

Strategic Report for DirecTV

Pandora Group **Out of the Box Consulting**

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Executive Summary

DirecTV is one of the largest providers of satellite television in the world, with over 15 million customers in the United States and 1.5 million in Latin America. The company has grown tremendously since its inception in 1993 because of its high-quality products, innovative technology, and dedication to customer service. It is the opinion of Pandora Group that the company is in a solid position for future success; however, a few strategic issues must be addressed.

First, Pandora Group strongly recommends that DirecTV develop a long-term solution to its current bundling problem. The agreements with BellSouth and Verizon to bundle Internet service with DirecTV cable is only a short-term solution. These partnerships are unstable, and DirecTV needs to develop its own integrated system to deliver Internet and cable over the same network. This will make DirecTV more competitive with traditional cable providers, and will take away current bundling advantage.

Second, the company should reel back its aggressive marketing campaign in the US, diverting some of that money to increase its Latin American customer base. High sales and advertising costs have resulted in industry-high customer growth rates in the US, but have also substantially lowered profit margins. Though money should continue to be spent on enticing competitors' customers to switch to DirecTV, it will be much more cost effective for DirecTV to utilize its advertising budget in the unsaturated Latin American market.

Finally, the company must emphasize its development of a viable encryption system for its signal. The pirating of DirecTV's signal is a continual threat to the company's profitability. A Robust encryption system not only enables DirecTV to keep its existing

customers, but also keeps DirecTV out of the courtroom, where large legal costs can erode company profits.

Company Background

Hughes Electronics, a subsidiary of General Motors, started DirecTV on December 17th, 1993 with the launch of its first satellite DIRECTV-1. Hughes had been working on its direct broadcast satellite system (DBS) since 1984 and was the first company to deliver the technology to the masses. DirecTV was the first service provider in the U.S. to deliver all digital-quality, multi-channel TV programming. The impact was immediate. The creation of DIRECTV, with its national reach, provided people across the continental U.S. with a much-needed alternative to traditional cable broadcasters. People all over the U.S. could use all-digital programming for the first time.

There were two distinct features of DirecTV service that separated it from the other satellite providers of the time. First, the company replaced the large, cumbersome TVRO satellite dishes with its new “minidish”. Only 18 inches in size, the minidish is still in use today. The dish can easily be mounted anywhere on the exterior of a home residence, making satellite TV available to anyone with an exterior wall. Aside from its compact size, the minidish also brought consumers a new way of receiving satellite television transmissions. Older TVRO dish systems were analog and based on open standards equipment.

The new minidishes offered clearer digital video and audio. In addition, the minidish is operated on a closed system that requires special reception equipment to ensure signal security against pirating. The new technology revolutionized the broadcasting market. Each DirecTV satellite (there are now ten, with 4 more planned for launch) has multiple

transponders that relay DirecTV signals from Castle Rock, Colorado or Los Angeles, California. These broadcasting stations receive their programming feed from hundreds of local, national, and international content providers via fiber optic cable, digital tape and most importantly, satellite. The stations digitalize, encrypt, and link up the programming for broadcasting. The content is sent through satellites to each customer's minidish, where the integrated receiver/decoder (IRD) separates each and every channel accordingly. The feed is then decompressed and translated so that a television is able to show it. The DirecTV remote control is used for interactive interface with the IRD to achieve multiple functions including programming guide manipulation. Currently, DirecTV utilizes MPEG-2 technology to ensure a crisp, quality feed, but MPEG-4 (which supports high-definition programming) has just been introduced.

DirecTV was a complete success from its start, experiencing tremendous growth throughout the 90s, with an annual customer growth rate of 275% in its first year and an average annual growth of 55% from 1995-1999. By 1997, DirecTV launched DirecTV-6 and in 1998, the company had over 4 million subscribers.

Table 1. DirecTV: Subscriber's per Year

1994	1995	1996	1997	1998	1999
320,000	1,200,000	2,300,000	3,301,000	4,458,000	6,679,000
2000	2001	2002	2003	2004	2005
9,554,000	10,218,000	11,181,000	12,290,000	13,000,000	15,000,000

The same period also saw consolidation within the satellite broadcasting industry. DirecTV entered into an agreement in 1998 to purchase its partner, US Satellite Broadcasting for over \$1.3 billion in stock and cash. The merger provided DirecTV

customers with access to USSB's premier movie broadcasting, increasing channel selection from 185 to 210. 1999 brought even more growth when DirecTV acquired Primestar, Inc. and their 2.3 million subscribers. As part of the transaction, DirecTV inherited Primestar's satellite assets—11 transponders and two satellites. DirecTV then had the ability to provide full coverage over the continental United States. In addition to the Primestar satellite acquisitions, DirecTV launched their own new satellite, DirecTV-1R the same year.

