td>
<td>47</td>
<td>46</td>
<td>39</td>
<td>22</td>
<td>26</td>
<td></td>
</tr>
<tr>
<td>Theme parks</td>
<td>213.2</td>
<td>249.8</td>
<td>269.2</td>
<td>289.2</td>
<td>319.5</td>
<td>358</td>
<td>408</td>
<td>444</td>
<td>498</td>
<td>582</td>
<td>604</td>
<td>648</td>
<td>681</td>
<td>805</td>
<td>963</td>
<td></td>
</tr>
<tr>
<td>Consumer products</td>
<td>12.4</td>
<td>16.8</td>
<td>26.2</td>
<td>38.3</td>
<td>52.2</td>
<td>128</td>
<td>109</td>
<td>90</td>
<td>58</td>
<td>44</td>
<td>44</td>
<td>58</td>
<td>63</td>
<td>44</td>
<td>25</td>
<td></td>
</tr>
<tr>
<td>Media Networks</td>
<td>104</td>
<td>104</td>
<td>122</td>
<td>135</td>
<td>169</td>
<td>176</td>
<td>180</td>
<td>169</td>
<td>172</td>
<td>182</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate</td>
<td>14</td>
<td>21.2</td>
<td>30.3</td>
<td>33.1</td>
<td>36.9</td>
<td>47</td>
<td>39</td>
<td>34</td>
<td>26</td>
<td>48</td>
<td>70</td>
<td>89</td>
<td>107</td>
<td>155</td>
<td>132</td>
<td></td>
</tr>
<tr>
<td>Amortization of intangible assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortization of film and television costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Amortization</td>
<td>1546</td>
<td>2087</td>
<td>2434</td>
<td>2945</td>
<td>456</td>
<td>1233</td>
<td>767</td>
<td>21</td>
<td>18</td>
<td>12</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total D&amp;A</td>
<td>263.5</td>
<td>317.3</td>
<td>364.2</td>
<td>409.7</td>
<td>2016.2</td>
<td>2759</td>
<td>3172</td>
<td>3754</td>
<td>1307</td>
<td>2195</td>
<td>1754</td>
<td>1021</td>
<td>1059</td>
<td>1198</td>
<td>1339</td>
<td></td>
</tr>
<tr>
<td>EBIT</td>
<td>1094.5</td>
<td>1435.3</td>
<td>1724.5</td>
<td>1965.7</td>
<td>899.7</td>
<td>946</td>
<td>2013</td>
<td>1070</td>
<td>3278</td>
<td>2831</td>
<td>3168</td>
<td>2822</td>
<td>3174</td>
<td>4488</td>
<td>2768</td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td>636.6</td>
<td>816.7</td>
<td>299.8</td>
<td>1110.4</td>
<td>1380.1</td>
<td>1534</td>
<td>1886</td>
<td>1850</td>
<td>1300</td>
<td>920</td>
<td>-158</td>
<td>1236</td>
<td>1267</td>
<td>2345</td>
<td>2533</td>
<td></td>
</tr>
</tbody>
</table>

### Domestic revenues

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>5315.4</td>
<td>6453.7</td>
<td>7110.6</td>
<td>8155.6</td>
<td>9858.8</td>
<td>15168</td>
<td>18742</td>
<td>19142</td>
<td>19243</td>
<td>21113</td>
<td>20970</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>International revenues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Europe</td>
<td>574.7</td>
<td>785.9</td>
<td>984.6</td>
<td>1344.8</td>
<td>1552.1</td>
<td>2086</td>
<td>2073</td>
<td>2215</td>
<td>2587</td>
<td>2756</td>
<td>2612</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rest of the world</td>
<td>241.3</td>
<td>295.1</td>
<td>434</td>
<td>554.7</td>
<td>701.2</td>
<td>1485</td>
<td>1658</td>
<td>1619</td>
<td>1625</td>
<td>1549</td>
<td>1687</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>6112</td>
<td>7504</td>
<td>8529.2</td>
<td>10051</td>
<td>12112.1</td>
<td>18739</td>
<td>22473</td>
<td>22976</td>
<td>23455</td>
<td>25418</td>
<td>25269</td>
<td>25329</td>
<td>27061</td>
<td>30752</td>
<td>31944</td>
<td></td>
</tr>
</tbody>
</table>

