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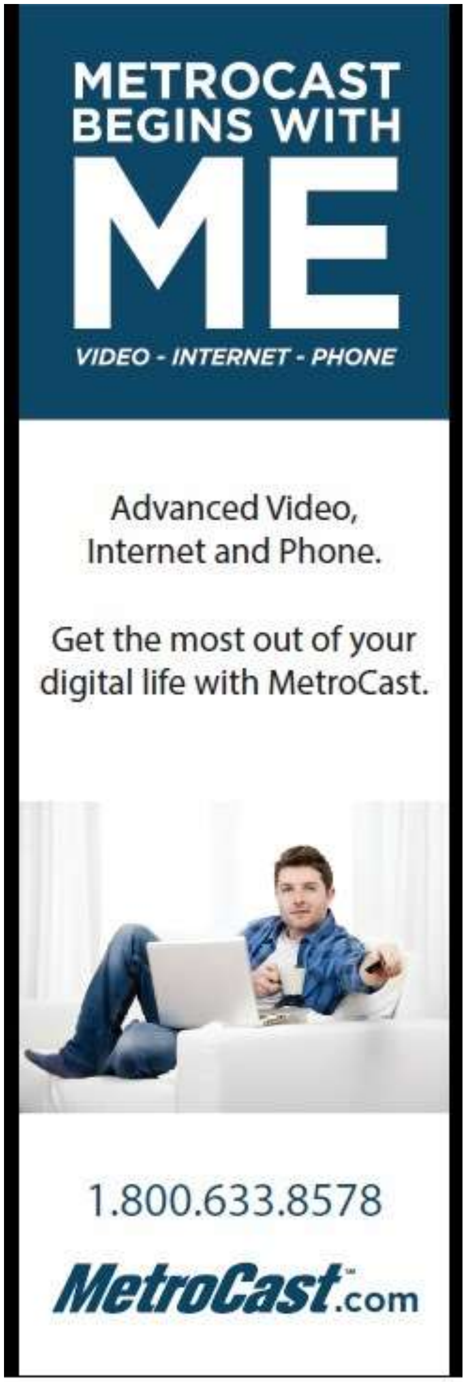
The pay-TV business finally looks like it's about to get seriously disrupted by the internet. And the insurgent now leading the most aggressive attack the industry has ever seen is Randall Stephenson -- who runs the largest pay-TV business in the U.S.



The AT&T chief proudly dropped a bombshell in announcing that the new DirecTV Now service will include a core bundle of more than 100 live channels, priced at a head-turning $35 per month. That's far lower than anyone expected, prompting analysts to suggest the internet-delivered offering likely has a negative net margin. It's also much more affordable than DirecTV's entry-level satellite service that features 145-plus channels, which carries a regular price of $88 monthly.

"This is the most exciting thing I've been a part of in a long time, and I can't wait," Stephenson said last month at the Wall Street Journal-hosted WSJD Live conference, where he announced initial details of DirecTV Now. "I border on the evangelical about it," he added. The telco, which declined to make execs available for interviews for this story, expects to launch the suite of DirecTV Now services later this month.

The implications are huge for all players in the sector. That includes DirecTV and its parent company, AT&T, which will likely see their combined 25.3 million video subscriber base cannibalized to some extent by practically tempting its own subs to shift to the cheaper package. The strategy demonstrates that the telco is willing to suffer short-term pain to establish a pole position in the rapidly changing over-the-top marketplace. But the price ceiling AT&T has set for DirecTV Now marks a seismic shift in how TV is consumed in the U.S. "We think the potential day of reckoning for the existing pay-TV ecosystem may finally have arrived," Cowen & Co. analyst Doug Creutz predicts.

DirecTV Now is not the first so-called "skinny bundle" to come along. This new category has already seen consumers' relatively muted reception of Dish Network's Sling TV and Sony's PlayStation Vue. Nor will these offerings be the last: More OTT entrants will be storming the gates in the months ahead, bringing more lower-cost opportunities for consumers to forgo traditional pay

TV. Hulu and its media-conglom parents plan to bow a live TV product in early 2017, and YouTube is now cobbling together a linear TV bundle of its own. Amazon and Apple have also eyed linear TV offerings, and both have deep pockets to stir things up should they decide to jump into the fray.