By 2000, cable companies started to offer similar services—digital programming, on demand movies, and special sports packages. As a result, DirecTV began to lose its first mover advantage. Since 2000, its customer base has grown at a relatively moderate annual customer growth rate of 9.5%. DirecTV announce its intention to merge with its prime competitor, EchoStar Communications (the parent company of DISH Network), in October 2001. However, after more than a year of speculations, the bid was officially blocked by U.S. federal antitrust regulators. In 2003, General Motors sold their controlling interest of Hughes Electronics to News Corporation. DirecTV is now under the umbrella of Robert Murdoch, News Corp.'s CEO.

Management

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Bruce B. Churchill, Executive Vice President

Larry D. Hunter, Executive Vice President, General Counsel and Secretary

Michael W. Palkovic, Executive Vice President and Chief Financial Officer

Romulo G. Pontua, Executive Vice President and Chief Technology Officer

Patrick T. Doyle, Senior Vice President, Treasurer, Controller and Chief Accounting Officer

Competitive Analysis

Any analysis of DirecTV must focus specifically on the product markets and geographic markets in which the firm is competing. DirecTV participates in two regional cable television broadcasting markets in the world: the United States and Latin America. Our competitive analysis will center on the United States; however, one can apply some of the considerations raised in this section to DirecTV's Latin American operation.

Cable television broadcasting in the US consists of two different types of firms, multiple system operators (MSOs) and direct broadcast satellite (DBS) companies. Both types broadcast cable television to consumers, while also offering an array of additional services, such as video on demand, digital video recording, and commercial-free music channels. DirecTV is a DBS firm, but both types of providers will be included in the internal rivalry section despite differences in their respective delivery methods of cable (discussed in the next section). Some analysts separate them, considering internal rivalry only in terms of DBS firms and placing MSOs in the substitute category. We think this separation is incorrect, as both DBS and MSO companies deliver the same products to consumers and compete for market share.

Internal Rivalry

Cable TV and its extra services can be delivered one of two ways. As discussed in the history section, a DBS firm utilizes an infrastructure made up mostly of satellites in geocentric orbit over the United States, a few major relay stations on the ground, and the small satellite dishes attached to a customer's residence. Conversely, MSOs require an integrated infrastructure on the ground (much like phone lines) in order to provide services to its customers. The geographical advantage in distribution definitely sides with DBS providers. Satellite TV can reach anyone in the US, regardless of how close

they are to a major communication network. A DBS company deals directly with the customer, with no contact with local governments. MSOs rely directly on under/above ground wiring to deliver their broadcasts. Therefore, MSOs must build their supply network in every area they have customers and then connect each individual area together. In addition, a MSO must get permission from each city or district for all of the work involved in establishing their cable delivery system. The relationship between MSOs and local governments is scrutinized in the buyer power section.

Because of the economies of scale in both methods of delivery, there has been a strong movement towards consolidation within the industry since the 1990s. After many buyouts, mergers, and acquisitions, only two major DBS companies existed in 2001. In October of that year, General Motors Hughes (DirecTV's parent) and EchoStar agreed to a merger. The merged company would have provided enhanced cable television services through technology collaboration, sharing of satellites, and integrated customer services. In addition, all satellite TV customers would have been able to receive local channels. The government blocked the merger because the resulting company would have controlled almost 100% of DBS broadcasting, leaving customers with only one choice for DBS cable. Currently, DirecTV owns 55% of the DBS submarket, with over 15 million customers in the US (1.5 million in Latin America). Echostar has 45% of the US submarket, with 12 million customers in the US. The impossibility of a merger has created an interesting situation for DirecTV and Echostar. There is almost no possibility of a new firm entering the DBS market (this will be discussed in the entry section), but each company is under constant pressure of MSOs. This situation has created a competitive, yet sometimes cooperative, relationship between DirecTV and Echostar. Each company has the incentive to ensure that the DBS cable delivery system outperforms the MSOs, but each firm also seeks to dominate satellite broadcasting.

