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Investing in Communication Services

Communication Services Sector Report

August 05, 2020

ANALYST(S)

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Companies mentioned in this report (SFL indicates companies on the Edward Jones Stock Focus List):

- **Activision-Blizzard** (ATVI - $86.45; Buy)
- **Alphabet** (GOOGL - $1,473.30; Buy) - SFL
- **AT&T** (T - $30.01; Buy)
- **BCE** (BCE - $42.71; Buy)
- **Comcast** (CMCSA - $43.21; Buy) - SFL
- **Disney** (DIS - $117.29; Buy) - SFL
- **Facebook** (FB - $249.83; Buy) - SFL
- **Omnicom** (OMC - $53.14; Buy)
- **Verizon** (VZ - $57.91; Buy) - SFL

Prices and opinion ratings as of market close on 8/4/20 and subject to change. Source: Reuters.

Investment Overview

The communication services sector represents about 10% of the S&P 500 Index and includes companies that develop, aggregate and transmit information to businesses and consumers. We have a positive long-term view of the sector; however, we feel that the sector faces risks from increased regulatory scrutiny and heavy competition. We prefer the companies that are most exposed to fast-growing online advertising spending, online subscription services, high-speed data connections, and wireless.

Near-term Risks and Impacts From the COVID-19 Pandemic - Companies in the communication services sector face varying levels of risk associated with the COVID-19 pandemic. We feel that companies with exposure to theme parks and motion-picture production and distribution face high risk in these businesses due to travel and crowd restrictions. However, we feel that these segments can recover after the current restrictions are lifted, and we feel positive about their longer-term outlooks. Also, companies with TV-advertising revenue could see cuts in ad activity. We estimate that companies with exposure only to online advertising could see reduced activity, but we still expect growth in total online ad revenue for the year. We anticipate companies that generate most of their revenue from wireless and Internet services will be least impacted because customers rely on these services for connectivity.

Digital Media Offers Best Growth Opportunity - Users are increasingly seeking information and entertainment online. As viewership moves away from print, broadcast TV and pay TV, advertisers are shifting their spending online. This trend is driving strong double-digit growth in online ad spending.

Online Video Replacing Traditional TV - Users increasingly seek video content online from numerous sources, including subscription-based services, such as Netflix, Hulu and Disney+. They are also shifting from cable and satellite pay-TV services to online subscription services that offer traditional TV channels, such as Dish's Sling TV and Google's YouTube TV. Also, free video on YouTube and social media sites are capturing more consumer time and attention.

Video Games Offer Attractive Growth - Video game developers continue to pursue new sources of growth, taking advantage of popular game franchises to drive revenue from in-game purchases and advertising. Developers are also still in the early stages of realizing value from esports, one of the fastest-growing professional sports categories.

High-speed Connections Increasingly Important - Service providers must offer increasing speeds for Internet service as multiple users in a household access content. As a result, consumers are willing to pay more for faster speeds. We believe that service providers who enable faster connectivity will be best-positioned to grow.

Wireless Services Are Growing Modestly but Could Accelerate With 5G - The industry's move away from wireless-service contracts and the introduction of unlimited wireless data plans constrained wireless growth for several years. Growth has resumed now that competitive pressures have eased. We anticipate modest near-term growth, and we expect improved growth in 2021 and beyond as fifth-generation (5G) wireless services become more widely available.

Recommended Names Should Benefit From These Trends - In media and entertainment, we recommend stocks that are benefiting from growth in online ad spending, online video services, video gaming and Internet services. In telecom, we favor stocks that are exposed to wireless and data services.

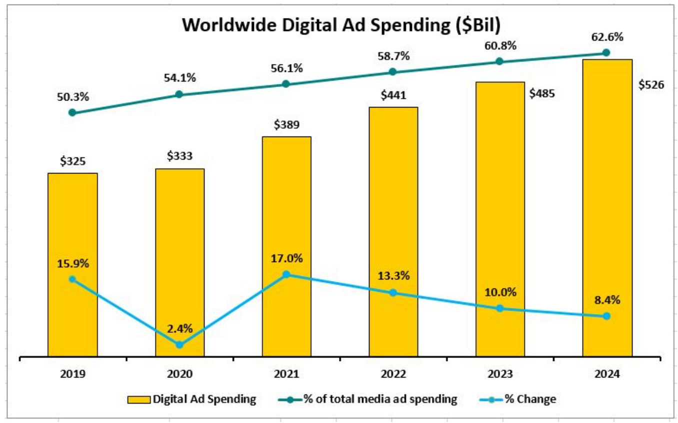
Valuation - We believe that our Buy-rated stocks trade at an attractive price-to-earnings (P/E) ratio relative to the companies' expected long-term growth outlooks. In our view, several of these stocks offer an attractive total return from share-price appreciation and the dividend yield.