Roger Lynch, CEO of Sling TV, says there's plenty of room for multiple OTT players. "Frankly, we've been surprised it has taken two years for meaningful competition to show up," he says. The upshot: If -- or when -- packages like DirecTV Now lead to a large migration of viewers away from existing cable and satellite TV, some programmers will be left out. The internet is allowing distributors to re-form the bundle to be smaller and cheaper, the way millions of people want to purchase it. That's rattling media companies that have grown fat and happy by forcing a big bundle on everyone via per-subscriber fee hikes.

Who's at risk of becoming roadkill along the skinny-bundle highway? Low-rated cable networks and those unaffiliated with a broadcast network will be the most harmed, say analysts, with Discovery Communications, Viacom, AMC Networks, and smaller independents among the most vulnerable. Says one top industry exec, "Their pricing is higher than their ratings. So they have no flexibility to lower their pricing for OTT."

AT&T's DirecTV Now maneuver may have already forced Sony to drop content to keep its PS Vue pricing competitive. Sony last week said Viacom networks including Comedy Central, MTV, and BET would be eliminated from PS Vue on Nov. 11. "We have determined that removing the bundle of channels from Viacom is the best way for us to continue to offer the most compelling value to our fans," Sony said in a message to customers. At the same time, PS Vue is adding BBC America, NBA TV, Viceland, and more local broadcast stations from CBS and Fox.

But operators like AT&T and Dish are playing a long game, and they have the financial reserves to withstand protracted unprofitability from their nascent OTT plays. "They're weighing the financial downside to the strategic upside in the long term," says Tuna Amobi, CFRA Research analyst. "This is going to be a marathon -- and a survival of the fittest."

Why is AT&T so eager to shake the foundations of such a highly profitable business? DirecTV's satellite TV gross margins are around 50%, with average revenue per customer of $115 per month, per MoffettNathanson estimates. At $35 per month, DirecTV Now is priced a whopping $45 less than the satcaster would need to charge to get comparable margins on the OTT side, according to the analyst firm.

Meanwhile, the telco is also throwing down the virtual pay-TV gantlet despite the tepid results of the initial players in the market: Sling TV has signed up an estimated 1 million subscribers after nearly two years, while PlayStation Vue just this summer reportedly reached the 100,000 mark. AT&T execs assert that nobody has introduced the right combo of an advanced user experience, robust content, and attractive pricing to really succeed -- and Stephenson and the team led by AT&T Entertainment Group CEO John Stankey believe they've cracked that code.

The telco giant's motives for effectively using DirecTV Now as a loss leader are myriad: Getting in front of cord-cutting: By using a big knife and fork to carve up pay TV, AT&T wants to make sure it's at the head of the table to nab consumers who want a better price/value equation -- before its traditional video businesses start to contract. Yes, DirecTV Now will peel away higher-value satellite subscribers, but AT&T would rather cannibalize itself than let someone else do it.

Lowering subscriber-acquisition costs: DirecTV Now is designed to reduce the friction of buying TV, following the model of Netflix and HBO Now: You will subscribe through an app in a few clicks, cancelling whenever you want, and you don't have to wait for a service tech to install it. That means DirecTV spends less on acquiring those customers, but at the same time, the model will generate less revenue and likely have higher churn.

Gaining leverage with programmers: After years of media conglomerates foisting low-watched cable channels on pay-TV providers, DirecTV Now gives AT&T a stronger hand in negotiations. The message: Want to be in our OTT package? Play by our rules.

Boosting wireless business: AT&T has had success tying DirecTV together with mobile service, and expects to do the same with DirecTV Now. In January, it rolled out plans offering unlimited wireless data with TV and has signed up 6.7 million customers for that combo. It's also offering "zero-rated" data for subs with both wireless and video, so the DirecTV/U-verse content they watch on their phones doesn't count against their data plans -- something AT&T is expected to do with DirecTV Now, too. But last week the FCC notified the telco that the zero-rating practices may be anticompetitive, because they put rival OTT services at an economic disadvantage. The panel asked AT&T to formally respond by Nov. 21.

Making the Time Warner deal look better to Washington: By launching DirecTV Now at a starting price of $35 per month, AT&T will try to present the case that it's acting in a consumer-friendly way, as the $85 billion deal for Time Warner faces intense scrutiny from lawmakers and regulators. See? We're actually lowering prices!

Make no mistake, though: AT&T wants to build DirecTV Now into a sizable business, one that will generate healthy returns over time. It's planning to offer various sign-up incentives, according to AT&T customer-support documents that leaked online, as Variety first reported. Customers who commit to three months of the service will get a free Apple TV (worth $150), while those who pay for one month will receive an Amazon Fire TV Stick ($35). That said, those bounties are relatively inexpensive, considering DirecTV spends $800-$900 in subscriber acquisition costs per satellite TV customer. "If you can bring a compelling price point and a compelling content package and some innovation with it," Stephenson told analysts on AT&T's third-quarter earnings call, "we are absolutely convinced that this is going to be very, very attractive for a large group of customers who really aren't even in the market today."

