Modeling the problem

De novo entry into daily newspaper markets

by Robert G. Picard

This financial projection model indicates a new daily entering a market against an existing daily would suffer huge monetary losses for the first 10 years.

The difficulties of maintaining competitive daily newspaper markets have long been recognized and led to waves of closures of competing dailies in the 1930s, 1950s, 1980s and early 1990s. The decline of direct daily newspaper competition has led to a great deal of discussion and concern in the United States and other Western nations over its causes, its impact, and what can be done to counteract the problem. Some observers of newspaper mortality have suggested that the development of newspaper groups led corporate owners to exercise their power to attack competitors in their markets in ways that led to the death of competitors. Others have suggested that television and changing audience lifestyles have made it difficult to maintain competitive papers in a single market. Clearly, daily newspaper markets in the U.S. have shown a trend toward one-newspaper markets in the 20th century. Indeed, although 43 percent of cities had two or more separately owned papers competing in 1920, that amount has fallen to one percent today.

The primary concerns about the loss of local daily newspaper competition are that the mortality diminishes the flow of information and ideas, reduces the diversity of voices in the community, and leads to economic monopoly. If new dailies are established, diversity and variety would presumably be restored and competition would be reestablished in the marketplace of ideas as well as the economic market.

In both Europe and the United States some observers have suggested that if new entries are encouraged, protected from unfair competition, and nurtured by public policies favoring competition, the decline of local daily newspaper competition can be reversed. This approach, however, ignores significant economic factors that promote one newspaper markets - particularly advertiser preferences for the one paper in a market with the largest circulation - and the fact that the cost structures of newspaper operations make it nearly impossible to achieve profitability if entry is attempted in a market where another local daily is published.

This article explores the financial and economic problems inherent in attempting to enter a market in which a daily newspaper is already published. It does so by exploring types of entry, modeling entry, and then applies financial data from a typical paper to make projections in the model that show why such entry has an extremely high probability of failure.

De novo entry

De novo entry denotes the entry of a fresh or new local paper into a market - because it creates local daily newspaper competition in both the content and economic senses. De novo entries are not to be confused with the startups of daily newspapers that have been generally successful in growing markets not already served by a local daily. These entries were the means by which several hundred dailies were established in suburban markets after 1950. The success of these papers resulted in them displacing and replacing competing metropolitan papers that died. As a result, the overall number of daily papers remained relatively stable until 1990.

De novo efforts to enter markets already served by a local daily have been recognized to face significant problems because of strong barriers to entry, such as capital requirements, high fixed costs, and economies of scale, and competitive advantages held by existing newspapers that provide significant market power. In the 1970s and 1980s, some European parliaments established government policies to help overcome such entry barriers as a means by which de novo entry can be promoted. These efforts were part of a wide range of state intervention in newspaper markets to try to overcome mortality by promoting competition and diversity. However, it now appears that such policies have not been successful in overcoming the strong barriers to new entrants in the daily newspaper industry in European nations.

During the past two decades, however, a number of notable de novo entries into existing newspaper markets have been attempted with differing results. They have involved both de novo and indirect de novo entry. Direct de novo
represents the pure form of entry of an emergent daily paper into a market as a new competitor directly challenging an existing daily. Indirect de novo represents a modified form of entry into areas served by established newspapers using properties already in place at nearby locations. These efforts involve exploitation of preexisting suburban daily newspapers or other publications in immediately contiguous suburbs and surrounding regions owned by the firm attempting market entry. This tactic allows the use of preexisting production facilities, circulation systems, advertising operations, etc., thus reducing capital startup investments in plant and facilities, and is believed by some to be a means of establishing competition without the much higher risk of pure de novo entry.

Although most attempts at both types of de novo entry are made in metropolitan markets, there are occasional attempts at de novo entry made in non-metropolitan communities. Usually, these entries involve papers of less than 5,000 circulation because barriers to their entry are low, and they typically occur in the face of weak competitors. These entries are primarily possible because the operations involve low fixed costs made possible by contracting most production and printing services from other publishers and because the costs of circulation and other necessary operations are low. Even such entries rarely survive, however.

