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RESEARCH NOTE

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SUBJECT: **Online Content Research Note**

EXECUTIVE SUMMARY

Why Online Content? Venture capitalists historically avoided online publishing companies largely because content was easy to produce, leading to commoditization and over-supply, but difficult to build an audience around. Furthermore, the reliance on writers to create repeatedly successful content was less attractive than software businesses where engineers could write a piece of software that required updates far less frequently than editorial pieces would.

Gradually over the last decade, as smartphones, tablets, computers, and televisions merged and proliferated, video, audio, and text content became available anytime, anywhere. Rather than "old media online", new online content companies are leveraging technology in innovative ways that have given some in the latest round of entrants the type of attributes attractive to tech investors – **high growth** and **consistent revenue**.

Defining the "Online Content" Market. Online content publishers attract and maintain users while serving advertisers. Many publishers have improved the efficiency of content creation by either leveraging technology platforms or processes that simplify content creation or by farming creation out to their users instead of hiring large content production teams. The most successful businesses are those that efficiently and repeatedly (i) **attract**, (ii) **maintain**, and (iii) **monetize** an audience. This memo is organized by these three aspects of audience engagement.

- **Attract** an audience through the use of advertisement and promotion on social and other media, with social sharing (e.g., Facebook, Twitter, email) increasing that audience over time
- **Maintain** the audience through the delivery of captivating content (typically in the form of *traditional publisher-owned/licensed content* or *user-generated content*)
- **Monetize** the audience by converting site traffic into revenue through various business models (most commonly *traditional display advertising*; new models include *native advertising*, *shoppable content*, *user data sales*)

Growing Market Size. The U.S. internet publishing market is estimated to be $39 billion in 2015 after growing at 9.6% per annum over the last five years, with growth expected to continue at a 5.6% annual rate through 2020. Key growth drivers include increased internet ad spend and rising popularity of mobile.

Market Trends. Advertisers are shifting their spending from traditional media to the internet as publishers have provided increasingly popular platforms for advertisements. Innovation in how these platforms attract, maintain, and monetize their audiences are contributing to accelerated growth.

- **Attract**
  - *Social Sharing Driving the Rise of Dedicated Viral Content* – attracting an audience through social-optimized content
    - Examples: BuzzFeed, Spartz Media, Upworthy, and Distractify
  - *Physical Technology Influencing How Audiences Connect* – content providers gaining the ability to use data, for instance from wearables and connected households, to predict what users want to watch or read with improved recommendation engines

        - Examples: Spotify running playlists choose songs according to pace; consumer blogs use geo-fencing to serve product information to users at the mall

- **Maintain**
    - *Sticky Content Features Follow Demand for Audience Engagement* – publishers experimenting with innovative features (e.g., infinite scrolling, embedded quizzes) to increase the value of content for advertisers (e.g., increased ad impressions per visit, total minutes spent on the page)
        - Examples: Twitter and Facebook infinite feeds, BuzzFeed quizzes
    - *User-Generated (and Curated) Content* – offers dual advantages of increasing audience resonance and sourcing without the need to pay content creators
        - Examples: Vine, The Huffington Post
    - *Enthusiast Communities / Vertically-Focused Content* – web destinations targeting a small but committed audience by focusing on a defined subject matter (attractive to advertisers seeking to target a specific audience)
        - Examples: Search Engine Land, Texture Media, Clinical Advisor
- **Monetize**
    - *Ad-Supported Content – Innovation in Technology Driving Growth* – programmatic has reduced the need for expensive sales teams to monetize undervalued inventory
        - Examples: Smaller websites able to monetize smaller audiences; more popular websites monetizing less popular content
    - *Native Advertising Increasingly Viewed as an Attractive Complement to Display* – publishers investing in technology and creative teams to facilitate in-house creation of native ad content in collaboration with brands
        - Examples: BuzzFeed, Conde Nast, CNN, and Bustle all feature native ads
    - *Paid Content No Longer "Digital Pennies", but Not a Growth Driver* – increased smartphone and tablet penetration and accelerating broadband speeds have led more consumers to pay up for online content
        - Examples: Netflix, Wall Street Journal, Cook's Illustrated
    - *Shoppable Content* – relies on authenticity of voice and distinctive/exclusive products
        - Examples: Refinery29, Net-A-Porter's The Edit, Uncrate