With the right mix of pricing, programming, and features, virtual pay-TV services could become a significant force in a few years. By 2020, financial services firm UBS predicts, there will be a total of 15 million internet pay-TV subscribers, with AT&T accounting for about 20% of the market. "AT&T believes this is the direction the industry is heading; TV is moving to the internet, and they're in a position to help drive it," says UBS analyst John Hodulik. "It can be an area where they make money over time."

AT&T spent the past year lining up new programming deals for DirecTV Now, and still has yet to officially land 21st Century Fox or CBS. Content partners on board include Disney/ESPN, NBCUniversal, HBO, Turner, AMC Networks, Viacom, Scripps, Starz, A+E Networks, and Univision Communications. DirecTV Now appears aimed at providing a full-blown package that's competitive with existing pay TV. But competitors like Sling TV are in market with even skinnier skinny bundles. "We didn't just re-create a big bundle of channels," Lynch says of Sling TV's core Orange lineup of 30 channels. "That would have actually been an easier thing to do, because big programmers like you to put all their channels in the base package. But that's a market that is well served."

Ultimately, what's happening in pay TV is market segmentation -- something that occurs in healthy ecosystems all the time. The fact that it has taken years for bundles of different sizes and shapes to appear underscores how hamstrung distributors have been in creating affordable but compelling TV plans. Verizon last year rolled out its own skinny bundle for Fios, dubbed Custom TV, which lets customers pick from among thematic add-on packs. But ESPN sued because its networks weren't in the baseline package as specified under its distribution pact, and Verizon ended up stuffing the sports programmer back in.

With OTT, television will increasingly become available at different price points and configurations, unchained from a monolithic lineup. It's already happened: If all you want is CBS, you can get CBS All Access for $6 per month (or $10 without ads), while HBO Now costs $15 monthly and Showtime is $9-$11. More a la carte offerings are coming, and if AT&T's takeover of Time Warner comes to fruition, expect new kinds of OTT plays there. In terms of pay-TV bundles, DirecTV Now might become the Toyota Camry of the industry -- while the legacy satellite service looks more like a BMW.

But there's some question, even given the $35 price point, of how broadly appealing DirecTV Now will be. For starters, it will be limited to a single stream per account -- which means that for multi-TV households (in other words, most of America), DirecTV's satellite service will be the preferred option. DirecTV Now also will lack 4K support and other bells and whistles available on the legacy platform.

Then there are infrastructure issues. DirecTV Now customers will still need to buy broadband service. That could be an opportunity for AT&T to bundle OTT with broadband or wireless. But assuming $50 per month for standalone broadband, subscribing to DirecTV Now might not end up being much of a bargain. "The savings from subscribing to these alternative packages are somewhat illusory," Telsey Advisory Group analyst Tom Eagan wrote in a recent research report.

Moreover, only half of the U.S. has access to the minimum broadband speeds recommended for virtual TV services (10 megabits per second), according to Michael Wolf, founder of the research and consulting firm Activate. Only 12% of the population has access to 25 Mbps service, which is what Sling TV recommends for streaming live TV on two or more devices.

Finally, analysts speculate that the price of DirecTV Now will eventually rise to be on par with the rest of the pay-TV market if the service gains traction. The $35 monthly fee "is probably a promotional price, and over time DirecTV will try to get you to pay full rate," Hodulik says. But with AT&T moving to establish itself as the leader in virtual pay TV, rivals like Comcast and Charter Communications, which now owns Time Warner Cable, may follow in AT&T's footsteps and further disrupt industry economics with their own OTT offerings.

It's worth noting that Comcast, concerned that it will get cut out of a wireless broadband-plus-video bundle, in 2017 plans to launch as a virtual mobile network operator, coupling the Verizon Wireless network with the cable operator's 14 million Wi-Fi hotspots dotted across the U.S. Comcast execs have disavowed any interest in launching an OTT service outside its service areas, but that could change quickly. "Their attitude is that they have a winning hand with what they're doing in their existing markets with X1," says VideoNuze analyst Will Richmond. "But if DirecTV -- or Hulu or YouTube -- change the equation, Comcast can turn on a dime."
– ***Variety***