Massive Shift to Online Media and Advertising

Over the past 20 years, consumption of various forms of media has dramatically shifted to online sources. News stories, searches for information, and video content have all moved online. The emergence of new technologies, such as social media and smartphones, have caused users to further increase their online viewing time. Video content has become available from a number of sources, which include free content on Google's YouTube, or on social media sites and paid subscription video-on-demand (SVOD) services, such as Netflix and Disney+.

As consumer attention has increasingly moved online, advertising spending has followed. Online or digital ad spending has grown at a strong double-digit rate for several years. We expect growth to slow in 2020 due to the COVID-19 pandemic, but we estimate it will resume at a double-digit rate in 2021 and beyond (Figure 1). Online advertising has grown to a point that more ad dollars are being spent on digital media than on other forms of media. We think that this trend will continue into the future and that online advertising will continue to grow faster than traditional-media advertising.

Figure 1 - Estimated Worldwide Digital Ad Spending - $325 Billion and Growing



Source: eMarketer

The primary forms of digital advertising are display and search. Display includes the image or video ads that appear on websites, on social media sites, or during YouTube or other free online video content. Search advertising reflects the money paid to search engines, such as Google, for a business' content to be prioritized to appear near the top of results for certain search criteria. Google's share of the worldwide digital ad market is estimated to be about 30%, and Facebook's share is estimated to be about 20%. These shares are even higher in the U.S., where the two companies garner over 60% of the market combined.

TV Ad Revenue Is Surprisingly Resilient

The shift of viewing time to online sources from traditional TV has caused viewer ratings to consistently drop for broadcast and pay-TV channels. Despite declining viewership, TV ad prices have continued to grow due to TV's effectiveness in reaching a relatively large audience. As a result, total advertising revenue across broadcast and pay-TV has remained relatively stable in recent years.

Media companies that operate pay-TV channels have benefited from stable ad revenue but have suffered from declining subscriber levels. Pay-TV subscriber levels peaked at around 80% of households in 2012 and have been falling ever since. Channel operators, such as Disney (ESPN, Disney Channel, etc.), AT&T (Turner Broadcasting, CNN, etc.) and Comcast (MSNBC, USA Network, etc.), have been able to still modestly grow subscription revenue by raising subscription fees. Pay-TV distributors, such as cable-TV, satellite-TV and telecom companies, were initially able to keep revenue stable via price increases and offering additional features, but more recently, pay-TV revenue has started to decline. In the future, we think that subscriber and ad revenue will be flat to modestly declining due to price increases partially offsetting subscriber losses. The cash generated from pay-TV services can help fund investment in new online services, in our view.

Changing Landscape Is Driving Consolidation and the Introduction of New Online Services

With these rapid changes, some pay-TV distributors have acquired content companies to improve their strategic positions and reduce costs. This trend started with Comcast's 2011 acquisition of NBC Universal and has continued more recently with AT&T's acquisition of Time Warner. Media companies have also consolidated, such as Disney's acquisition of Twenty-First Century Fox. These acquisitions reflect the value of owning high-quality content to attract viewers to streaming services. We anticipate further consolidation as a means of reducing costs, increasing content libraries, and preparing for new online services.

Across the media landscape, content originators have been developing their own online services to compete with SVOD services. Disney has introduced its Disney+ and ESPN+ services and has gained majority ownership in Hulu via the Fox acquisition. In 2020, Comcast is introducing its Peacock service, and AT&T is introducing HBO Max. Some pay-TV companies have launched slimmed-down online bundles of pay-TV channels for customers who still want access to live sports and other pay-TV programming. Examples of these services include AT&T Now, Dish's Sling TV and Google's YouTube TV. The traditional media companies are introducing these services to capture growth from the online migration and to offset declines in broadcast and pay-TV subscribers.

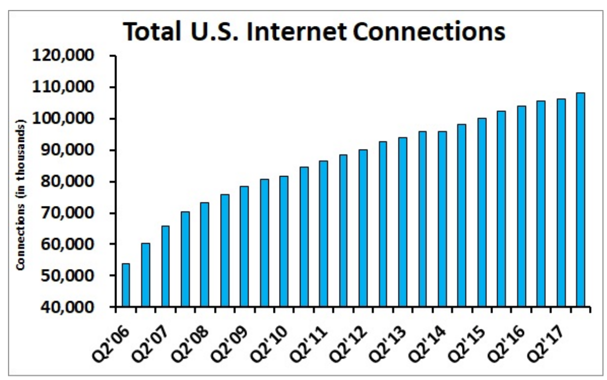
Video Gaming Offers Growth Opportunity From Multiple Drivers

We have a positive long-term outlook on the video game industry. We believe the industry can grow at least 8% due to growth within mobile and console gaming, more focus on in-game purchases and advertising, and growth within esports. As more and more of the population has access to smart phones, it only increases the potential for more gamers playing mobile games. With consoles, we expect the launch of the next generation of consoles to help drive attractive growth within this segment. In our view, the focus on increased in-game content will drive higher engagement among gamers. Further, continued growth within in-game advertising could add another lucrative revenue stream for game companies. Finally, as esports continues to grow in popularity, this should drive higher engagement, more in-game purchases tied to esports teams, and the potential for higher licensing and advertising revenue tied to esports broadcasts.