### Statement of Income

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>6112</td>
<td>7504</td>
<td>8529.2</td>
<td>10051</td>
<td>12112.1</td>
<td>18739</td>
<td>22473</td>
<td>22976</td>
<td>23455</td>
<td>25418</td>
<td>25269</td>
<td>25329</td>
<td>27061</td>
<td>30752</td>
<td>31944</td>
<td></td>
</tr>
<tr>
<td>EBITDA</td>
<td>1358</td>
<td>1752.6</td>
<td>2088.7</td>
<td>2375.4</td>
<td>2915.9</td>
<td>3705</td>
<td>5185</td>
<td>4824</td>
<td>4585</td>
<td>5026</td>
<td>4922</td>
<td>3843</td>
<td>4233</td>
<td>5686</td>
<td>4107</td>
<td></td>
</tr>
<tr>
<td>Operating Income (EBITA)</td>
<td>1094.5</td>
<td>1435.3</td>
<td>1724.5</td>
<td>1965.7</td>
<td>2445.7</td>
<td>3033</td>
<td>4447</td>
<td>4015</td>
<td>3760</td>
<td>4112</td>
<td>4005</td>
<td>2822</td>
<td>3174</td>
<td>4488</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBIT</td>
<td>1094.5</td>
<td>1435.3</td>
<td>1724.5</td>
<td>1965.7</td>
<td>899.7</td>
<td>946</td>
<td>2013</td>
<td>1070</td>
<td>3278</td>
<td>2831</td>
<td>3168</td>
<td>2822</td>
<td>3174</td>
<td>4488</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td>636.6</td>
<td>816.7</td>
<td>299.8</td>
<td>1110.4</td>
<td>1380.1</td>
<td>1534</td>
<td>1886</td>
<td>1850</td>
<td>1300</td>
<td>920</td>
<td>-158</td>
<td>1236</td>
<td>1267</td>
<td>2345</td>
<td>2533</td>
<td></td>
</tr>
<tr>
<td>Net Profit Margin</td>
<td>10%</td>
<td>11%</td>
<td>4%</td>
<td>11%</td>
<td>11%</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
<td>6%</td>
<td>4%</td>
<td>nm</td>
<td>5%</td>
<td>5%</td>
<td>8%</td>
<td>8%</td>
<td></td>
</tr>
</tbody>
</table>

### Per Share

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings</td>
<td>0.55</td>
<td>2.04</td>
<td>2.6</td>
<td>1.96</td>
<td>2.86</td>
<td>0.89</td>
<td>0.62</td>
<td>0.57</td>
<td>-0.02</td>
<td>0.6</td>
<td>0.62</td>
<td>1.12</td>
<td>1.22</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>0.24</td>
<td>0.29</td>
<td>0.35</td>
<td>0.42</td>
<td>0.51</td>
<td>0.2</td>
<td>0.21</td>
<td>0.21</td>
<td>0.21</td>
<td>0.21</td>
<td>0.21</td>
<td>0.21</td>
<td>0.21</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Assets</strong></td>
<td>11751</td>
<td>12826</td>
<td>14606</td>
<td>36626</td>
<td>37776</td>
<td>41379</td>
<td>43679</td>
<td>45027</td>
<td>43810</td>
<td>50045</td>
<td>49988</td>
<td>53902</td>
<td>53158</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Debt</strong></td>
<td>6720</td>
<td>7318</td>
<td>7955</td>
<td>20540</td>
<td>20491</td>
<td>21990</td>
<td>22704</td>
<td>20927</td>
<td>21138</td>
<td>26600</td>
<td>26197</td>
<td>27821</td>
<td>26948</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Stockholders’ Equity</strong></td>
<td>5031</td>
<td>5508</td>
<td>6651</td>
<td>16086</td>
<td>17285</td>
<td>19388</td>
<td>20975</td>
<td>24100</td>
<td>22672</td>
<td>23445</td>
<td>23791</td>
<td>26081</td>
<td>26210</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Statements of Cash Flow

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash provided by operations</strong></td>
<td>2145</td>
<td>2808</td>
<td>3510</td>
<td>4625</td>
<td>7064</td>
<td>5115</td>
<td>2568</td>
<td>3755</td>
<td>3048</td>
<td>2286</td>
<td>2901</td>
<td>4370</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Investing Activities</strong></td>
<td>-2660</td>
<td>-2887</td>
<td>-2288</td>
<td>-13464</td>
<td>-5901</td>
<td>5665</td>
<td>-2290</td>
<td>-1091</td>
<td>-2015</td>
<td>3176</td>
<td>1034</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Financing Activities</strong></td>
<td>113</td>
<td>-97</td>
<td>-332</td>
<td>-8040</td>
<td>-1124</td>
<td>360</td>
<td>9</td>
<td>-2236</td>
<td>-1257</td>
<td>-1511</td>
<td>-1523</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Other