MSOs have also amalgamated at a rapid pace over the last ten years. The top 5 MSOs—Comcast, Time Warner, Cox Communications Inc., Charter Communications Inc. & Adelphia Communications—control about 75% of the 65 million customers in the MSO submarket. Competition will shrink even more this year once the pending acquisition of Adelphia by Comcast and Time Warner is completed. Since more and more people are now switching to satellite TV (about 2 out of every 3 new users buy satellite services), MSOs have a strong incentive to cooperate. It is also important to note that MSOs are in less direct competition with one another because of the regional nature of each company. The US cable market is made up of thousands of small city markets. Each city only allows one authorized MSO operator, which competes directly with DirecTV and DISH Network. Only on the fringes of two MSOs' infrastructures would one see direct competition between them.

The competition among DirecTV, Echostar, and the MSOs is fierce. They all have one nearly identical product, cable television, which they offer their customers. Each major company also offers additional services, but the range, quality, and availability of these services vary dramatically. In general, the monthly price of cable service from a DBS firm is lower than an MSO. However, sometimes one must pay to have the satellite dish and other equipment installed. The prices of DirecTV and Dish Network are essentially equal, with the standard DISH Network package being slightly cheaper (there are more channels offered in the DirecTV package). A price war is not on the horizon, with companies instead opting to use sign-up specials and discounts. For example, both DirecTV and DISH Network offer free installation. DBS firms and MSOs also discount the first 3 months of service or include free premium movie channels for three months to lure potential buyers. This attempts to capitalize on the relatively high

switching costs of consumers. Despite the trend of firm consolidation, the remaining sellers in the market remain aggressive because of the increased demand for cable over the past decade. Pandora Group expects prices to remain low, quality to increase, and technological advances to expand into the foreseeable future.

Entry

The possibility for successful entry into the cable broadcasting market is nearly impossible at the present time for both structural and strategic reasons. The largest barrier to entry is fixed costs. Economies of scales dominate this industry, requiring a new entrant to be able to gain a respectable market share before they can compete. In order to gain a foothold, a new DBS company would have to be able to offer the same services as DirecTV and DISH Network. The existing DBS companies have over 20 satellites between them over the US, with more due for launch. The cost of launching that many satellites quickly, assuming one could even get approved for space orbit by the government, would be astronomical. MSO ground networks are even more expensive to install. In addition, MSOs bid for long-term city cable contracts, which firmly establishes a specific MSO in that city. Once an MSO is settled into an area, it is very difficult to dislodge it. Lastly, cable companies have acquired a sophisticated knowledge of distribution, service, and technology that would put a new entrant at a serious cost disadvantage.

Substitutes and Complements

Few viable substitutes for cable television exist. All major cable companies offer well over 200 channels, sports packages, music channels, digital video recording equipment (DVRs), and access to on-demand movies. It is hard for other mediums of entertainment to provide that so much variety for the same cost. Hypothetically, if

cable television were to become much more expensive, \$500 a month for example, then people would begin to find other means of entertainment. These substitutes could include video/DVD rentals, going to the movie theater, or seeing live entertainment. However, it is the opinion of Pandora Group that the demand for cable television is fairly inelastic.

Complements for cable television are more prevalent. The most evident complement for cable television service is a television set. More specifically, customers who pay a premium for high-definition digital cable are likely to want a high-definition quality television. DirecTV has partnered with Samsung and Humax to produce TVs with built-in satellite receiver boxes. Other complements include speaker systems, subwoofers, or even comfortable couches. Any object that goes with a home theater system is a complement to cable service. The price elasticity of demand is almost zero because of the lack of substitutes and the high demand for cable television in American society. The cross-elasticity between cable television service and its complements is more pronounced. If high-definition TV sets drop in price, one will see an increase in the purchase of high-definition programming by existing cable customers (high definition service is an additional service that must be purchased from the cable company separate from standard cable service). Since the price of technological products like TVs and home stereos tend to fall relatively quickly, we expect the demand for cable to increase, with the demand for high-definition options to expand even faster. Presently, MSO's also have another complement, internet service. Technological bundling will be discussed in detail in the last section; however, only MSO's, not DBS firms, have the capability of offering cable TV and internet over the same network.

Supplier Power

The main input for cable broadcasting is television content. The content is mainly provided by the major networks and their local affiliates (ABC, NBC, FOX, CBS), cable channels (USA, TBS, FX), and premium movie channels (HBO, Cinemax, STARZ). In the unique world of broadcasting, the cable broadcast companies do not pay the networks for TV content. The DBS firms and MSOs are given the content by the each supplier to broadcast, and the suppliers earn their revenue from charging advertising fees for companies' on-air commercials. The broadcasting firms need only enter into agreements with each supplier in order to distribute that suppliers TV content, but the supplier has no price control on the input. Because suppliers gain no profit from withholding, major cable distributors have little problem acquiring TV content, though the process can take a substantial amount of time.