Catalyst Investment Themes. We are primarily focused on digital-first businesses (vs. declining revenue legacy businesses attempting to transition to digital) with the following attributes:

- **Innovative models in attracting audience**
    - Repeatable, scalable, tech-supported methods of attracting audiences
        - Minimize costs of audience attraction through algorithmic audience testing to drive viral promotion of media
        - Leverage formulaic patterns for successful content
    - With a metrics-driven approach to investing, Catalyst applies a unit-focused returns analysis to online content businesses to assess whether they are succeeding at profitably adding customers

- **Engaging content with a targeted message vital to maintaining an audience**
    - Cost-efficient methods of content creation (e.g., outsourcing to a dedicated network of users) while maximizing the quantity of the content for consumers
        - Tech innovation in analytics to optimize what content is produced, how it is packaged, when and to whom it is served, and its placement on the site

        - Interest in sites with an enthusiast audience, typically evidenced by a strong social following
    - Catalyst assesses premium content businesses to determine whether they have achieved a critical mass of visitors (verifying visitor engagement via metrics such as time on site)

- **Innovative monetization approaches**
    - Businesses with proven, scalable branded content and native advertising strategies to monetize content without alienating audience, or shoppable content sites that wed a captive audience with the platform to convert
    - Catalyst has more experience with B2B/B2B2C business models, and the diversified revenue base (traditional advertising in addition to native ads, transaction revenue, data sales, etc.) represents an attractive opportunity

Conclusion. Given the risk profile of online content businesses (i.e., reliance on consumer tastes, highly fragmented space), Catalyst is interested in opportunities to invest in companies that have demonstrated success in attracting, maintaining and monetizing its audience at scale, with a stable financial profile.

SCOPE

This memo analyzes key trends and areas of interest for Catalyst investments in online content. While in a broad sense, anything on the internet with an audience is "content", for the sake of this research report we will refer to online content as any third-party ad-supported or subscription online destination or digital product to which people navigate for entertainment or information. This distinction narrows the scope to exclude sites such as Catalyst's website that are not monetized through third-party advertisements or a paywall.

MARKET OVERVIEW

In the past, media companies (e.g., newspapers, magazines, TV networks) developed and/or aggregated content to attract large audiences, and sales representatives sold advertising in the form of print ads and TV /radio spots to companies wanting to reach those readers or watchers.

In the online world, content producers, or publishers, have the same function: they attract and maintain users while continuing to serve advertisers; however, the way in which they create value has become more sophisticated. Many publishers have improved the efficiency of content creation by either leveraging technology platforms or processes that simplify content creation or by farming creation out to their users instead of hiring content production teams. Rather than sell advertisements targeting a broad audience, new media disruptors leverage sophisticated information about individual users into hyper-targeted advertisements. These changes have shifted the balance away from media incumbents in favor of innovators.

The online content market, in its broadest sense, includes any content published on the internet, from the *New York Times* to Facebook, from Netflix to the Catalyst web page. More narrowly, it involves the sale of access to online media to consumers (subscription-based models) or ad space attached to online media to advertisers who support otherwise free content for consumers. As with all content businesses, the success of an online content business depends on its ability to (i) *attract*, (ii) *maintain*, and (iii) *monetize* an audience. This research memo is organized by these three aspects of audience engagement.

Attract. *Attracting* an audience to online content is effected through the use of advertisement and promotion on social and other media

- **Social sharing** (e.g., Facebook, Twitter, email) increases that audience over time
- **Virality** is an important aspect of attracting audiences: every day, countless new articles, videos and blogs are uploaded to the internet, and while most of these languish in obscurity, a few go viral, attracting the attention of hundreds of thousands (sometimes millions) of people
    - Studies have found that content most likely to go viral tends to induce activated emotions (ideally triggering emotions like anger, anxiety, or awe), capitalizes on triggers (e.g., brings to mind related events), or makes the sharer feel educated/"in the know"