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Common Shares Outstanding</strong></td>
<td>544</td>
<td>545</td>
<td>530</td>
<td>619</td>
<td>687</td>
<td>2079</td>
<td>2083</td>
<td>2103</td>
<td>2100</td>
<td>2044</td>
<td>2067</td>
<td>2106</td>
<td>2089</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(millions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Stockholders</strong></td>
<td>408</td>
<td>459</td>
<td>508</td>
<td>564</td>
<td>588</td>
<td>658</td>
<td>842</td>
<td>882</td>
<td>909</td>
<td>995</td>
<td>1026</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Employees</strong></td>
<td>62</td>
<td>65</td>
<td>71</td>
<td>100</td>
<td>108</td>
<td>117</td>
<td>120</td>
<td>120</td>
<td>114</td>
<td>112</td>
<td>112</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a includes Internet operations from 1999 onwards
EXHIBIT 18: Analysis of Financial Performance: The Walt Disney Company

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Studio Entertainment</td>
<td>42%</td>
<td>50%</td>
<td>24%</td>
<td>24%</td>
</tr>
<tr>
<td>Media Networks</td>
<td>0%</td>
<td>0%</td>
<td>39%</td>
<td>41%</td>
</tr>
<tr>
<td>Theme parks</td>
<td>46%</td>
<td>33%</td>
<td>27%</td>
<td>28%</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>12%</td>
<td>18%</td>
<td>11%</td>
<td>7%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Studio Entertainment</td>
<td>12.3%</td>
<td>16.3%</td>
<td>16.9%</td>
<td>17.9%</td>
<td>20.4%</td>
<td>23.9%</td>
<td>20.5%</td>
<td>2.6%</td>
<td>2.1%</td>
<td>4.3%</td>
<td>4%</td>
<td>8%</td>
<td>8%</td>
<td>3%</td>
<td>5.4%</td>
<td></td>
</tr>
<tr>
<td>Theme parks</td>
<td>19.6%</td>
<td>19.5%</td>
<td>21.7%</td>
<td>19.8%</td>
<td>21.7%</td>
<td>22.0%</td>
<td>22.7%</td>
<td>31.3%</td>
<td>24.3%</td>
<td>23.7%</td>
<td>22.6%</td>
<td>18%</td>
<td>15%</td>
<td>14%</td>
<td>13%</td>
<td>-11.3%</td>
</tr>
<tr>
<td>Media networks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer Products</td>
<td>31.7%</td>
<td>26.2%</td>
<td>25.1%</td>
<td>23.7%</td>
<td>23.7%</td>
<td>23.7%</td>
<td>21.0%</td>
<td>18.0%</td>
<td>18.9%</td>
<td>14.0%</td>
<td>15.5%</td>
<td>16%</td>
<td>16%</td>
<td>21%</td>
<td>24%</td>
<td>11.8%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Studio Entertainment</td>
<td>15.8%</td>
<td>17.1%</td>
<td>4.9%</td>
</tr>
<tr>
<td>Theme parks</td>
<td>20.1%</td>
<td>24.4%</td>
<td>17.8%</td>
</tr>
<tr>
<td>Media networks</td>
<td>na</td>
<td>15.3%</td>
<td>16.5%</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>26.7%</td>
<td>21.1%</td>
<td>18.0%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Assets (EBIT/Total Assets)</td>
<td>6%</td>
<td>3%</td>
<td>5%</td>
<td>3%</td>
<td>8%</td>
<td>6%</td>
<td>7%</td>
<td>6%</td>
<td>5%</td>
<td>7%</td>
<td>8%</td>
</tr>
<tr>
<td>Return on Sales (EBIT/Sales)</td>
<td>7%</td>
<td>5%</td>
<td>9%</td>
<td>5%</td>
<td>14%</td>
<td>11%</td>
<td>13%</td>
<td>11%</td>
<td>8%</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td>Gross Profit Margin (EBITDA/Sales)</td>
<td>24%</td>
<td>20%</td>
<td>23%</td>
<td>21%</td>
<td>20%</td>
<td>20%</td>
<td>19%</td>
<td>15%</td>
<td>16%</td>
<td>18%</td>
<td>13%</td>
</tr>
<tr>
<td>Leverage (Total debt/total assets)</td>
<td>54%</td>
<td>56%</td>
<td>54%</td>
<td>53%</td>
<td>52%</td>
<td>46%</td>
<td>48%</td>
<td>53%</td>
<td>52%</td>
<td>52%</td>
<td>51%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>16%</td>
<td>5%</td>
</tr>
</tbody>
</table>
### EXHIBIT 19: Key Financial Data: Bertelsmann AG

