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Online Video: The Market Is Hot, but Business Models Are Fuzzy

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On July 11, Sony Pictures Home Entertainment became just the latest media giant to put its heft behind a small startup, as the white-hot online video market has players both big and small placing bets on digital distribution.

The startup in this case -- video sharing site Guba -- landed deals with not only Sony Pictures Home Entertainment but also Time Warner's Warner Bros. Entertainment on June 26. And Guba isn't alone. Internet video startup YouTube teamed with NBC in a marketing and advertising pact on June 27. In addition to broadening the range of video content available online, these deals are signs that web-delivered video is expanding from user-provided content to encompass more professionally authored (and legally licensed) material.

Add up the venture capital dollars funding online video startups, the technology advances, the willingness of established players like ABC, CBS and NBC to try new distribution models and the increasing web viewership, and it's clear that the video market is at an inflection point, say experts at Wharton. Indeed, it's hard to argue with the numbers from various research firms. Video streams viewed rose 50% in 2005 and are forecasted to rise 32% to more than 23 billion served in 2006, according to AccuStream. Comscore notes that the average consumer of online video watches 100 minutes per month, up from 85 minutes six months ago. YouTube says people watch more than 70 million videos a day on its site. IDC forecasts that online video services will generate $1.7 billion in revenue by 2010, up from $230 million in 2005.

With that kind of growth, it makes sense for established media companies like NBC and startups like YouTube to partner, says Wharton marketing professor Peter Fader. "It's like all the old line businesses suddenly get it," he notes, referring to the bevy of dot-com and big media partnerships. "I think it's great that [the media giants] are realizing what the consumer wants and are just doing it."

To Fader, the happenings in online video represent lessons learned from the original Napster's battles with the music industry. Faced with encroachment from digital music sharing, the recording industry launched lawsuits to shut down sites like the first version of Napster, which at that time allowed users to distribute copyrighted music. In contrast, YouTube reportedly notified NBC when copyrighted works were posted, and removed them at NBC's request -- and then wound up partnering with the network. It's unclear what business model will emerge to support YouTube, but Fader reckons its partnering approach will give it a fighting chance. "The YouTube and NBC partnership symbolizes what can happen when traditional media companies and new media companies find common ground," said John Miller, chief marketing officer at NBC Universal Television Group, in a June 27 statement.

However, questions about the online video market remain. What will ultimately become of all the wheeling and dealing in the online video market? What are the most important technologies needed to expand online video? Can online video startups find viable business models? And aren't all parties simply hedging their bets since it's unclear which online video distribution models will win out?

To some degree, the online video market today involves companies -- a Stifel Nicolaus & Company report names 25 major players -- putting their chips in multiple areas to see which bet pays off, explains Kendall Whitehouse, senior director of IT for Wharton. "From the studio's standpoint, you want to learn the business models because you don't want [users of peer-to-peer file sharing technologies like] BitTorrent running off with your content," he says. "From the startup side, these companies are also looking for a business model and for credibility -- they don't want to become the next Napster."

The Technology behind the Boom

So why is the growth of online video on fast forward now? For starters, broadband access is prevalent and media companies -- including ABC, CBS and NBC -- are jumping headfirst into digital distribution. Whitehouse also notes that amateur content -- consumers sharing their own personal videos on the web -- has ballooned as well. Indeed, prior to these deals, sites like YouTube and Guba presented mostly user-uploaded videos -- either material the users created themselves or digitally captured content from television or elsewhere.

And, while these technical developments are important, Fader adds there's a particular technology -- the addition of video playback to Adobe System's ubiquitous Flash Player -- that has helped online video explode. The Flash software, bundled with all the major web browsers, allows rich media to be displayed on the web without requiring a separate media player. "I don't think people fully appreciate the transformation Flash has created," says Fader. "I usually don't like to put technology on a pedestal, but Flash means you can see video without waiting."

Whitehouse also notes that YouTube's use of Flash, along with the way it allows users to embed YouTube-hosted videos onto their own web pages, has helped the site's rapid rise to prominence. "Part of what YouTube has done is to provide a syndication strategy that allows users to easily put videos on their site," he says. "It gives you a simple cut-and-paste option to add video to your site. YouTube hosts the video and you present the content on your web page. This has gotten YouTube a lot of mindshare."

Nevertheless, technology hurdles remain. According to Devitt, "there continue to be constraints to online video distribution." For instance, the picture quality still trails that of television. And then there is "the difficulty of moving content from the PC to the TV, where it will be watched by the majority of consumers," he says.

Joshua Martin, an analyst with research firm IDC, notes that hardware to facilitate sharing digital video between devices is still under development and not widely adopted. For instance, Intel has a semiconductor platform called Viiv, which is designed to enhance media and better share video with consumer electronics. Advanced Micro Devices has a similar chip called Live. But these have yet to produce a "must have" product for the digital home. Better wireless networking technology is also needed to share video with multiple devices, says Martin. "There is a movement underway to enhance the [digital] video market, but it will take awhile."

Perhaps the biggest hurdle for moving digital video around the home from PC to TV or PDA is digital rights management (DRM) software, which restricts where and how content can be played. As experts interviewed for a previous Knowledge@Wharton article point out, if DRM restrictions are too burdensome or products from different vendors don't interoperate, widespread home use of digital video may slow down. "DRM is still a struggle to balance the rights of content owners with the rights of consumers," says Whitehouse.