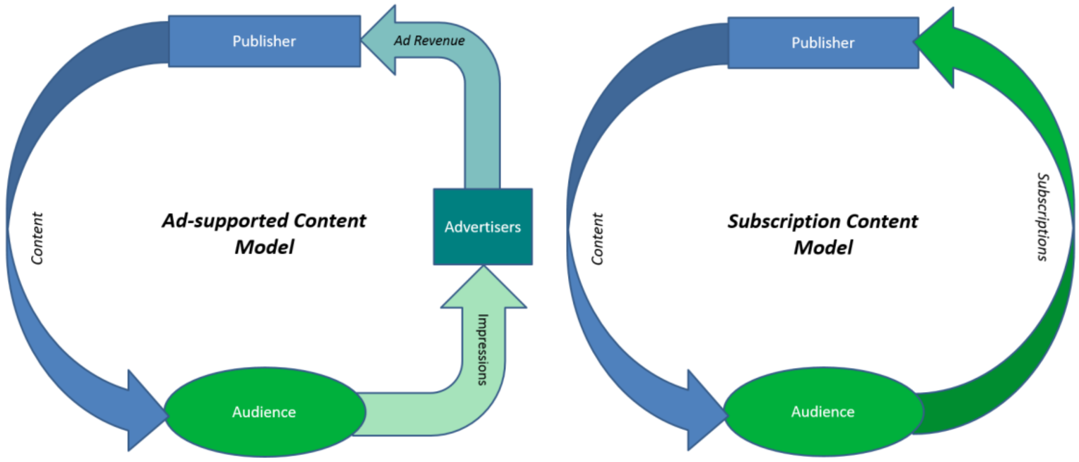
Maintain. An audience is *maintained* through the delivery of captivating content. Below are the key models of content production:

- **Traditional publisher-owned or licensed content** (e.g., an article on nytimes.com or a song on Spotify)
- **User-generated content** (e.g., a YouTube video, blog, or social media post)
- **Curated content** – hybrid of publisher-owned and user-generated content where committed users produce content that is vetted, curated, and published either by content aggregators (e.g., SheKnows Media, The Huffington Post) or by users themselves (e.g., Pinterest, Reddit).

Monetize. Online content *monetization* is the process of converting site traffic into revenue. Business models include:

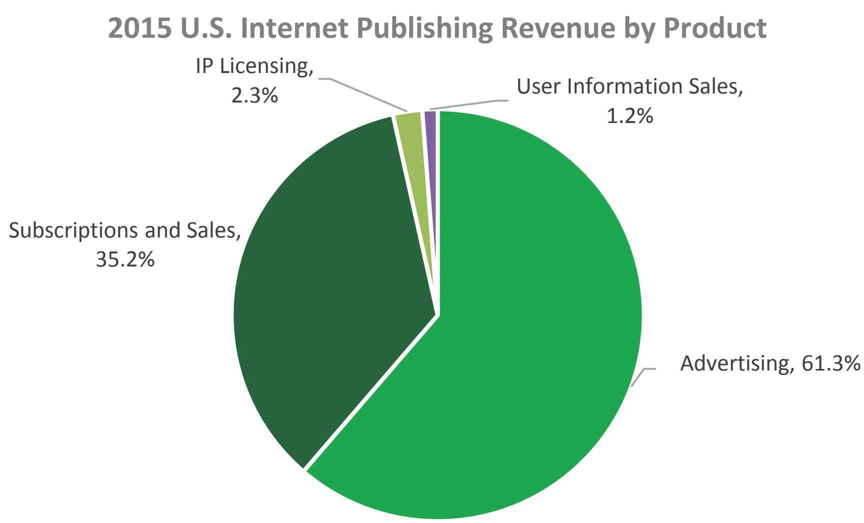
- **Traditional display advertising** (most common business model) – ad networks place advertisements (in various forms: banners, interstitials, screen takeovers, pre-rolls, pop-ups) on pages of the website to benefit from the site's traffic
    - Advertisers compensate publishers on the basis of (i) Cost per Thousand (CPM), (ii) Cost per Click (CPC), or (iii) Cost per Action (CPA)
        - CPM – advertiser agrees to pay the publisher a predetermined amount for every 1,000 ad impressions served; the publisher is paid every time the ad is shown, regardless of whether the viewer clicks on it
        - CPC – advertiser pays the publisher each time an ad is clicked, so the advertiser pays for visitors sent to his or her site via a linked object on the original publisher's site
        - CPA – advertiser pays the publisher (either a fixed or transaction-based fee) for clicks that lead visitors to complete a specific action (e.g., product purchase, document download)
- **Native advertising** – advertisement matches the form and function of the platform on which it appears, such as an article written by an advertiser on a different publisher's site featuring the advertiser's product while using the same format as an article written by the editorial staff
    - **Sponsored content** – Branded content published on a website other than the brand's own
        - According to the *New York Times*, Mashable and BuzzFeed, their respective readers spend as much time reading sponsored content as regular editorial
    - **Branded content** – Media that is associated with a brand and published by the brand on its own platform (e.g., this video produced by Chipotle)
    - **Advertorial** - Ad written in the form of an objective editorial or news article and designed to look like an independent piece
- **Affiliate marketing/lead generation** – website (e.g., EverQuote.com) is paid to funnel its visitors to a third-party site, directly or through selling their contact information
- **Paid content** – transaction and subscription models (e.g., subscription to access The Wall Street Journal)
- **Integrated commerce/shoppable content** – real-time buying opportunities alongside engaging editorial content without disrupting the context of the information (e.g., The Chive, Net-a-Porter)
- **Events** – webinar or conference that users pay to attend or a sponsor pays to host
- **User data sales** – sale of audience data to third-party (e.g., Yummly sells consumer data to large CPGs in a Nielsen-like model)
- There are also various hybrid versions which incorporate several of the above (e.g., Thrillist).