Other inputs for DBS firms and MSOs (satellite dishes, receivers, remote controls, etc.) can be acquired in a competitive market. However, many inputs are developed in joint projects with technology companies, resulting in strong, long-term relationships. The major DBS and MSO firms can deliver much stronger pressure on their suppliers, than vice versa.

Buyer Power

Another difference between DBS and MSO companies is revealed when buyer power is examined. DirecTV and DISH Network sell their broadcast service and equipment directly to the individual consumer through four major channels—internet, phone, independent retailers, and DSL company partnerships. Direct internet and phone sales are the most popular, followed by sales at independent distributors like Best Buy or Circuit City. DirecTV and DISH Network also have strategic partnerships with major

DSL internet providers Bell South, Qwest, Earthlink, & Verizon. Consumers can purchase packages that include DSL internet service coupled with satellite TV service at a discount. Because DirecTV and DISH Network sell directly to millions of individual consumers, they experience no buyer power pressure.

MSOs also sell to the individual consumer, but they can only sell to a consumer in an area that they have established an integrated network. In order to establish a network in an area, the MSO has to get permission from each individual town, city, or village government for which they wish to provide cable TV. Each local government invites MSOs to bid for the right to provide cable in their town, encouraging MSOs to involve themselves in bidding wars. The MSO must bid every time their contract expires; hence, local governments can extract extreme price reductions from MSO's through bidding. The ultimate power of the individual consumer remains extremely low for MSOs, but local governments have the ability to squeeze profit margins for MSO's.

Summary

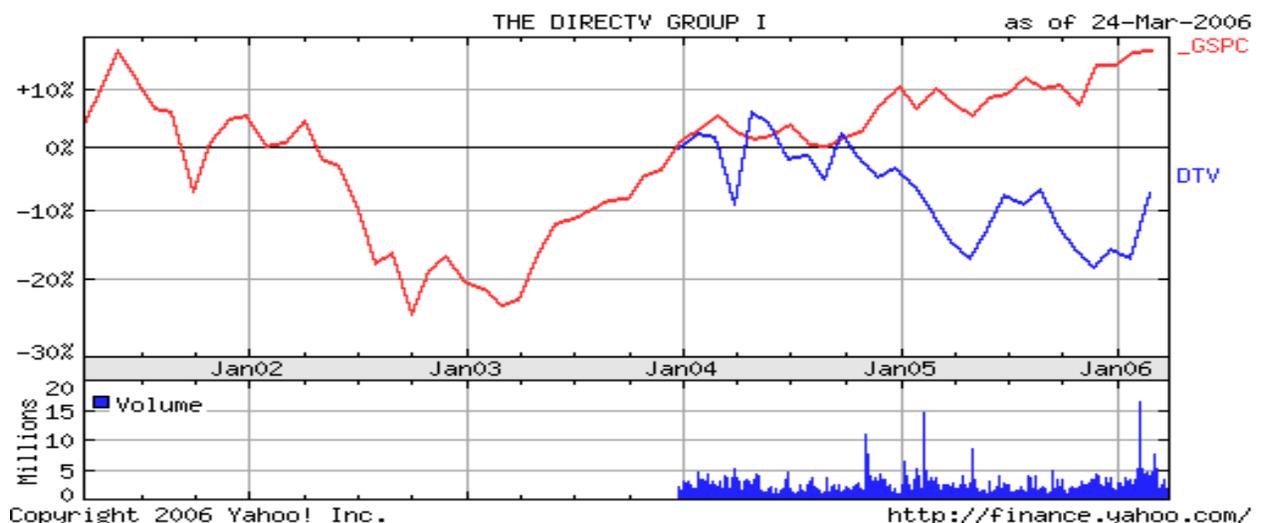
Internal Rivalry.....	High
Entry.....	Low
Substitutes.....	Low
Complements.....	Medium-High
Supplier Power.....	Low
Buyer Power.....	DBS—Low
.....	MSO—Medium-High