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td>11460</td>
<td>11738</td>
<td>13289</td>
<td>16524</td>
<td>20788</td>
<td>2036</td>
<td>18312</td>
<td>16801</td>
<td>17016</td>
<td>17890</td>
<td>-0.8%</td>
</tr>
<tr>
<td>Television (RTL Group)</td>
<td>1665</td>
<td>4079</td>
<td>4332</td>
<td>2074</td>
<td>2432</td>
<td>2714</td>
<td>2714</td>
<td>2712</td>
<td>2547</td>
<td>2128</td>
<td>-7.8%</td>
</tr>
<tr>
<td>Book Publishing (Random House)</td>
<td>3634.3</td>
<td>4252.9</td>
<td>4332</td>
<td>2074</td>
<td>2432</td>
<td>2714</td>
<td>2714</td>
<td>2712</td>
<td>2547</td>
<td>2128</td>
<td>-7.8%</td>
</tr>
<tr>
<td>Magazines (Gruner + Jahr)</td>
<td>2460.8</td>
<td>2755.4</td>
<td>2931</td>
<td>3027</td>
<td>1900</td>
<td>1900</td>
<td>1900</td>
<td>1900</td>
<td>1900</td>
<td>1900</td>
<td>-7.8%</td>
</tr>
<tr>
<td>Music (BMG)</td>
<td>3747.3</td>
<td>4165.5</td>
<td>3664</td>
<td>5112</td>
<td>3664</td>
<td>5112</td>
<td>5112</td>
<td>5112</td>
<td>5112</td>
<td>5112</td>
<td>-7.8%</td>
</tr>
<tr>
<td>Printing (Arvato)</td>
<td>1722.5</td>
<td>1940.4</td>
<td>2239</td>
<td>2992</td>
<td>2992</td>
<td>2992</td>
<td>2992</td>
<td>2992</td>
<td>2992</td>
<td>2992</td>
<td>-7.8%</td>
</tr>
<tr>
<td>Business Services (Direct Group)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>-7.8%</td>
</tr>
<tr>
<td>Multimedia</td>
<td>160</td>
<td>250</td>
<td>477</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>-7.8%</td>
</tr>
</tbody>
</table>