The graphic at the top of the next page outlines a simplified version of the typical online media business model for the two most common forms of monetization: ad-supported and subscription content. The attached market map is organized by content strategy and monetization model.



MARKET OPPORTUNITY

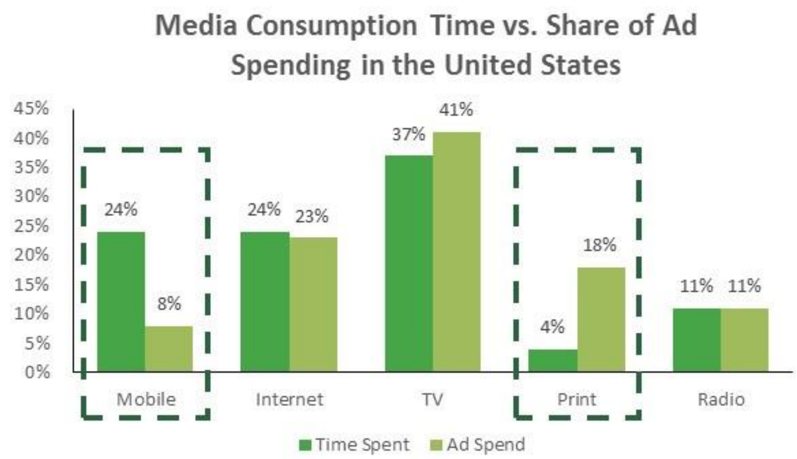
[IBIS World]() estimates the size of the U.S. internet publishing market to be $39 billion in 2015 after growing at 9.6% per annum over the last five years, with growth expected to continue at a 5.6% annual rate through 2020. The pie chart below shows IBIS' breakdown of the market in 2015 by product.



Key growth drivers:

- Increased internet ad spend
    - Advertisers are shifting their spending from traditional media to the internet as publishers provide increasingly popular platforms (grew from 13% of total ad spend in 2009 to 23% in 2014)
    - Increasing programmatic advertising (monetizing media inventory that would otherwise be undervalued)
        - Increasing accuracy of advertisement targeting to individual users based on their personal information and browsing history
        - U.S. display advertising is expected to grow at a 19% CAGR through 2018, driven largely by programmatic, which is growing at a 37% CAGR

- Rising popularity of mobile
    - Smartphones and tablets have increased content viewership across screens and transformed the way it is displayed and produced
        - As depicted in the chart (for 2014, data from IAB), the mobile and internet share of ad spend lags the time spent with mobile and internet media (thus mobile represents an opportunity for increased ad spend as ad dollars shift from legacy print media to mobile and internet)



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    - Mobile ad revenues are growing in concert with mobile connections, which in the U.S. increased at a 24.6% annual clip since 2010, reaching 259.7 million in 2015
        - Of these mobile consumers 63% go online using their phones
    - Mobile advertising is expected to grow at a 54% CAGR through 2018
- Subscription revenue expected to remain relatively constant, with growth in line with the overall industry
    - Consumer digital media spending is expected to overtake traditional media in 2015
    - Paywall strategy is popular among legacy media businesses attempting to transition to digital
    - Digital-first content providers may institute a paywall to restrict certain content to paying customers; however, typically viewers will have the option to circumvent the paywall by viewing an ad
    - Subscription services are more popular for unique content such as TV programs or movies on Netflix or music on Spotify or iTunes