Financial Analysis

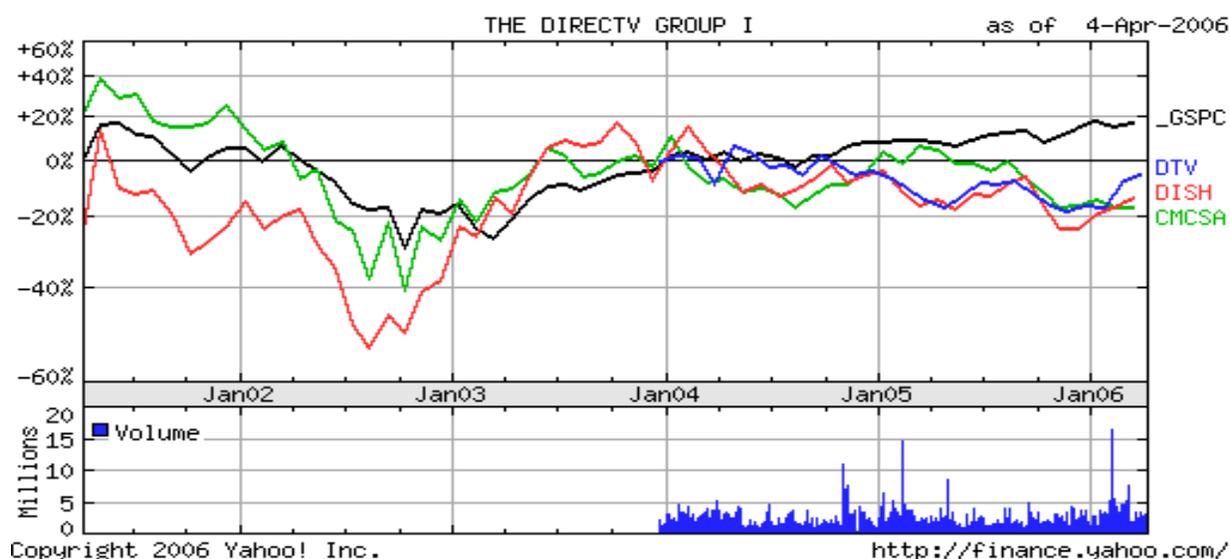
DirecTV (DTV) is a relatively young stock. In December 2003, Hughes Electronics (operator of DirecTV) was sold by General Motors to News Corp. Hughes Electronics was taken off the NYSE, and was replaced by DirecTV (DTV). News Corp. acquired a 34% stake in DirecTV for \$6.6 billion¹. After the sale, Hughes shed its automotive, defense and electronics operations to focus purely on its satellite broadcasting operations. Hughes ceased to be a tracking stock, and changed its name to The DIRECTV Group in March 2004. Hence, the data presented in some charts in this section will only reflect DirecTV's stock performance since the beginning of 2004. In addition, because Time Warner Cable and Cox Communications are privately held companies, only Echostar and Comcast serve as peers to DirecTV in this analysis.

Graph 1 traces the price of the stock compared to the market (S&P 500). The stock has done poorly relative to the market as a whole, only trading above its IPO price for a few months. However, as illustrated by graph 2, the industry as a whole has been underperforming the market over the last two years, with DirecTV performing slightly better than its peers.

Graph 1. DirecTV vs. the market (S&P 500)



Graph 2. DirecTV vs. Competitors



Recently, DirecTV’s stock price has experienced an upswing due to strong fourth quarter growth in 2004 and positive announcements about its new leasing program and expansion of local HD offerings.

DuPont Analysis

DirecTV, with an ROE of 4.35% for 2005, has the largest return on equity (ROE) of its peer group.

Table 2. Return on Equity (ROE) 2005

	DirecTV	Echostar	Comcast	Industry
Profit Margin	2.55%	17.98%	4.17%	2.95%
Asset Turnover	0.88	1.25	0.21	0.41
Financial Leverage	1.94	-4.56	2.55	-
ROE	4.35%	-102.86%	2.27%	3.28%

When disaggregating ROE, one can see that DirecTV's ROE is being hampered by its low profit margin and financial leverage. In comparison, Echostar has a strong profit margin and a respectable asset turnover rate, but the company's financial leverage is large and negative. This unusual number is the direct result of Echostar's negative net income and negative retained earnings. Comcast's low ROE comes from its low asset turnover rate and unimpressive profit margin. DirecTV can increase its ROE by taking on more debt, thus expanding its financial leverage. At the end of 2005, DirecTV was 30% leveraged. As I will suggest in the next section, DirecTV should use its borrowing capacity to expand its Latin America operations and increase its ROE. With a stable cash flow, DirecTV is in a position to take on more debt with little risk of default.