Direct de novo entry

Because of the barriers to entry and the advantages held by existing competitors, direct de novo rarely occurs. In fact, no de novo entry into a distinct market in which a local daily newspaper already exists has been clearly successful in the U.S. for half a century. The last entry that clearly met that criteria appears to have been the Chicago Sun in 1941.

The most recent entry to survive for more than a decade is the Washington Times, which entered the Washington, D.C., market as a competitor to the Washington Post in 1982. Its establishment was heavily subsidized by financing from the Reverend Sun Myung Moon's Unification Church, and the paper was not intended to operate as a traditional commercial newspaper. Nevertheless, the paper has generated steady advertising revenue and introduced different perspectives in news and feature stories. The paper has never managed to generate sufficient circulation, however, and has less than 15 percent of the circulation of the Post.

The appearance of Gannett's USA Today is sometimes erroneously considered a de novo entry. Because it did not enter a local market with an existing competitor but created a new national market, it does not fit the traditional definition of de novo entry.

Indirect de novo entry

The primary attempts to use the indirect de novo entry tactic are seen in the establishment of The New York Newsday, the St. Louis Sun, the Daily News in Atlanta, the Kansas City Star, and the Daily News in Los Angeles. These efforts were made in ways that achieved cost savings in production, distribution, management, and other factors as a means of reducing the financial risk of the entry by linking the new daily with a pre-existing publication owned by the firm.

Times Mirror Company, for example, used its successful daily Newsday, which serves Long Island, as the platform for establishing and publishing New York Newsday. The paper was established in 1985 and even though the paper achieved a circulation of more than 200,000 daily, it was never successful. Times Mirror Co. covered approximately $100 million in losses before the paper closed in 1995.

The St. Louis Sun was established by Ingersoll Publications Co. in September 1989. The Sun was created using a chain of suburban weeklies and shoppers (Suburban Newspapers of Greater St. Louis) as a base. Drawing on their established advertising, circulation, and production operations, Ingersoll hoped to establish the Sun as a daily competitor to the St. Louis Post-Dispatch. Ingersoll Publications suffered an estimated loss of $30 million on the project before the paper was closed in April 1990 after seven months of publication. At the time of its demise, it had an estimated circulation of 100,000 but had not been able to establish and maintain a stable, measurable circulation base.

One of the most closely watched attempts at de novo entry occurred in 1987 when the New York Times Co. bought the Gannett Daily News in Duluth (Gwinnett County), Georgia, an Atlanta suburb, for $90 million. In 1990 it completed building a $40 million production facility to use the paper as a means of entering direct competition with the Atlanta Journal and Constitution for that market. In 1991, the name Gannett was dropped from the paper and the paper launched its entry throughout the Atlanta metropolitan area. After a year of operations, New York Times Co. closed the Daily News in September 1992 and sold its assets to Cox Enterprises, owner of the Atlanta Journal and Constitution after 40 potential buyers declined to purchase the paper. Circulation never rose above 10,000 outside of Gwinnett County and the company lost an estimated $125 million on the venture.

In May 1990, Sun Publications in Overland Park, Kansas, used its base of 20 suburban shoppers and weeklies to launch a daily newspaper, Kansas City Evening News, as a competitor against the Kansas City Star. The paper managed to attain only 15,000 daily circulation before it was shut down in June.
1990. Sun Publications lost an estimated $300,000 in startup costs on the five-week venture.