### Depreciation
- 273
- 2452

### Amortization
- 620
- 1507

### Total D&A
- na
- 893
- 3959
- 590
- 531

### Operating EBITDA
- 1666
- 1866
- 2112
- 2274
- 10.9%

### EBITA
- 940
- 1252
- 1770
- 3167
- 573
- 936
- 1291
- 1825
- 2035
- 29.5%

### Divisional EBITA
- 769
- 926
- 1245
- 1207
- 251
- 1051
- 1259
- 2154
- 2388
- 31.5%

### Television (RTL Group)
- 372
- 502
- 880
- 942
- 75
- 136
- 186
- 668
- 492
- 36.3%

### Book Publishing (Random House)
- 172
- 145
- 188
- 207
- 6.4%

### Magazines (Gruner + Jahr)
- 399
- 305
- 286
- 331
- 6.0%

### Music (BMG)
- 133
- 37
- 232
- 264
- 25.7%

### Printing (Arvato)
- 214
- 261
- 496
- 551
- 37.1%

### Business Services (Direct Group)
- -150
- 4
- 72
- 93
- -185.3%

### EBIT
- na
- 1138.6
- 1181
- -2098
- -1291
- 733
- 1522
- 1743
- 10.5%

### Television (RTL Group)
- 382.4
- 357
- 136
- 186
- 668
- 756
- 77.1%

### Book Publishing (Random House)
- 121.2
- 29
- 96
- 75
- 140
- 166
- 20.0%

### Magazines (Gruner + Jahr)
- 322.1
- 384
- 56
- 125
- 210
- 250
- 64.7%

### Music (BMG)
- 171.3
- 223
- -1230
- -52
- 162
- 177
- -152.4%

### Printing (Arvato)
- 141.6
- 188
- 155
- 226
- 310
- 341
- 30.1%

### Business Services (Direct Group)
- -323
- -35
- 32
- 53
- -154.7%

### Multimedia
- 212.2
- -261

### Net Income
- 573
- 465
- 672
- 970
- 931
- 1898
- 968
- 208
- 1172
- 1041
- 2.5%

### Balance Sheet
- Total Assets
- 7041
- 10070
- 14692
- 17551
- 23734
- 23734
- 22188
- 20164
- 20970
- 22932
Appendix

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Debt</strong></td>
<td>4688</td>
<td>7336</td>
<td>11054</td>
<td>13050</td>
<td>17431</td>
<td>15350</td>
<td>14444</td>
<td>12533</td>
<td>12124</td>
<td>13762</td>
<td></td>
</tr>
<tr>
<td><strong>Total Equity&lt;sup&gt;b&lt;/sup&gt;</strong></td>
<td>2353</td>
<td>2734</td>
<td>3638</td>
<td>4501</td>
<td>6303</td>
<td>8384</td>
<td>7744</td>
<td>7631</td>
<td>8846</td>
<td>9170</td>
<td></td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employees</td>
<td>57173</td>
<td>57807</td>
<td>64839</td>
<td>71289</td>
<td>81239</td>
<td>80296</td>
<td>80632</td>
<td>73221</td>
<td>76266</td>
<td>88516</td>
<td></td>
</tr>
<tr>
<td><strong>Geographical Revenue Split</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>3767</td>
<td>3586</td>
<td>3736</td>
<td>5052</td>
<td>6139</td>
<td>5691</td>
<td>5166</td>
<td>5059</td>
<td>5313</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rest of Europe</td>
<td>3667</td>
<td>3561</td>
<td>3926</td>
<td>4731</td>
<td>6309</td>
<td>6498</td>
<td>6486</td>
<td>7182</td>
<td>7836</td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S.</td>
<td>3010</td>
<td>3586</td>
<td>4618</td>
<td>5568</td>
<td>6446</td>
<td>5029</td>
<td>4210</td>
<td>3816</td>
<td>3669</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>1018</td>
<td>1006</td>
<td>1010</td>
<td>1173</td>
<td>1142</td>
<td>1094</td>
<td>939</td>
<td>959</td>
<td>1072</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

<sup>a</sup> Starting in 2001, financial year was moved to a calendar-year basis. Figures a for the 1997-2001 columns are according to German GAAP accounting standards, and for the columns 2002-2005 are according to the International Accounting Standards (IAS).

<sup>b</sup> Total Equity includes shareholders' equity, minority interests, and PPCs.
EXHIBIT 20: Analysis of Financial Performance: Bertelsmann AG

Revenue contribution of media sectors

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Television (RTL Group)</td>
<td>0%</td>
<td>20%</td>
<td>29%</td>
<td></td>
</tr>
<tr>
<td>Book Publishing (Random House)</td>
<td>32%</td>
<td>10%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>Magazines (Gruner + Jahr)</td>
<td>21%</td>
<td>15%</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>Music (BMG)</td>
<td>33%</td>
<td>18%</td>
<td>12%</td>
<td></td>
</tr>
<tr>
<td>Printing (Arvato)</td>
<td>0%</td>
<td>15%</td>
<td>24%</td>
<td></td>
</tr>
<tr>
<td>Business Services (Direct Group)</td>
<td>0%</td>
<td>19%</td>
<td>13%</td>
<td></td>
</tr>
<tr>
<td>Multimedia</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td></td>
</tr>
</tbody>
</table>

Return on Sales per Segment (Operating income/sales)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Television (RTL Group)</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>21.4%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>3.1%</td>
<td>4.2%</td>
<td>13.7%</td>
<td>14.8%</td>
<td>68.0%</td>
</tr>
<tr>
<td>Book Publishing (Random House)</td>
<td>na</td>
<td>na</td>
<td>2.8%</td>
<td>0.7%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>4.8%</td>
<td>4.2%</td>
<td>7.8%</td>
<td>9.1%</td>
<td>23.6%</td>
</tr>
<tr>
<td>Magazines (Gruner + Jahr)</td>
<td>na</td>
<td>na</td>
<td>11.7%</td>
<td>13.1%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>2.0%</td>
<td>5.0%</td>
<td>8.6%</td>
<td>9.5%</td>
<td>68.3%</td>
</tr>
<tr>
<td>Music (BMG)</td>
<td>na</td>
<td>na</td>
<td>4.1%</td>
<td>4.7%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>-45.3%</td>
<td>-1.9%</td>
<td>6.4%</td>
<td>8.3%</td>
<td>nm</td>
</tr>
<tr>
<td>Printing (Arvato)</td>
<td>na</td>
<td>na</td>
<td>7.3%</td>
<td>8.4%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>4.2%</td>
<td>6.2%</td>
<td>8.3%</td>
<td>7.8%</td>
<td>22.7%</td>
</tr>
<tr>
<td>Business Services (Direct Group)</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>0.0%</td>
<td>0.0%</td>
<td>-11.9%</td>
<td>-1.5%</td>
<td>1.5%</td>
<td>2.2%</td>
<td>147.2%</td>
</tr>
<tr>
<td>Multimedia</td>
<td>na</td>
<td>na</td>
<td>84.9%</td>
<td>-54.7%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>nm</td>
</tr>
</tbody>
</table>

Development of Average ROS per Business Segment

<table>
<thead>
<tr>
<th></th>
<th>1996-1999</th>
<th>2002-2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Television (RTL Group)</td>
<td>na</td>
<td>8.9%</td>
</tr>
<tr>
<td>Book Publishing (Random House)</td>
<td>na</td>
<td>6.5%</td>
</tr>
<tr>
<td>Magazines (Gruner + Jahr)</td>
<td>na</td>
<td>6.3%</td>
</tr>
<tr>
<td>Music (BMG)</td>
<td>na</td>
<td>5.0%</td>
</tr>
<tr>
<td>Printing (Arvato)</td>
<td>na</td>
<td>6.6%</td>
</tr>
<tr>
<td>Business Services (Direct Group)</td>
<td>na</td>
<td>-2.4%</td>
</tr>
<tr>
<td>Multimedia</td>
<td>na</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

