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Succeeding in China's online video market

Profits are coming, but only players with the deepest pockets will survive to enjoy them.

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More than 700 million people in China will be watching online video content in four years, new McKinsey research shows (exhibit).[1] The successful stock market debut of Youku, one of China's leading online video sites, reflects what many feel is the industry's dazzling future. Youku, whose shares rose 2.6 times on the first day of trading in the United States, in 2010, already has more than 200 million monthly users. Its closest rival, Tudou, has 180 million.

Despite that potential, many observers remain cautious about the industry's outlook. They note that although the market is growing at a furious pace, few companies are making money. Our research suggests that profits will indeed materialize, but only players with the deepest pockets will survive to enjoy them. Successful online video sites will need capital on three fronts: to expand their bandwidth; to attract experienced online advertising salespeople, who are in short supply; and, most important, to buy the content that will win the biggest audiences and the most advertising. The best-funded sites are therefore likely to pull steadily ahead, in what could be a winner-takes-all phase of the market.

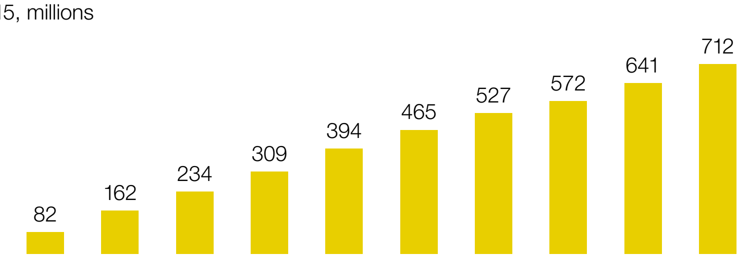
The average Chinese user spends four hours a week watching online video content, such as movies, TV, and live sports—double the time spent by US users. That high figure partly results from taste: the user-generated content so popular on sites such as YouTube has

[1] To better understand China's online video market, McKinsey interviewed 22 executives at online video companies, advertising agencies, and content providers, as well as academics and regulators. The research also included an online survey of 1,500 online video users, a telephone survey of 100 more, and eight home visits and interviews.

Exhibit

By 2015, more than 700 million Internet users in China are expected to watch video content online.

China's online video users,[1] 2006–15, millions



	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Year-on-year growth, %		98	44	32	28	18	13	9	12	11
Penetration: online video users as % of Internet users[2]	60	77	79	79	82	84	86	87	88	89

[1] Internet users who watched online video content in past 6 months; 2010 figures are estimated, 2011–15 are projected.
[2] Share of Internet users who have surfed Internet in past 6 months and also watched videos online.

Source: iResearch Apr 2010; McKinsey analysis proved less appealing to the Chinese, who prefer professionally made offerings.[2] Yet the difference is also a question of supply: the online video sites often have a much wider choice of content than do China's pay-TV channels, which find themselves caught in a bind. Although more than 40 percent of Chinese households (close to 200 million) have pay-TV subscriptions, the charge of just 15 to 20 renminbi (about $2.32 to $3.09) a month is so low that the pay-TV operators have been unable to invest in either their networks or content. That explains why only 80 million viewers have switched to digital, despite government efforts, as it offers little more content, for twice the money.

Internet Protocol television (IPTV), with its video-on-demand offering, isn't about to take off. Telecommunications companies are currently preoccupied with upgrading their networks to offer faster broadband Internet connections, but regulatory hurdles prevent them from offering IPTV as an alternative to cable-based pay-TV.

This lack of imminent competition gives online sites some breathing space to strengthen their business models. Advertising revenues will undoubtedly grow. Last year, they were estimated at 3 billion renminbi, some 8.8 percent of China's total online ad expenditures. Advertisers we surveyed said that this sum would probably double in 2011, to 6 billion renminbi, and reach more than 13 billion renminbi by 2013—well over 16 percent of total online ad spending.

But what of costs? The single biggest future one will be content, which used to come cheap—not least because so much of it was pirated. But the government is now attempting to enforce licensing rights, and companies considering initial public offerings in Hong Kong or the United States are keen to comply. In addition, there is fierce competition for content among China's 200 or so online sites. Expenses have already shot up: *Golden Marriage*, a popular Chinese TV series, cost 8,000 renminbi per episode in 2008, the sequel the following year 80,000 renminbi. We estimate that costs will rise 50 to 80 percent in 2011.

As content volumes rise, so too will the cost of expanding the network to cope with user demand. Peer-to-peer technology, which lets viewers download content from each other rather than from servers, is relatively inexpensive. But the nature of the technology means that it is really suitable only for very popular programs that people watch simultaneously, such as a live football match, and is therefore a limited solution.

Another (often unconsidered) cost and a potential barrier to growth is the shortage of advertising salespeople with experience in the Internet environment. The industry experts we interviewed estimated that only about a third of the 2,000 Internet salespeople in

[2] Seventy-four percent of online users in our survey said they mostly watched movies and TV while online. User-generated content ranked near the bottom of ten categories.

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China had enough. “Most of those at leading Internet players have stock options. They are reluctant to move unless you pay them very high salaries,” said one executive. Increases of up to 40 percent are not unusual.

The best business model under these conditions is still unclear. Some sites charge advertisers to host their own branded channels, some charge subscribers for an ad-free service, and some have found partners to move into e-commerce and online gaming.

Other sites are creating their own shows—either in-house or with partners—becoming more like integrated media companies than simple distributors and cutting costs and differentiating themselves in the process. Still others are experimenting with additional foreign content: for Hollywood studios that want to crack the Chinese market, online video sites may prove to be critical collaborators.

Ultimately, as with Chinese Web portals a decade ago, the first online sites that can tap the capital markets may turn out to be those that prosper, thanks to the necessary financial firepower. These players, having built their brands, content libraries, and easy-to-use interfaces, will be in the best position to tap into new revenue pools as the default partners for telecom operators offering IPTV or for Chinese TV manufacturers integrating Internet TV into their television sets. At that stage, online video sites will be an even greater power to reckon with on China’s media landscape. Content providers the world over should take note.

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