Telecom and Cable-TV Companies Need Broadband and Wireless Exposure

Traditional telecom providers have faced declines in voice telephone lines and other wireline services for years. To partially offset these declines, they have invested in upgrading their networks with fiber-optic technology to offer faster speeds for home Internet service and business data services, the two areas of wireline telephone services that are growing. Cable companies are especially well-positioned for providing high-speed Internet service because their networks enable faster speeds than what are available on copper-based telephone networks. Overall, high-speed Internet connections have grown steadily in the U.S. (Figure 2), which we think will continue and will especially benefit cable companies, such as Comcast.

Figure 2 - Total U.S. Internet Connections



Source: FCC

More importantly, telecom companies need exposure to the wireless market, which is larger than the wireline market and offers better growth potential. The pricing in the wireless industry was challenging for a few years during the transition to unlimited data plans and away from two-year contracts, but now competitive pressure has subsided, and the industry is growing again.

Over the next few years, the emergence of fifth-generation (5G) wireless networks could be a new growth driver for wireless revenue. Network activations of 5G technology have begun, although we expect that nationwide availability could take several years and will require the construction of small cell networks to enable faster speeds. We anticipate that 5G networks will enable emerging technologies, such as driverless cars; advanced Internet of Things (IoT) capabilities, such as automated traffic control and other "smart city" applications; and extensive health care monitoring and proactive medicine.

How to Invest in the Sector

We recommend that in a diversified equity portfolio, 10% of equity assets be invested in the communications services sector. The media & entertainment subsector is the largest component of this sector, so we recommend starting here. The stocks within this subsector can be sensitive to economic cycles and may have some volatility in their share prices. In the media & entertainment subsector, our current Buy-recommended names are **Activision Blizzard**, **Alphabet** (Google's parent company), **Comcast, Disney, Facebook** and **Omnicom Group**. Our outlook for these companies is positive because they are exposed to one or more of the industry growth drivers, and they trade at attractive valuation levels.

Activision-Blizzard is well-positioned to benefit from growth in mobile and console gaming based on its solid positioning in these segments, more focus on in-game purchases and advertising within its popular core gaming titles, and its leading position within the growing esports market.

Alphabet (Google) is a dominant company in the fast-growth market of Internet advertising, and we expect this leadership position to continue given its superior user experience.

Comcast is exposed to high-speed Internet services, is successfully penetrating the business data services market, and is benefiting from proprietary content via its NBC Universal ownership.

Facebook is the largest company in the social media space with 2.9 billion users worldwide across its Facebook, Instagram and WhatsApp platforms. We expect Facebook to grow faster than the overall online advertising market.

With **Disney's** acquisition of Fox completed, we recommend buying Disney shares because we believe the addition of the Fox studio and TV-production assets, plus the gain of a controlling ownership in Hulu, will bolster Disney's competitive positioning in the growing online video space.

We view **Omnicom** as the leading provider of advertising and marketing services, and we feel that its leading reputation within the industry, strong financial position, and global footprint position the company well to compete as spending shifts to more digital advertising.

To offset potential cyclicality in the media & entertainment subsector, investors may diversify their holdings with stocks from the telecom services subsector. Companies in this subsector have historically been less sensitive to the health of the economy due to their relatively stable earnings. Because telecom services stocks typically pay high dividend yields, they tend to be sensitive to interest rates and may underperform the overall equity market in a rising-interest-rate environment.

In the telecom services subsector, our current Buy-recommended names are **AT&T, BCE** and **Verizon**. These companies are exposed to both wireless data and high-speed Internet services and are involved in the video services market.

Please see the full opinions of the individual companies mentioned in this report for additional information, including valuation and risks.

Valuation

The valuations of communication services companies are attractive, in our view. Thus, we see opportunities in companies that offer potential long-term growth that is above the sector average. When valuing communications stocks, we use a combination of methodologies, including price-to-earnings (P/E) ratios on an absolute and relative basis, as well as discounted cash flow (DCF) analysis. We typically look for stocks that are trading below their historical average P/E ratios and trade at share prices that we believe do not fully reflect the companies' long-term growth outlooks. We also consider a stock's potential total return, which includes both share appreciation and the dividend yield.

Risks

Investors face several risks investing in the communications services sector, in our view. The sector is highly competitive and is facing rapidly changing technology. Stocks in the media & entertainment subsector tend to be more sensitive to economic cycles. The telecom services subsector requires significant investment to add network capacity and deploy emerging technology, and these stocks tend to be sensitive to interest rates. Thus, this subsector tends to underperform the overall equity market in a rising-interest-rate environment.

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