Table 3. Profit Margin Breakdown 2005

	DTV	DISH	CMCSA	Industry
Gross Margin	50.9%	28.7%	64.2%	43.4%
SGBA/Sale	39.9%	0.0%	26.0%	-
EBIT Margin	4.8%	13.9%	16.6%	17.6%*
Profit Margin	2.5%	18.0%	4.2%	3.00%
				*EBITD Margin

Another way DirecTV can improve ROE is through its profit margin. As table 3 shows, DirecTV has very little interest and tax costs since profit margin is only 1.27% less than operating margin; however, its sales and administrative costs are massive. This reflects DirecTV's aggressive advertising campaign to attract new customers, or steal existing cable customers from MSO's. Because virtually everyone who is going to buy cable or DBS has already done so, DirecTV has to spend heavily on persuading customers to

switch and to get them to stay. The firm has to spend millions in upgrading equipment, which includes making good on such offers as providing a free receiver for every TV in the house and upgrading users' TiVo digital video recorders (DVRs) as technology improves. Though the strategy has been successful in promoting customer growth (see table 8), DirecTV spends a much greater amount on SGBA compared to its competitors. For example, Echostar had almost no sales and administrative costs in 2005, but still was able to gain almost 1 million new customers. It is the opinion of Pandora Group that DirecTV should cut sales and marketing costs for its US market, and focus on expanding its Latin American operations. That market is not saturated like the US market, and it is much cheaper to acquire new customers than to persuade competitors' customers to switch. DirecTV is one of the leading cable providers in Latin America reaching approximately 1.5 million customers in a region with over 500 million inhabitants. DirecTV is currently available in: Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Puerto Rico, Trinidad & Tobago, Uruguay, Venezuela and several Caribbean island nations, all of which have unsaturated cable markets compared to the US.

Multiples

Table 4 compares the multiples for DirecTV and its peers. The highlighted areas indicate where peers are experiencing higher multiples than DirecTV. The relatively P/E ratio indicates that investors see room for growth for DirecTV.

Table 4. Multiples as of Dec. 31 2005

Multiple	DirecTV	Echostar	Comcast
P/E	19.46*	12.9	24.37
EV/EBITDA	13.72	9.06	9.371
EV/Revenue	1.5	2.11	3.57
Price/Book	2.82	NA	1.41

Industry Variables

MSO's and DBS firms use industry specific metrics to gauge performance. Average revenue per user (ARPU) is the prime indicator of operating performance and pricing power for cable companies. ARPU gauges the average monthly revenue generated for each customer unit. This may be computed for a particular service, such as digital cable or high-speed Internet access, or in total for a particular cable or satellite provider. Currently, add-on services, such as digital video recorders (DVRs), pay-per-view channels, sports packages, and telematics (the wireless transfer of information), are considered drivers of ARPU growth. However, the industries constant promotional offers, as well as discounts due to bundled packages and family plan subscriptions, tend to make many companies experience a fluctuating ARPU. Table 4 gives the ARPU breakdown for DirecTV. The total ARPU of \$69.61 is \$20 higher than the cable industry's "expanded basic" package in 2005. More promising than the large total is the growth of 4%. DirecTV increased revenues in all categories except pay-per view services. With the roll-out of the new MPEG-4 box sets, increased interest in DVR technology, and the new leasing program, we expect total ARPU to continue to grow in 2006.

Table 7. DirecTV ARPU

	2004	2005	% Change
Packages/Premium Channels/Sports Packages	\$52.10	\$53.00	2%
Mirroring Fees	\$4.80	\$5.90	19%
Pay-Per-View	\$2.70	\$2.50	-8%
Ad Sales	\$1.10	\$1.30	15%
Advanced Products	\$0.30	\$0.90	67%
Other	\$5.95	\$6.01	1%
Total ARPU	\$66.95	\$69.61	4%

Net subscriber additions (NSA) are the primary growth statistic for the industry. DBS firms have an advantage over MSOs in this category because they can market to the whole US population, where MSOs are constricted to their networks. NSA is also a leading indicator of the success of a cable or satellite provider's marketing programs. NSA is the number of new customers added, less customers that terminated service.