Searching for a Business Model

While many technological underpinnings are in place for the online video boom, it's unclear what business models will emerge. For now, advertising seems to be the money-making method of choice. Although YouTube hasn't outlined its business model yet, its NBC deal could provide a blueprint for future sponsorship arrangements. NBC will promote its fall network lineup on a new "NBC channel" on YouTube's site. Chad Hurley, co-founder and CEO of YouTube, says the deal "provides greater visibility and access to both NBC and YouTube's audiences, providing both companies with new outlets for growth and opportunity."

But Martin says the leading startups in the market, notably YouTube, will face significant challenges making money. "YouTube has developed its reputation by offering free content," he explains. "To wean users off that is difficult. The NBC deal is a step in the right direction, but at the end of the day making money will require a culture change." Terms of the NBC-YouTube deal were undisclosed, but Martin says it's likely to be more of an experiment for NBC than a profit opportunity for YouTube.

Whitehouse agrees. While advertising revenue for online video may be significant in the future, startups like YouTube and Guba have to pay for the bandwidth to deliver content today. YouTube has reportedly raised $11.5 million in venture capital funding from Sequoia Capital, but "their bandwidth usage is enormous. And bandwidth costs money," says Whitehouse. "It's unclear what the long-term business strategy is and how long they can sustain their current burn rate [of expenditures]."

Meanwhile, advertising may not be a holy grail. Consumers may revolt when ads start appearing in videos, says Whitehouse. Online video companies will have to weigh the pros and cons of embedding ads within videos versus placing them on the web pages on which the videos appear. "There may be a lot of resistance [from users] to ads embedded in user-uploaded videos," he says. But YouTube's popular feature that allows users to place videos on their web pages may not leave the company with many options. After all, video displayed on another site can still use YouTube's bandwidth without displaying any other YouTube content, such as ads -- unless YouTube decides to embed them in the videos. "The same features that have made the site so popular may make it hard to monetize," says Whitehouse.

Desperate Deals?

While there has been a bevy of deals to ponder in the online video sector, it remains to be seen which ones will deliver the most promise.

In the case of NBC and YouTube, there is little risk for either side. "If you're NBC, why not do a deal to have YouTube host promotional snippets of your programs?" says Whitehouse. "It's moving your advertising to where people are already looking. There's almost no downside."

Other partnerships, however, aren't as clear-cut. For instance, Whitehouse notes that Warner Bros. bestowed a lot of credibility on Guba with its deal to allow video to be sold through the site. Why didn't Warner Bros. sell its video on its site, or through sister company AOL, and thus extend an existing corporate brand, or team up with a well-respected distribution partner like Apple or Amazon.com? "[The deal] certainly makes sense from the Guba side," says Whitehouse, because it gives the company both credibility and a path to profitability. "From the studio's side -- I'm not so sure."

Under the Guba-Warner Bros. agreement, rental prices start at $1.99 per movie for unlimited views during a 24-hour period. Viewers can buy extra viewing days for reduced fees without the need to download the film again.

Guba also allows users to buy Warner Bros. movies such Harry Potter films and television shows like "The Jetsons". Catalog films will retail for $9.99 and new releases, available on the same date that DVDs are released in stores, will retail for $19.99. Television shows will retail starting at $1.79 per episode. Users may keep permanent copies of purchased titles, load purchased titles onto portable devices, and stream purchased and rented content through their home network.

Guba's deal with Sony Pictures Home Entertainment is similar. Sony will provide Guba with more than 100 full-length movies including *Spiderman* and *Memoirs of a Geisha*. Under the Sony deal, Guba will price new releases at $19.99 and catalog titles at $9.99. Video content will play on compatible home computers.

In the future, Devitt says that Yahoo! and Google are likely to be the web's video gatekeepers. "We think Google and Yahoo! have the capacity to store video content and match it up with demographically/behaviorally-targeted advertising that could be digitally delivered. In short, Google and Yahoo! could become the gatekeepers of video insertion ads and the video content aggregators of the Internet," says Devitt.

Fader notes that the variety of online video deals is a positive step. "These arrangements are about more than just hedging bets," he says. "And it's nice to see this mix happen." More experimental deals are likely between old media companies and web startups, he says. Why? For all the hubbub about web video supplanting television, the most likely outcome is that the two are complementary, he argues. "I just don't see online video ever supplanting TV. I see them mashed together."

Fader's view of the future includes scenarios such as the following: A consumer is watching a baseball game on TV and has a laptop by the couch. With the laptop, the viewer calls up a replay of recent action via MLB.com. "Things are clearly moving in that direction," says Fader. "I'm never going to watch "Grey's Anatomy" over a [portable] wireless device, but I may watch a preview before seeing it on TV."

In the future, those simultaneous web-TV interactions may be coordinated with advertising from the likes of Google or even YouTube and a successful business model could emerge, argues Fader. It won't happen overnight, but as startups and media giants continue to cooperate anything is possible. "I'm upbeat about the prospects here," says Fader. "There's a lot more to come in this transformation."