MARKET TRENDS

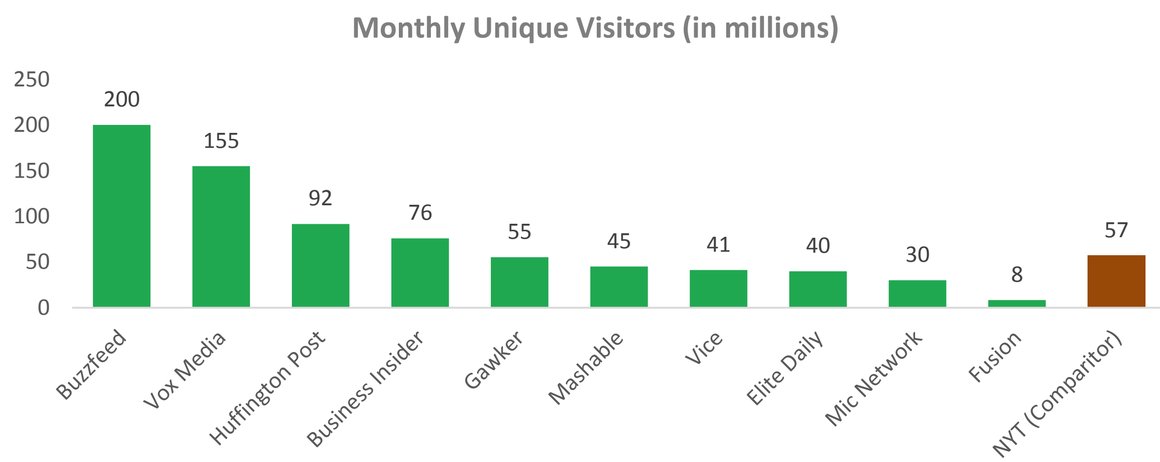
Attract.

Social Sharing Driving the Rise of Dedicated Viral Content

- Attracting an audience through social-optimized content has shifted from a cost-effective means to augment an existing audience to a distinct strategy as new upstarts use tech to capture online eyeballs. Examples of innovative audience attraction tools include:
    - Algorithmic testing of headlines and thumbnails to drive clicks and shares
    - Social monitoring tools to identify engaging content on the web
    - Machine learning to identify which content will resonate with a specific audience
- Peer-to-peer content shares are growing across devices, but the changes are most pronounced in mobile

- According to a report from ShareThis, from January 2014 to January 2015 mobile device sharing activity grew 28%
- Growth driven by tablets, which showed a 49% lift
- By device, smartphones contributed 52% of shares, with desktops and tablets contributing 34% and 14% respectively
- 81% of content shares take place on Facebook
    - The homepage is dying as consumers increasingly rely on social feeds for content

- Companies like BuzzFeed, Spartz Media, Upworthy, and Distractify are attracting high volumes of social users through paid and unpaid social placements, with viral lift multiplying the ad arbitrage returns
    - Viral lift is traffic to a site driven by social shares, which account for the virality of traffic
    - Allows viral media companies to buy advertisements on social media platforms to attract viewers to their site even if the advertising revenue per visit is less than the cost of the Facebook or Twitter ad it required – free social shares multiply the ROI on "paid" audience
- Technology to optimize content for social media has brought huge audiences to new media entrants:



Physical Technology Influencing How Audiences Connect

- Increasing adoption of wearable technology provides a new medium to draw users to online platforms
- Content providers are using data, including from wearables and connected households, to predict what users want to watch or read with improved recommendation engines
- Continued rollout of Google Fiber is allowing true high-definition streaming in 1080p and 4K, encouraging the shift from traditional cable to connected TVs and OTT systems
    - Amazon Prime and Netflix starting to offer streaming in 4K
    - Encourages further shift from old media to IP-delivered platforms and furthers screen convergence

Maintain.