Table 8. Net Subscriber Additions (in thousands)

Service Provider	2004	2005
1. Comcast	80	-139
2. DirecTV	1,728	993
3. Echostar	1,480	805
4. Time Warner	-35	39
5. Cox	-51	-22
6. Charter	-439	-86
7. Adelphia	-208	-345
8. Cablevision	19	46
9. Bright House	-547	-85
10. Mediacom	-85	-29
11. Insight	-21	-2

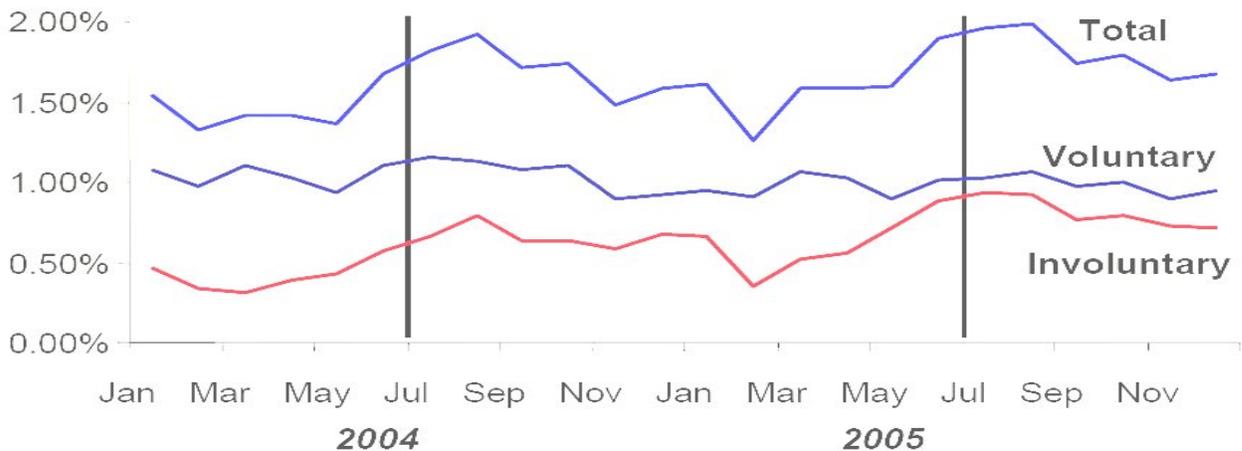
The large NSA's held by DirecTV and Echostar are a direct result of their national reach (though DirecTV spends much more on advertising). DirecTV has added over a million

customers in both 2004 and 2005. By the end of 2005, over 15 million customers had DirecTV. The large NSA for DirecTV is a result of its aggressive advertising campaign. However, EchoStar has a comparable NSA to DirecTV in 2005, but spent almost no money on advertising. DirecTV should evaluate how it can lower advertising costs while maintaining a high NSA. Table 8 also indicates that MSO's are neither attracting new customers, nor retaining existing ones. Only Cablevision had positive NSA values for both 2004 and 2005.

Because customer retention is very important in the cable industry, another vital measure of potential growth is churn. Churn measures the stability of a customer base by giving the percentage of subscribers that terminate service with a cable or satellite provider on a monthly basis.

Table 9.

DIRECTV U.S. Churn (2004-2005)



Churn may be voluntary (e.g., due to service dissatisfaction or relocation) or involuntary (e.g., due to bad debt). A low churn rate means high customer retention, which in turn allows for savings in advertising costs. Because customers must sign long term cable agreements, it is hard to regain lost customers. Churn rates below 2.5%, are better than average DBS providers. DirecTV had an average monthly churn rate of 1.59% in 2004 and 1.70% in 2005, while Echostar had a churn rate of 1.70% in 2004 and 1.85% in 2005. DirecTV expects to have a lower involuntary churn rate in 2006 as it continues to select more credit-worthy customers. DirecTV's low churn rate supports analysts' estimates of high future growth.

Applicable only to DBS firms, subscriber acquisition costs (SAC) per gross addition is a measure of operating efficiency. SAC is the total direct and indirect costs incurred to acquire each subscriber, typically including hardware, installation, advertising, and marketing expenses, as well as sales commissions, equipment subsidies, and retail incentives. Firms tend to have a higher SAC early in their histories, with it tapering over time. This is an area that DirecTV must become more efficient in order for the company to increase its ROE. Lowering its SAC will lower sales costs immensely, increasing profit margins. DirecTV must continue to lower its SAC if the company wishes to stay competitive in the future.

Table 10. DirecTV subscriber acquisition costs (SAC)

	2004	2005
Hardware	\$273	\$272
Installation	\$173	\$167
Dealer Commission	\$154	\$153
Marketing	\$43	\$50
Total	\$643	\$642

Overall, DirecTV is in a strong financial position for continued growth and expansion. It had a \$1 billion net cash position as of YE 2005. There are high expectations for cash flow growth and the company has considerable borrowing capacity. Revenue is expected to maintain its high growth rate. DirecTV's low profit margin will continue if the company continues its strategy of aggressive advertising, but the firm is still secure in its position as the top DBS provider. High APRU and NSA values and low churn rates indicate strong potential growth for 2006. New satellite launches, expanded HD service, and new technology will also help revenues grow.