Return on Equity (Net Income/Equity)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Equity (Net Income/Equity)</td>
<td>24%</td>
<td>17%</td>
<td>18%</td>
<td>22%</td>
<td>15%</td>
<td>23%</td>
<td>13%</td>
<td>3%</td>
<td>13%</td>
<td>11%</td>
</tr>
</tbody>
</table>

Leverage (Total debt/total assets)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Leverage (Total debt/total assets)</td>
<td>na</td>
<td>67%</td>
<td>73%</td>
<td>75%</td>
<td>74%</td>
<td>73%</td>
<td>65%</td>
<td>65%</td>
<td>62%</td>
<td>58%</td>
</tr>
</tbody>
</table>

Averaged total revenue growth

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>-3%</td>
</tr>
</tbody>
</table>
## Viacom Inc. Key Financial Data

### Note

The data presented in this exhibit is unaudited data compiled from company reports. The differences from audited data are generally due to rounding differences, inclusion of non-recurring items such as restructuring and impairment charges, and the use of different accounting standards.

### Consolidated Revenues

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenues (in US$ '000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>1599625</td>
</tr>
<tr>
<td>1991</td>
<td>1711562</td>
</tr>
<tr>
<td>1992</td>
<td>1864683</td>
</tr>
<tr>
<td>1993</td>
<td>204949</td>
</tr>
<tr>
<td>1994</td>
<td>6701400</td>
</tr>
<tr>
<td>1995</td>
<td>10915900</td>
</tr>
<tr>
<td>1996</td>
<td>12084200</td>
</tr>
<tr>
<td>1997</td>
<td>10684900</td>
</tr>
<tr>
<td>1998</td>
<td>12096100</td>
</tr>
<tr>
<td>1999</td>
<td>12858800</td>
</tr>
<tr>
<td>2000</td>
<td>20043700</td>
</tr>
<tr>
<td>2001</td>
<td>23222800</td>
</tr>
<tr>
<td>2002</td>
<td>19186800</td>
</tr>
<tr>
<td>2003</td>
<td>20827600</td>
</tr>
<tr>
<td>2004</td>
<td>23252900</td>
</tr>
</tbody>
</table>

### Revenues by Segment

- **Television**: $1081339 - $5426400
- **Cable Networks**: $378026 - $2404000
- **Entertainment**: $273488 - $3680900
- **Video & Music/Theme Parks**: $1070400 - $5156700
- **Publishing**: $1786400 - $1160800
- **Radio & Outdoor**: $2764700 - $1166200
- **Online**: $10400 - $748300
- **Consolidated Revenues**: $1599625 - $23252900

### Total Expenses

<table>
<thead>
<tr>
<th>Year</th>
<th>Operating expenses (in US$ '000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>1266464</td>
</tr>
<tr>
<td>1991</td>
<td>1371954</td>
</tr>
<tr>
<td>1992</td>
<td>1466897</td>
</tr>
<tr>
<td>1993</td>
<td>5819500</td>
</tr>
<tr>
<td>1994</td>
<td>8800500</td>
</tr>
<tr>
<td>1995</td>
<td>9903400</td>
</tr>
<tr>
<td>1996</td>
<td>9226900</td>
</tr>
<tr>
<td>1997</td>
<td>10567200</td>
</tr>
<tr>
<td>1998</td>
<td>10696100</td>
</tr>
<tr>
<td>1999</td>
<td>12858800</td>
</tr>
<tr>
<td>2000</td>
<td>20043700</td>
</tr>
<tr>
<td>2001</td>
<td>23222800</td>
</tr>
<tr>
<td>2002</td>
<td>19186800</td>
</tr>
<tr>
<td>2003</td>
<td>20827600</td>
</tr>
<tr>
<td>2004</td>
<td>23252900</td>
</tr>
</tbody>
</table>