Sticky Content Features Follow Demand for Audience Engagement

- Audience engagement efforts driven by advertiser assertions that many banner ads on a page (especially towards the bottom) are never viewed or clicked
    - DoubleClick found that 56% of display ads it served were not seen
    - Growing skepticism from advertisers about "click-bait" sites not holding audience attention
- Publishers are experimenting with innovative features to increase the value of content for advertisers (e.g., increased ad impressions per visit, total minutes spent on the page)

    - Infinite scrolling provides a passively loaded, never-ending stream of content
    - Increased publishing of quizzes, use of embedded videos, links, and tweets on text pages, and photo galleries that stay on one long page rather than sequential pages (slideshow-style)
    - Video content provides rich media to maintain an audience at formerly print-only destinations
        - Vox Media leveraged proprietary publishing technology to produce video ads for Nike and Samsung
    - Content tuning (e.g., leaving more compelling content on the site longer, creating clutter-free website designs) make pages more attractive to audience and advertisers alike
- Platforms like The Skimm and Fortune's Data Sheet curate the news for their target audience by repackaging it as an email
    - Target the routines of the user base with abridged format and pointed voice (e.g., The Skimm arrives every morning at 6am, just as readers wake up)

User-Generated (and Curated) Content
- User-generated content has the dual advantages of increasing audience resonance, particularly among millennials, and sourcing without the need to pay content creators
    - User-generated content speaks to a site's ability to engage its audience
    - It is difficult to build a community, but user-generated content enables a virtual circle of end users creating content and other end users reading it
        - Increases the stickiness of the site
    - Users also promote their material on social media, increasing audience
- Platforms curating publisher- and user-generated content are destinations as well as traffic directors of the internet
    - Social platforms like Pinterest allow users to organize content from the rest of the web
    - Wikipedia crowd sources the world's collective knowledge
    - Redditor's vote-ups determine what content receives the most attention
    - Social features on Spotify allow users to listen to music their friends have curated into playlists
- Consumer activism - Technology enables advocates to propagate their opinions seamlessly
    - Contributes to popularity of sites like Yelp and TripAdvisor

Enthusiast Communities / Vertically-Focused Content
- Web destinations that target a small but committed audience by focusing on a defined subject matter
    - Examples include WebMD (sick people, hypochondriacs), bleacher report (sports enthusiasts), and Tastemade (foodies)
- Attractive for advertisers hoping to target a specific audience
    - High interest in a subject translates to high purchase intent
- Interested, engaged audience facilitates the building of communities and user-generated content
- Targeted content trades potential reach for loyalty

Monetize.

Ad-Supported Content – Innovation in Technology and Ad Content Driving Growth
- The efficiency of selling ads through real-time auctions has led to a shift to programmatic advertising, which has reduced the need for large sales teams to monetize undervalued inventory
    - Empowers the publishers that own audience
- The ability to marry data about consumer behavior with ad inventory at scale has driven expansion in ad spending as advertisers have extracted increases in ROI and shifted more of their budgets online
- Users prefer ad-supported content: According to a study by the digital advertising alliance, 92% of respondents preferred "free, ad-supported content" rather than "pay[ing] for ad-free content"

- Nevertheless, marketers still pay the highest rates in direct, human-brokered advertising deals, evidencing stubborn reliance on an antiquated practice and room for growth in programmatic

Native Advertising Increasingly Viewed as an Attractive Complement to Display

- Native advertising leveraged for brand and product awareness as well as conversions
- Successful entrants such as Vox Media and BuzzFeed have invested in technology and creative teams to facilitate the in-house creation of native ad content in close collaboration with brands
    - BuzzFeed earns the majority of its revenue through native ads such as the following article sponsored by BP:

      28 Podcasts To Rock On Your Next Road Trip

      Avoid radio static during your next road trip and entertain your brain with some solid podcasts. These podcasts can fuel your curiosity, and BP is here to help fuel your journey.

      posted on Jul. 23, 2015, at 10:19 a.m.

      bp fuelthejourney
      Brand Publisher

        - The site claims that the click-through rates on its native "story units" are 10x the industry standard for banner ads
    - Old media companies are also investing in native ad content – CNN created an in-house studio to produce news-like editorials on behalf of advertisers, Conde Nast has a branded content studio where magazine editors work directly with advertisers
- According to Mintel estimates, U.S. native ad spending reached $1.3 billion in 2013 and is expected to rise to $9.4 billion by 2018
- This infographic provides a side-by-side comparison of native and display advertising (takeaway: native advertising is more successful and engaging)

Paid Content No Longer "Digital Pennies", but Not a Growth Driver

- "All-access" services, such as Netflix for film and TV, Spotify for music, and Oyster for books, which provide unlimited content for a monthly fee, are encouraging people to spend more on digital products
    - Consumers opting for unlimited subscription services over a-la-carte models
- Increased smartphone and tablet penetration and accelerating broadband speeds have led more consumers to pay up for online content
    - Access via a mobile platform is often offered as a benefit for signing up for the "premium" (paid) version of a freemium platform
- Hybrid models also show promise, with the *New York Times* reporting over 1 million paying digital subscribers as well as record advertising revenue (at one third of total revenue)