Perhaps the most successful de novo entry in recent years, the Los Angeles Daily News, emerged after the Tribune Company purchased the Valley News and Green Sheet in the San Fernando Valley, north of Los Angeles, in 1973. It began a ten-year effort to turn the free distribution shopper into a new daily serving a portion of the metropolitan Los Angeles market. Between 1973 and 1982, the company invested heavily, increasing the news content of the publication, increasing its frequency, and gradually switching away from free circulation, so that in 1982 it became a fully paid, 7-day-a-week newspaper in competition with the Los Angeles Times and the Los Angeles Herald-Examiner, which ceased publication in 1989. Tribune Company sold the Daily News to Jack Kent Cooke Inc. in 1985. The paper's daily circulation is only about 20 percent of that of the Los Angeles Times. Cooke made efforts to sell the publication for several years in the mid-1990s but then decided to keep the paper, saying that it was meeting financial goals.

**Modeling de novo entry**

The difficulty of making a successful de novo entry can be explored by modeling market entry and projecting the financial performance of an enterprise making such an entry. If one could have access to the proprietary financial data of a past entry, one could make such an analysis using actual data and not need the model. Such data are not available. In order to make the cost data used in this model realistic, cost figures from the author's experience and knowledge were utilized. These data were then checked against the industry norms calculated by the Inland Daily Press Association and International Newspaper Financial Executives. The data were found to be within the ranges appropriate for the circulation sizes and competitive situation being modeled.

Under the model, the entry paper will increase its circulation and advertising shares over time, taking away circulation and advertising from the existing paper's market, but with its acquisition of shares slowing over time. The model also incorporates the effects of dual circulation and advertising placement which tend to expand market revenues slightly. The model does so by building a 15 percent competitive increase into market revenues in the projections. Although the market revenues expand somewhat, the shares will increasingly shift if a successful entry is being made and the model incorporates the effects of that changing market share.

In the newspaper industry, success in a competitive market is considered to be survival and profitability. This typically results when each of two established papers reaches parity with the competing daily newspaper and neither is undercutting the other's circulation or advertising prices to the extent that either or both lose profitability. At parity both papers equally split the market, each achieving a 50 percent market share. This point is significant because a paper that has more than 50 percent receives disproportionately more advertising and thus gains financial advantages over its rival. A paper that is unable to achieve and maintain a 50 percent market share ultimately falls prey to the circulation spiral phenomenon that typically leads to its demise.

Failure of a newspaper can then be conversely described as a situation in which relative parity may or may not have been achieved and operating income and net income makes it unprofitable for a firm to continue operations.

In this article, a model and projections using that model will examine financial performance of the entry firm to show why success evidenced in profitability is nearly impossible to achieve.

**The model**

The financial projection model developed for this study that incorporates the financial performance concerns is as follows:

\[ (\text{CRM} \times \text{ECMS}) + (\text{NARM} \times \text{EAMS}) + \text{CI} - [\text{EOE} + \text{ENOE}] = \text{ENI} \]

- **CRM** = circulation revenue in the market
- **ECMS** = the entry paper's circulation market share
- **NARM** = the newspaper advertising revenue in market
- **EAMS** = the entry paper's advertising market share
- **CI** = the competitive increase to market revenues
- **EOE** = the entry's operating expense
- **ENOE** = the entry's net operating expenses
- **ENI** = the entry's net income

**Applying the model**

In applying the entry model, the author a mid-sized newspaper market was selected to serve as an example. Mid-sized markets can be expected to have advertising and circulation bases that could reasonably provide sufficient resources to split between two papers and make the market attractive enough for a firm to even consider entry. For this example, the selected market produces $18 million in circulation revenue and $74.4 million in advertising revenue, a total revenue of $92.4 million, for its local daily.

The market is a city with a population of just under 250,000 residents and the retail trading zone has approximately 750,000 inhabitants. The existing
paper has a daily circulation of approximately 140,000 daily, with a household penetration of 53 percent in its city zone and 47 percent in the retail trading zone. Whenever choices were made in assumptions and projections, the author a more conservative approach was used by erring toward the best or better case scenario. Because this model is being used to show why de novo entries typically fail, erring toward success and lower costs is thus conservative.