Strategic Issues and Recommendations

DirecTV's short-term and long-term challenges are related to technological convergence, or "bundling". Major innovations over the past decade have allowed individuals to combine once different products or services into a combined product or service. Five years ago, different companies existed for cable, Internet, and phone services. Now, phone companies offer phone/internet packages and are investing heavily to upgrade their networks to include broadcast cable. MSO cable companies have the ability to bundle cable and Internet over their networks. DBS providers do not have the ability to bundle cable, Internet, and phone services, putting them at a pronounced disadvantage. To solve this major problem, DirecTV has entered into agreements with Verizon and BellSouth phone companies. If one purchases DirecTV service, then the customer has the option to bundle DirecTV cable with Internet & phone service from their phone companies for a discount.

While these agreements alleviate DirecTV's problem in the short run, DirecTV still needs a long-term solution to this problem for two reasons. First, phone companies might not be stable bundling partners, as the recent merger of AT&T and BellSouth displays. AT&T, who is in a bundling agreement with DISH Network, recently

acquired BellSouth, DirecTV's bundling partner. DirecTV's ability to provide Internet through BellSouth is now in jeopardy, as it is unclear whether AT&T will honor BellSouth's agreement with DirecTV. Second, phone companies are in the process of upgrading their networks to support cable broadcasting. It will take years for companies like AT&T and Verizon to refit their networks, and even more time for them to get permission to broadcast the hundreds of cable channels. After that time, however, phone companies will become direct competitors with DirecTV, and the current bundling contracts will be terminated.

If DirecTV wishes to remain competitive in future periods, Pandora Group recommends it develop a long-term strategy of bundling cable and Internet. Currently, DirecTV is in negotiations with Echostar concerning joint development of a Wi-Fi Internet system. Though DirecTV should continue to investigate this path, we believe it is vital for DirecTV to develop its own system. Therefore, DirecTV should partner with or acquire one of the satellite internet providers. Even if people need two dishes to receive internet and cable, both dishes will belong to DirecTV. Since DirecTV already offers free installation, there should be no major impact on acquiring customers. In addition to developing its own cable/internet system, DirecTV needs to continue to offer the latest in cable broadcasting technology. People will be hesitant to switch to other cable broadcast companies, even if that new company bundles, since DirecTV provides superior cable service. Items like NFL Sunday Ticket, which only DirecTV offers, are vital to distinguishing DirecTV from its competitors.

Next, Pandora Group suggests that DirecTV should use its excess profits and borrowing capacity to expand its Latin America operations. Unlike the United States, sophisticated phone and in-ground cable networks do not exist in many areas of Latin American countries. Hence, satellite cable is the only option for the majority of the Latin

American population. DirecTV can easily apply its expertise and experience to these developing markets, giving them an advantage over domestic cable providers. As of 2005, DirecTV was servicing 15 million homes in the US. If one calculates the average home to have 3 people, then there are 100 million homes in the US (population 300 million). Therefore, DirecTV is in 15% of homes in the US. In contrast, there are 167 million homes in Latin America, of which DirecTV is only servicing 1%. DirecTV should divert money away from its advertising campaign in the saturated US market, and invest in gaining market share in the unsaturated Latin American market. With less money being spent in the US on advertising, DirecTV should reduce its sales expenses and be more profitable.

Lastly, DirecTV must continue to fight against the stealing of its signal, with the most current attack coming from smart card devices. These devices are computers on a card that have legitimate uses ranging from your credit/debit cards to access control cards to computer systems. However, specific cards called unloopers and bootloaders can be configured exclusively for use in pirating DirecTV's satellite signal. The original strategy of DirecTV was to sue anyone in the possession of unloopers and bootloaders, regardless of whether they were used legitimately. This policy created thousands of lawsuits for DirecTV, and as of 2004, the company revised its policy to only charge people for actually using the smart card to steal the DIRECTV's signal. Pandora Group feels this is the right path for DirecTV, as litigation costs can eat into profits. Instead, the company should focus its time and money on developing more sophisticated encryption systems, such as its upgrade to MPEG-4.

ⁱ \$3.1 billion in cash and \$0.8 billion in ADRs for GM's 19.8% stake, and \$2.7 billion in ADRs for the 14.2% public stake.

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