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21st CENTURY THEMES

Digital leisure: leveraging the consumer revolution

'Digital leisure' is a global investment theme that encompasses innovative online and mobile consumer content with leisure activities designed for our entertainment.

We explore the breadth and appeal of the diverse sectors that make up the digital leisure universe including social networking, social gambling, real-money gambling, video gaming and digital music, film and TV. We also discuss how these sectors are likely to evolve, grow and consolidate into increasingly attractive investment opportunities as these activities become subject to increasing monetisation.

Today's digital age influences our lifestyles as much as any industrial or cultural revolution in history. As consumers, we are at the heart of the digital revolution by choosing to spend more of our leisure time online using computers and digital televisions and connecting with mobile devices like touch-screen tablets and smartphones.

Technology has enabled consumers to tailor leisure content to their precise tastes and preferred formats. We can spend our downtime engrossed in digital music and film, high-stakes poker games and the latest blockbuster video games online. Digital leisure's disruptive trends have already gained considerable commercial traction. Almost half of the video watched in the US, for example, has shifted to digital video recorders as well as video-on-demand. Music has become even more digital in nature with more than two-thirds of content being consumed in streamed, MP3 and satellite radio formats.¹ User-behaviour changes look set to continue to disrupt existing industry value chains and economics across digital leisure, introducing risks but creating investment opportunities.

Industry research shows that consumer demand for entertainment and media will continue to grow at a similar rate to GDP in the period 2013-2017. The global entertainment and media market is expected to generate revenues in 2017 of \$2.2 trillion, up from \$1.6 trillion in 2012.²

We examine how the different sectors vying for consumer attention and market share are aiming to make their offerings appealing to consumers and to the investors seeking to share in the upside of the continuing digital leisure revolution.

AT A GLANCE

- **Digital leisure** is a global investment theme with very broad relevance and appeal.
- **Technology** advances have facilitated the growth of disruptive sectors in the digital leisure universe.
- **Digital and mobile advertising** spending totals are on target to outstrip traditional advertising spending.
- **Social networking** is constantly evolving its product offering to appeal to users and advertisers.
- **Monetising social gaming and social gambling** continues to be a hot topic.
- **Online gambling** has tremendous growth potential but faces fiscal and regulatory pressures.
- The **video gaming** industry has matured and appeals to a broad group of users.
- **Digital music, film and TV** continue to attract **disruptive innovations**, sparking intense competition and commercial agreements.

GLOBAL ADVERTISING MARKET BY KEY SEGMENT (\$BN) 2011-2017

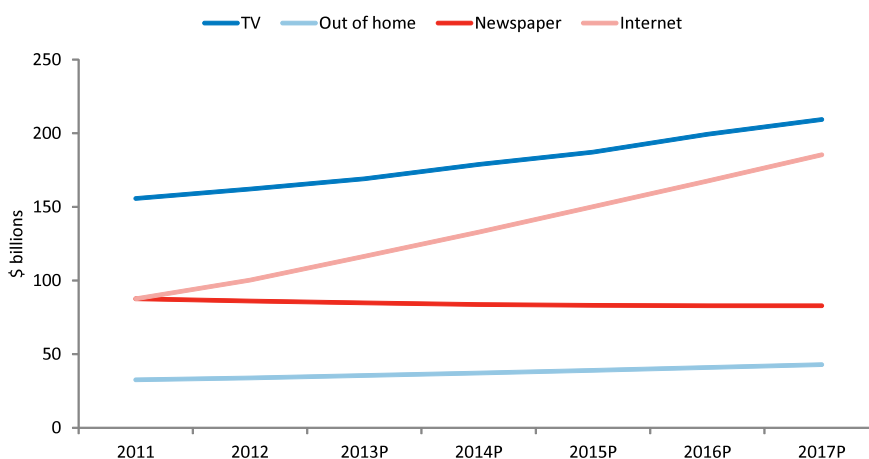


Chart 1. Source: Global Entertainment and Media Outlook 2013-2017, PwC.

