The ESPN Business Model

Excerpt from ESPN: The Company - The Story and Lessons Behind the Most Fanatical Brand in Sports by Anthony F. Smith with Keith Hollihan

When the Model Doesn't Work, Flip It Over

Despite the Us vs. Them mindset, the beacon in the sky, the fortuitous location in Bristol, and the fast, cheap and out of control approach to quality programming, ESPN didn't make any money until it figured out how to stop giving its product away.

Getty Oil had expected to break even on its $10 million investment into ESPN within two years. But by a year in, Getty had spent about $60 million and ESPN was burning through another $30 million per year. So Getty called in McKinsey and Company to assess whether there was any hope for the asset called ESPN or what its liquidation value would be if the pieces were sold off as scrap. As I mentioned in the previous chapter, Roger Werner, future president of ESPN, was part of that outside team of consultants. The McKinsey group looked at ESPN, the possibilities of satellite and cable as a medium, and the sports television marketplace in general, and drew some startling and harsh conclusions. Yes, cable was a growth industry that would steadily penetrate the American television marketplace. Yes, sports television was a growth market and there was room for some organization to distribute the extensive programming that ESPN was offering. And yes, ESPN was viable and could become a significant media entity. But it was going to take another 5 years and $120 million. And it was going to require flipping the industry business model to do it.

According to Werner, "We felt that at the rate cable was being built and subscribed to, over a five to ten year horizon, a large universe of paid TV homes would emerge and an all-sports service could command a meaningful share of viewership in that universe. We also felt that ESPN could sustain that market share on a given level of spending. But the cost side of the business had to be modeled carefully."

Simply following industry convention, ESPN had adopted the broadcast network model. The long-standing traditional approach to television distribution was for networks to pay affiliate stations to show their programs, and earn all their revenue from advertising. The big four networks, ABC, NBC, CBS, and FOX, still conduct business that way today. But ESPN would never survive, Werner believed, if it pursued an advertising revenue driven model exclusively. "We questioned the long-term viability of that and pointed to the need to challenge the fundamental assumption and explore the possibility of developing a second revenue stream." To obtain that second revenue stream, Werner advocated that ESPN stop paying affiliates to carry programming and start charging them for the privilege.

Any media executive would swallow hard at the audacity behind such a reversal. But for ESPN, a three-year old cable channel based in Bristol, Connecticut, such a plan seemed particularly bold, if not outrageous. Perhaps it took an outsider to see what industry insiders, particularly at the major networks, were blind to, but the McKinsey vision was prescient. Fortunately, Stu Evey from Getty and Bill Grimes at ESPN agreed and convinced Getty Oil to double down yet again. The McKinsey group switched its focus from assessing the business model to executing the strategic and tactical operating plan. As the primary architect, Roger

Werner was lured onto the executive team as chief operating officer to lead the implementation.

That was when luck came to ESPN in another particularly nice piece of timing. In the fall of 1982, after only a year in operation, the plug was pulled on CBS cable because it had already lost $30 million. As one of the trumpeted industry leaders, this was a terrific shock and wake up call, and caused the many dozens of smaller publicly traded cable operators to lose significant market value as their share prices took a nose dive. In the press, there was a frenzy of speculation that cable itself was doomed and the 200 channel universe was never going to happen because the promise of original independent programming could not be fulfilled.

"It was at this point," Werner says, "that we saw an opportunity. I felt that we could go to the industry and say, guys, if we can't reverse this flow, if we can't change our business model and get paid a nominal fee as opposed to paying you guys a nominal fee, we're going to go out of business, too. And you may as well face the music and deal with it now."

The job became convincing cable operators that flipping the business model would be good for all parties, that it was in fact not just a viable plan for ESPN but a necessary one for the health of the industry. ESPN's primary argument was that it could no longer afford to provide the sports programming that cable operators' customers were becoming hooked on if the payment system wasn't reversed. But this "stop me before I shoot myself" kind of logic could only take ESPN so far. The more convincing case was that all cable channels, not only ESPN, were suffering under the conventional way of operating. The limited revenue obtainable via advertising on niche channels was stifling the growth of cable in general. If the model was reversed, more cable channels would get into the game, providing more programming and handing cable operators a more attractive line-up to lure television subscribers.

Of course, that kind of visionary perspective requires a certain generous and visionary mindset in turn to appreciate and align with. An equally persuasive point of view was that cable operators, despite a setback at CBS and a temporary dip in share price, had a good thing going already. Reversing the flow of fees to a cable channel just to keep it alive was like signing over a paycheck to a desperate used car salesman. Within the cable industry, there were some fierce opponents to the idea and some who got it. In particular, John Malone, then chairman of the cable group TCI and Bill Daniels, one of the pioneers of the industry and an enthusiastic sports fan who was a founder of the USFL, realized ESPN was right and became advocates with their colleagues inside the business.

Using the leverage that the current five-year distribution contract with affiliates was expiring in two years, ESPN proposed new rates going forward. Those cable operators who signed on immediately were offered a gradual progressive rate over the life of the next two agreements. Those who didn't sign up would be stuck with whatever prevailing rate the market could bear when the current agreement ended in 1985. The discussions were often ugly and heated, edging to threats of lost distribution and lawsuits. By the end of 1983, ESPN had a few deals in hand. By the end of 1984, most of the industry had been converted to the new model. Turmoil in the cable industry continued as hundreds of small independent operators got consolidated by a few bigger players. The 1984 Cable Act which deregulated the industry further accelerated the churn of consolidation and investment. Communities and households all over the country were rapidly being connected and more programs than ever were being developed. By 1985, ESPN had finally become profitable, meeting the schedule McKinsey had set for it when it concluded its study five years before. Most impressively, it achieved profitability without sacrificing on its mission to serve the sports fan with quality programming. In fact, it enhanced that mission because profitability was the catalyst for new programs, ground-breaking deals with the major sports leagues, and an expanded number of channels.

The impact of ESPN's flipping of the cable model can't be overstated. Not only did it save ESPN but it helped progress the variety of channels, programs and information sources we have access to today. The idea of a cable company paying affiliates to carry its broadcast seems ludicrous now from an operating perspective. But I'm not sure that revolution could have been started or even conceived by someone already vested in the traditional way of doing business. Radical innovations that change industries almost always come from outside those industries. McKinsey needed to conceive it, a backer from the oil industry needed to see the sense of it, and a desperate outcast operation from Bristol needed to implement it.

Naturally, the other cable channels – many of which we enjoy and take for granted today, like MTV, A&E, Discovery, etc. – followed ESPN's lead and began charging cable affiliates a nominal fee. There was nothing nominal about ESPN's fee, however, in the decades to come. From the initial five cents per month charge, the fee quickly became twenty cents a month, and the executives at ESPN, surprised at the success of what they were doing, found themselves wondering how much higher it could go. The dual revenue stream from advertising and affiliate fees was the holy grail. Steadily, as the revenues led to better programming, and the programming led to more subscribers, higher ratings, and higher fees that could be charged to advertisers, that virtuous circle of profitability continued to expand. From an astounding 70 cents per month in the early 1990s, Bornstein and Bodenheimer were able to raise affiliate fees to an industry-rocking $3 per month in the late 1990s. No other cable channel even comes close to that universe of profitability.

To describe the significance of that achievement Bornstein relies on a metaphor used by Warren Buffet. “We dug the moat around ESPN.” By driving affiliate fees higher than any other competitor, ESPN has put a serious impediment in place that secures its position as the most popular and profitable cable channel, if not the most profitable entity in the media industry.