### EBITDA

<table>
<thead>
<tr>
<th>Year</th>
<th>EBITDA (in US$ '000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>445098</td>
</tr>
<tr>
<td>1991</td>
<td>492729</td>
</tr>
<tr>
<td>1992</td>
<td>538052</td>
</tr>
<tr>
<td>1993</td>
<td>881900</td>
</tr>
<tr>
<td>1994</td>
<td>2115400</td>
</tr>
<tr>
<td>1995</td>
<td>2091900</td>
</tr>
<tr>
<td>1996</td>
<td>1634600</td>
</tr>
<tr>
<td>1997</td>
<td>1705000</td>
</tr>
<tr>
<td>1998</td>
<td>2248800</td>
</tr>
<tr>
<td>1999</td>
<td>4549900</td>
</tr>
<tr>
<td>2000</td>
<td>4974100</td>
</tr>
<tr>
<td>2001</td>
<td>4952700</td>
</tr>
<tr>
<td>2002</td>
<td>5215500</td>
</tr>
<tr>
<td>2003</td>
<td>5838000</td>
</tr>
<tr>
<td>2004</td>
<td>5162100</td>
</tr>
</tbody>
</table>

### Additional Financial Information

- **Revenue Growth**: Significant revenue growth was observed from 1990 to 2004, with revenues increasing from $159,962,500 to $1,918,680,000.
- **EBITDA Trend**: EBITDA increased from $445,098,000 in 1990 to $5,162,100,000 in 2004, reflecting the company's strong profitability.
- **Segment Performance**: The Entertainment segment showed the highest growth, while the Publishing segment had lower revenue and EBITDA compared to other segments.

This exhibit provides a comprehensive overview of Viacom's financial performance from 1990 to 2004, highlighting key trends and growth areas within the company.
<table>
<thead>
<tr>
<th>Year</th>
<th>Online</th>
<th>Depreciation &amp; Amortization</th>
<th>EBIT</th>
<th>Revenues by Type</th>
<th>Net Income (Loss)</th>
<th>Revenues by geographic area</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Advertising sales</td>
<td></td>
<td>United States</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Rental/Retail sales</td>
<td></td>
<td>Europe</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Affiliate fees</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Feature film exploitation</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>TV license fees</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Other</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Appendix

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rest of the World</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1237000</td>
<td>1451600</td>
<td>1480300</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Stockholders'</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Debt</td>
<td>11791600</td>
<td>12093800</td>
<td>12586500</td>
<td>13383600</td>
<td>12049600</td>
<td>11132000</td>
<td>47966900</td>
<td>62716800</td>
<td>62487800</td>
<td>63205000</td>
<td>42024300</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Assets</td>
<td>16482100</td>
<td>16932200</td>
<td>16247500</td>
<td>14905100</td>
<td>11563500</td>
<td>13354400</td>
<td>34679200</td>
<td>28093100</td>
<td>27555400</td>
<td>26643500</td>
<td>25978000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>28273700</td>
<td>29026000</td>
<td>28834000</td>
<td>28288700</td>
<td>23613100</td>
<td>24486400</td>
<td>82646100</td>
<td>90809900</td>
<td>90043200</td>
<td>89848500</td>
<td>68002300</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## EXHIBIT 22: Analysis of Financial Performance: Viacom

### Revenue contribution of media sectors

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Television</td>
<td>19%</td>
<td>27%</td>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>Cable Networks</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Entertainment</td>
<td>82%</td>
<td>14%</td>
<td>23%</td>
<td></td>
</tr>
<tr>
<td>Radio</td>
<td>nya</td>
<td>7%</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>Outdoor</td>
<td>nya</td>
<td>7%</td>
<td>9%</td>
<td></td>
</tr>
<tr>
<td>Video</td>
<td>nya</td>
<td>25%</td>
<td>disposal</td>
<td></td>
</tr>
</tbody>
</table>

### Return on Sales per Segment (Operating income/sales)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Television</td>
<td>25.6%</td>
<td>26.2%</td>
<td>28.1%</td>
<td>28.5%</td>
<td>6.1%</td>
<td>6.5%</td>
<td>5.5%</td>
<td>15.8%</td>
<td>16.0%</td>
<td>18.2%</td>
<td>29.5%</td>
</tr>
<tr>
<td>Cable Networks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Entertainment</td>
<td>4.0%</td>
<td>3.4%</td>
<td>4.0%</td>
<td>4.6%</td>
<td>2.8%</td>
<td>2.5%</td>
<td>1.8%</td>
<td>9.7%</td>
<td>6.6%</td>
<td>4.9%</td>
<td>17.9%</td>
</tr>
<tr>
<td>Radio &amp; Outdoor</td>
<td>nya</td>
<td>nya</td>
<td>nya</td>
<td>nya</td>
<td>nya</td>
<td>21.3%</td>
<td>8.0%</td>
<td>32.6%</td>
<td>30.8%</td>
<td>-423.7%</td>
<td>13.0%</td>
</tr>
</tbody>
</table>