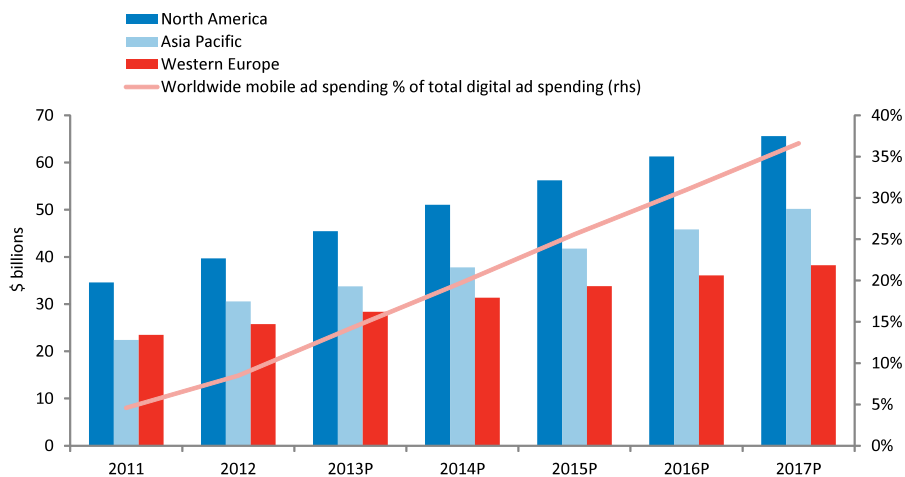
ADVERTISING REVENUE SUPPORTS CONSUMER-FACING INDUSTRIES

Considering the projected global advertising spend over the next five years, Chart 1 shows that the fastest-growing segment is expected to be internet advertising, which is forecast to total more than \$185 billion in 2017, up from an actual spend of just over \$100 billion in 2012. This strong year-on-year growth in internet advertising reflects the growing penetration of internet-connected users visiting digital leisure websites, particularly free-to-access social media and entertainment sites.

Although global TV advertising is still projected to be the largest advertising segment in 2017 at over \$209 billion (up from \$162 billion in 2012), the rate of growth is far slower than for internet advertising, so we can see the disruption created by the internet. The trajectories of these two advertising segments in Chart 1 show that it will only be a few years before internet advertising spend overtakes TV advertising in absolute terms.

Advertising will continue to be a vital revenue stream in the digital industries, particularly for social networking businesses that have managed to build major brand acceptance and loyalty by making their services appealing and free to access. The short-term challenge for many social networking and other free-to-access websites will not only be to ensure that the various advertising revenue streams are maximised but that they continue to convert free-to-access users to paying subscribers.

DIGITAL ADVERTISING SPENDING BY REGION (\$BN) AND WORLDWIDE ADVERTISING AS A % OF TOTAL DIGITAL SPENDING (2011-2017)



Note: digital advertising includes advertising that appears on desktop and laptop computers as well as mobile phones and tablets. It includes all the various formats of advertising on those platforms. It excludes SMS, MMS, and P2P messaging-based advertising. Mobile advertising includes display and search but excludes SMS, MMS and P2P messaging-based advertising. It also includes spending on tablets.

Chart 2. Source: eMarketeer, August 2013.

THE LIFEBLOOD OF SOCIAL NETWORKING TODAY IS ADVERTISING REVENUE

Media companies that rely heavily on advertising revenue need to maintain their skill in balancing their buy-sell relationships with their stakeholders – this keeps their advertising revenue flowing. To combat the slower growth rate in internet-based advertising this year and last, some companies have focused on generating financial leverage from its mobile users. Chart 2 shows the worldwide average of mobile advertising as a percentage of digital advertising spending is just over 14% in 2013.

SOCIAL NETWORKING'S TAKE ON GAMBLING IS EVOLVING

Social gambling is a large and potentially high-growth industry, which is an intrinsic part of the social networking sector. Keeping social networkers occupied with social gambling and social gaming while connected to the site obviously has the potential to boost a social networking site's advertising revenues, which helps to pay for these games. So, most social gambling games follow a 'freemium' or free-to-play model, where users can play for free using complementary chips or betting tokens that are reloaded every day. Although users who want to continue playing immediately can pay for additional credits, only an estimated 2% of all social gambling users spend any money on a monthly basis.⁵ The most popular social gambling games are poker with 47% of market share, slots (27%) and casino (17%)⁶ – these are also very popular real-money gambling games.

Convergence between online (real money) and social (virtual currency) gambling is a hot topic in the gambling industry as service providers look for ways to convert social gamblers to real-money games. Social gambling could grow from \$1.7 billion in 2012 to a projected range between \$2.5 billion and \$7 billion by 2015, according to research by Morgan Stanley. A proportion of the estimated 170 million social gambling player base could be converted to real money gambling. Table 1 shows how social gambling in 2012 was still a very small slice of the online gambling market; only 3.2 million of the 173 million social gambling player base were actually paying to play.

SIZE AND REVENUE OF GAMING AND GAMBLING MARKETS (2012)

2012	Social gaming	Social gambling	Online gambling
Player base (m)	799	173	49
Market size (m)	7,952	1,704	35,058

Table 1. Source: SuperData Research, H2 Gambling Capital, Morgan Stanley Research

CONVERGENCE AND ACQUISITIONS IN ONLINE AND SOCIAL GAMBLING

There is a growing convergence between online gambling and social gambling companies. While some social gaming companies have skirted with the idea of online gambling and pulled back, online gambling operators are expanding into social gambling. Social gambling is still unregulated and could thrive where online gambling is restricted. Regulation of real online gambling in currently unregulated jurisdictions could drive higher conversion rates and boost industry growth, allowing social and real-money gambling to converge. Winners will excel in scale, balance sheets, technology, marketing and regulatory skills.