Shoppable Content

- Sites like Food52, Into the Gloss, Net-a-Porter, GOOP, and Preserve combine features like enthusiast content, communities, user-generated-content (blog posts, reviews), and editorial content with integrated buy buttons
    - Allow the brand to remain the official point of sale
    - Avoids inventory risk of point-of-sale vendors without requiring scale of an exchange platform

    - Success determined by authenticity of voice and promoting distinctive/exclusive products
    - Frequently partner with shoppable content enablement providers such as rewardStyle, Spring, and Amplience
- Diversified mix of advertising and transaction fee-based revenues

INVESTMENT THEMES

As online content has solidified itself as the premiere medium for the dissemination of information and entertainment, innovators have developed methods that have shifted the industry from a human capital-intensive, low-growth industry dominated by legacy players to one where a nimble stable of upstarts has allowed for differentiation and growth. This change has pushed content closer to the Catalyst "sweet spot" of technology-enabled services. As we examine the new generation of content businesses, the following attributes stand out among the leaders:

- ***Innovative models in attracting audience***
    - Repeatable, scalable, tech-supported methods of attracting audiences
        - Minimize costs of audience attraction through algorithmic audience testing to drive viral promotion of media
        - Leverage formulaic patterns for successful content
    - Catalyst applies a unit-focused returns analysis to online content businesses to assess whether they are succeeding at profitably adding customers

- ***Engaging content with a targeted message vital to maintaining an audience***
    - Cost-efficient methods of content creation (e.g., outsourcing to a dedicated network of users) while maximizing the quality of the content for consumers
        - Tech innovation in analytics to optimize what content is produced, how it is packaged, when and to whom it is served, and its placement on the site
        - Focus on sites with an enthusiast audience, typically evidenced by a strong social following
    - Catalyst assesses premium content businesses to determine whether they have achieved a critical mass of visitors (verifying visitor engagement via metrics such as time on site)

- ***Innovative monetization approaches***
    - Businesses with proven, scalable branded content and native advertising strategies to monetize content without alienating audience, or shoppable content sites (e.g., Naturally Curly and Uncrate) that wed a captive audience with the platform to convert
    - Catalyst has more experience with B2B/B2B2C business models, and the diversified revenue base (traditional advertising in addition to native ads, transaction revenue, data sales, etc.) represents an attractive opportunity

CONCLUSIONS

In the past three years, Catalyst has reviewed dozens of online content deals, although we have yet to make an investment. Business (vs. transaction)-specific reasons for declining have included a lack of revenue scale, low quality content with low engagement/short site visits, limited track record of demonstrated technology success, growing digital revenue being offset by declining print revenue, and reputational risk from unsuitable content. As we evaluate existing and new content businesses, we'll continue to look for properties with **(i) re-occurring or recurring revenue profiles**, **(ii) consistent traffic and advertising revenue**, **(iii) repeatable data- and technology-supported practices,** and **(iv)** the **opportunity to grow** by exploring alternative content monetization strategies.

When measuring the success of online content companies against scale, a barbell effect appears. A strategy of remaining small and targeted works for companies like Search Engine Land and The Awl, since less expense is needed to attract a sufficient audience. At the same time, massive scale and a broad audience can work for companies like BuzzFeed, Vox, and Vice because they have the reach that attracts advertisers (since the most lucrative advertising contracts are negotiated at large scale, the size of a platform's audience can be the key to its survival). In between are less targeted content companies investing heavily in achieving that scale. If they are unable to attract a broader audience and lucrative direct-to-brand advertising contracts, they can lose momentum and are shuttered or rolled up.

Given the risk profile of online content businesses, Catalyst will review deals at our typical $10 million revenue threshold while keeping in mind that the most attractive transaction for our investment mandate may be to invest in a later-stage company that has demonstrated success in attracting, maintaining, and monetizing its audience at scale, and that has a stable financial profile.

Catalyst Investors employs a proactive, research-based approach to investing. We target sectors that are experiencing above-average growth. If you are a growth-stage content company seeking investment, our team would love to start a dialogue. Please send inquiries and business plans to david@catalyst.com.