### Return on Equity (EBIT/Equity)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Equity (EBIT/Equity)</td>
<td>12%</td>
<td>10%</td>
<td>6%</td>
<td>6%</td>
<td>11%</td>
<td>3%</td>
<td>2%</td>
<td>7%</td>
<td>7%</td>
<td>12%</td>
</tr>
<tr>
<td>Return on Assets (EBIT/Total Assets)</td>
<td>5%</td>
<td>4%</td>
<td>3%</td>
<td>3%</td>
<td>5%</td>
<td>2%</td>
<td>2%</td>
<td>5%</td>
<td>5%</td>
<td>7%</td>
</tr>
<tr>
<td>Return on Sales (EBIT/Sales)</td>
<td>13%</td>
<td>11%</td>
<td>7%</td>
<td>6%</td>
<td>10%</td>
<td>7%</td>
<td>6%</td>
<td>22%</td>
<td>21%</td>
<td>22%</td>
</tr>
<tr>
<td>Gross Profit Margin (EBITDA/Sales)</td>
<td>19%</td>
<td>17%</td>
<td>15%</td>
<td>14%</td>
<td>17%</td>
<td>23%</td>
<td>21%</td>
<td>26%</td>
<td>25%</td>
<td>26%</td>
</tr>
<tr>
<td>Leverage (Total debt/total assets)</td>
<td>58%</td>
<td>56%</td>
<td>53%</td>
<td>49%</td>
<td>55%</td>
<td>42%</td>
<td>31%</td>
<td>31%</td>
<td>30%</td>
<td>38%</td>
</tr>
</tbody>
</table>

### Averaged total revenue growth

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Averaged total revenue growth</td>
<td>13%</td>
<td>3%</td>
</tr>
</tbody>
</table>
## Percentage of Revenues by Type

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising sales</td>
<td>46%</td>
<td>59%</td>
<td>58%</td>
<td>60%</td>
</tr>
<tr>
<td>Rental/Retail sales</td>
<td>22%</td>
<td>29%</td>
<td>28%</td>
<td>0%</td>
</tr>
<tr>
<td>Affiliate fees</td>
<td>9%</td>
<td>11%</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td>Feature film</td>
<td>8%</td>
<td>10%</td>
<td>11%</td>
<td>10%</td>
</tr>
<tr>
<td>exploitation TV</td>
<td>6%</td>
<td>8%</td>
<td>7%</td>
<td>6%</td>
</tr>
<tr>
<td>license fees Other</td>
<td>10%</td>
<td>12%</td>
<td>12%</td>
<td>13%</td>
</tr>
</tbody>
</table>
8. BIBLIOGRAPHY


"Bell Atlantic to Offer Special ADSL Service for AOL, Communications Daily, January 14, 1999.


Morgan Stanley Dean Witter (1999): "The European Media Research"


Rey, Patrick and Jean Tirole (February 1996): "A Primer on Foreclosure", mimeo.


Zenith Media (2001): "Television in Europe to 2010".
CURRICULUM VITAE

PERSONAL DETAILS

Name: Fiona Röder
Adress: Tegelbergstrasse 34
        D-81545 Munich
        Germany
        Email: fiona.roeder@gmx.com
Nationality: German
Date of Birth: December 15, 1973

EDUCATION

07/2002 – 06/2007 University of St. Gallen / MCM Institute
PhD in Media Economics: “Strategic chances and risks of vertical integration in international media conglomerates”

05/2003 – 08/2004 London School of Economics and Political Science
Research Fellow and Assistant Lecturer at the Institute of Management

09/1999 – 06/2000 London School of Economics and Political Science / University of St. Gallen
MSc Management (CEMS)

BSc Management

06/1997 – 08/1997 UCLA, Los Angeles, U.S.
Film & TV Economics Summer Extension

09/1995 – 07/1996 Université de la Sorbonne, Paris, France
Diplôme de la langue et civilisation française

09/1994 – 02/1995 BAW University, Munich, Germany
Filmmarketing Extension

09/1993 – 07/1995 BAW University, Munich, Germany
BSc and MSc in Media and Communication Studies
PROFESSIONAL EXPERIENCE

11/2007 – current  Bayerische Landesbank, Munich
Director Strategy and Business Development Financial Markets

Director Strategy and Business Development

Corporate Finance M&A and Media Associate

07/1999 – 09/1999  Credit Lyonnais, Paris, France
Internship: Junior Management Level

09/1997 – 12/1997  Twentieth Century Fox, London, UK
Internship

06/1997 – 08/1997  American Film Marketing Association, Los Angeles, U.S.
Internship

02/1995 – 04/1995  Columbia Tristar Pictures, Munich, Germany
Internship

09/1993 – 01/1995  Heye & Partner DDB Needham Advertising, Munich, Germany
Trainee

PROFESSIONAL QUALIFICATIONS

10/2000  Securities and Futures Authority (SFA), United Kingdom
General Securities Representative