ONLINE GAMBLING IS DEVELOPING QUICKLY

Gambling and bookmaker firms with existing brand loyalty and a solid grasp of managing regulatory risk are well positioned to increase their product offerings and to secure more market share. But there is still close scrutiny from regulators and governments. There are structural growth drivers that support the investment case for online gambling including increased social acceptance in social frameworks, incremental revenue from mobile and online gambling, increased frequency of play and the total amount spent by users.

New digital and mobile products continue to be introduced alongside existing offerings – these include in:play (live match-betting), live casino and fast poker games. What is likely to distinguish the winners from the losers though will be their scale and operational efficiencies. An interesting feature of some gambling stocks – particularly companies with exposure to online and mobile services – is that valuations do not really reflect their long-term revenue growth potential. This means investors need to keep a keen eye on

the players as stocks in this sector tend to move quickly.

In late August, Delaware – the first state in the US to offer legal casino games online – gave the green light to its three casinos to launch the first phase of the state's online gambling operation. The casinos opened internet portals for free slots, poker, blackjack and roulette games, supported by the Facebook-hosted game platform DoubleDown Casino, run by IGT, one of Delaware's contractual slots vendors. The no-money games are a precursor to the state's full-service, real-cash online gambling operation, planned to launch in late October.

VIDEO GAMING: DIGITAL AND MOBILE GROWTH PICKS UP

Digital gaming is a growing industry with a rate of sales growth that is catching up with the sales growth of physical games. Global market revenue for physical video games reached \$8.8 billion in 2012, digital sales totalled \$5.9 billion, followed by \$4.0 billion in hardware sales and \$1.9 billion in accessories sales.⁷ The trend shows that more people are spending their leisure time and money on mobile gaming (see Chart 2). Digital sales are generally on the rise, at a pace of 22% year-on-year.⁸ The ratio of sales in the gaming industry shifted from 80% physical and 20% digital in 2009 to 60% and 40%, respectively, in 2012.

The gaming industry is developed enough to boast its own distinct player categories, which reflect individuals' appetite to play video games. 'Hardcore' gamers – who purchase and play PC and console games – have been around for decades and remain the largest driver of video games sales. For these consumers, gaming is a primary hobby and they are willing to pay for high-quality games and graphics.

GLOBAL MOBILE GAMING REVENUES (\$BN) 2008-2017

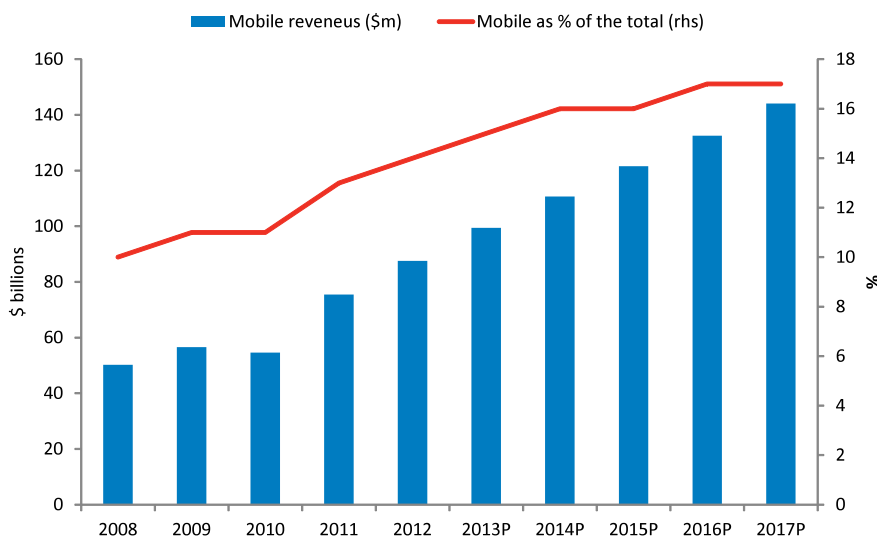


Chart 3. Source: Global Entertainment and Media Outlook 2013-2017, PwC.

While there is significant demand for mobile games, few developers have managed to consistently produce popular games. Digital gaming – especially mobile gaming – is a fragmented industry with scores of companies laying claim to very small percentages of the overall market. It is difficult to predict which games will be popular and which will go unnoticed among the tens of thousands of other iOS or Android games – and this presents a significant challenge to smaller digital game developers.

Many companies have found success in the changing digital gaming industry by targeting hardcore, midcore and casual gamers at the same time. The big money is still in physical games, but the growing mobile market offers attractive growth potential. These gaming companies have adapted quickly and successfully to growing demand by converting existing PC and console games to mobile and creating others from partnerships with franchises – tactics that help encourage success amid the uncertainty of game discovery within the mobile gaming industry.

MUSIC, FILM AND TV: TECHNOLOGY IS ENGINEERING DISRUPTION

Digital music, film and TV collectively have very broad appeal across age ranges, social groups and geographies. With the proliferation of internet-connected portable digital devices and PCs, these media segments have displayed some of the most disruptive characteristics of any in the digital leisure universe.

Taking the UK market as an example, digital music and film consumption have both increased notably in the two years to early 2013, according to an IPSO MediaCT survey.⁹ Legal digital music downloads increased from 18% of all music consumption in early 2011 to 23% in early 2013, while CD sales decreased from 37% to 32% over the same period. Legal digital film downloads increased to 10% from 6% and all digital film increased from 11% to 14% over the same period, while DVD and Blu-Ray sales decreased from 40% to 31%. Interestingly, pirated consumption of music (8%) and film (6%) remained flat over the period, according to the survey.

Digital music continues to break into new markets displacing existing retail sales but also creating new markets where no retail option has previously existed. Chart 4 shows how digital music sales are growing strongly at the expense of physical sales.

GLOBAL RECORDED MUSIC REVENUES – PHYSICAL AND DIGITAL (\$BN) - 2008-2017

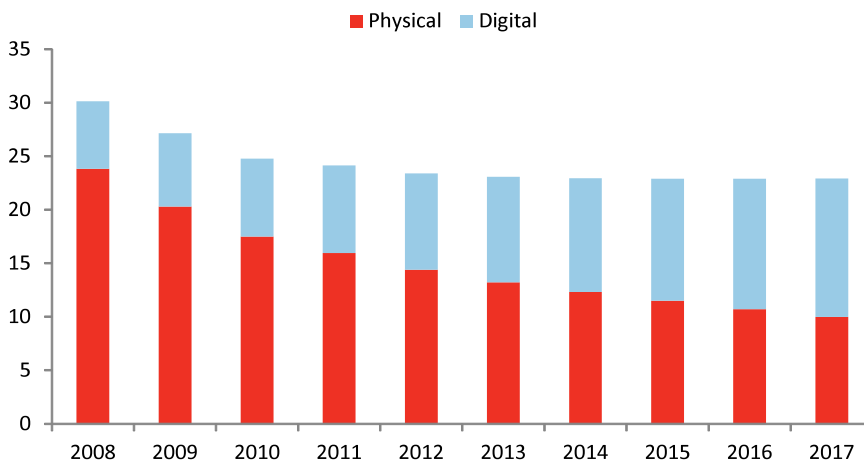


Chart 4. Source: Global Entertainment and Media Outlook 2013-2017, PwC.

MUSIC FILM AND TV ON DEMAND – REPLACING THE PROGRAMMED APPROACH

The race for market share across all of these content sectors is intensifying in all markets as content originators and distributors are cooperating and competing for consumer attention. There are many examples in the vast media world of the blurring of boundaries between content originators, broadcasters, distribution channels and media platforms.

In the US – one of the most developed digital leisure markets – the annual value of the electronic home video market – both for pay-TV and over-the-top (OTT) streaming services – will surpass regional box office cinema for the first time in 2017. North America's electronic home video market will be worth \$14.78 billion in 2017 compared to a box office market of \$13.50 billion. OTT services that deliver video over the internet will continue to grow rapidly, generating revenues of \$17.4 billion in 2017, up from \$5.2 billion in 2012. Subscription and rental models, rather than ownership models, will continue to be the dominant consumer preference.¹⁰

SUMMARY

As advances in technology proliferate and more users worldwide have access to mobile devices and personal computers, there is scope for more widespread disruption of traditional leisure activities by innovative digital alternatives. As well as advances in technology platforms and innovations in software development, we are seeing growing

verification of the premise that 'content is king' within the digital leisure universe. This is likely to stimulate further mergers, acquisitions and commercial agreements across media platforms as companies seek to achieve market-leading positions. The strongest and most successful companies are likely to be agile, flexible and appealing to increasingly sophisticated consumer groups. These companies will also likely lead the way in monetising the many opportunities digital leisure will continue to offer for years to come.

***ALL REFERENCES TO \$ ARE US\$.**

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³ Facebook 2Q accounts, July 24, 2013, <http://investor.fb.com>.

⁴ <http://investor.fb.com>.

⁵ SuperData Research.

⁶ SuperData Research, Morgan Stanley Research.

⁷ The Games Market Dynamics: US, The NPD Group.

⁸ Gamasutra.

⁹ Ipsos MediaCT, Tech Tracker, Quarter, 2, 2013.

¹⁰ Global Entertainment and Media Outlook 2013-2017, PwC.

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