In applying the model to this example, this article considers not merely the projected results for one year but for a 10-year period. (see Table 1)

**Revenue assumptions and projections**

In terms of circulation, the entry paper gains 15 percent market share in first year, an additional five percent for each of the four years thereafter, and an additional 3 percent for the next five years. It is assumed that the prices of the entry paper and existing paper will be similar because newspaper competitors tend to set the same price in the long run. The assumption recognizes that price cuts are harmful to both papers if maintained over time and does not project significant cuts although sometimes occur in competitive situations. Error introduced by this price assumption thus produces higher income projections than might occur and thus errs toward success. The error introduced by this assumption is therefore conservative.

In applying the model to advertising revenue, the projections take into account the circulation-advertising share disparity problem and incorporate the largest disparity in the 35 percent to 40 percent circulation share range.

The fixed costs of newspaper publishing limit the ability of firms, especially startup enterprises, to substantially lower their cost-per-thousand for advertising and maintain unprofitably low rates over a long period of time, so the projections utilize revenue levels based on the existing revenue, which is known. Although competing newspapers tend to engage in advertising price competition, the use of actual revenues of the existing market was selected for the projections because competitive markets have evidenced no single long-term pricing strategy, and behavior is most determined by the personalities and resources of the firms involved. In competitive situations, advertising rates tend - over the long run - to be about 15 to 20 percent less than in monopoly situations. Any error introduced by the use of the known current revenue levels will result in an overestimation of the entry paper's revenue, operating profit, and net income and an underestimation of any operating loss or net income loss produced by the entry paper. This potential error should be considered when reviewing the results.

For the analysis, it is assumed that there is constant improvement in market share after de novo entry so that parity is reached at the 10-year mark. Although no example of this type of success with a de novo entry in a metropolitan area exists in the U.S. newspaper industry in modern times, the scenario is employed because it models a successful competitive outcome. Because it errs

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Table 1: Financial and performance projections based on the model

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales Revenue</th>
<th>Expenses</th>
<th>Operating Income</th>
<th>Year</th>
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<tbody>
<tr>
<td>1</td>
<td>$10,000</td>
<td>$5,000</td>
<td>$5,000</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>$12,000</td>
<td>$6,000</td>
<td>$6,000</td>
<td>2</td>
</tr>
<tr>
<td>3</td>
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<td>$8,640</td>
<td>$8,640</td>
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<tr>
<td>5</td>
<td>$20,736</td>
<td>$10,068</td>
<td>$10,668</td>
<td>5</td>
</tr>
<tr>
<td>6</td>
<td>$24,874</td>
<td>$12,328</td>
<td>$12,546</td>
<td>6</td>
</tr>
<tr>
<td>7</td>
<td>$29,849</td>
<td>$14,908</td>
<td>$14,941</td>
<td>7</td>
</tr>
<tr>
<td>8</td>
<td>$35,806</td>
<td>$17,846</td>
<td>$17,960</td>
<td>8</td>
</tr>
<tr>
<td>9</td>
<td>$42,968</td>
<td>$21,024</td>
<td>$21,944</td>
<td>9</td>
</tr>
<tr>
<td>10</td>
<td>$51,561</td>
<td>$24,625</td>
<td>$26,936</td>
<td>10</td>
</tr>
</tbody>
</table>
toward entry success and profitability rather than failure, the use of this projection also makes this portion of the model conservative.

**Expense/cost assumptions and projections**

In the projections the operating expenses for editorial, advertising, circulation, administration, marketing and promotion are held stable across the 10-year projection period.

The decision to do so was made because there is no undisputed way to estimate increases in labor and benefit costs; not including such increases results in an underestimation of such costs, thus skewing the results toward financial success, a conservative error.

In normal operations advertising expenses would be expected to increase over the period, especially because commissions would increase as ad share and ad revenue increased at the entry paper, along with some ad processing and preparation costs. Because of this there was no reasonable way to incorporate potential rate cuts that would affect commissions in the projections as competition increased, and because the amount or number of increasing staff would be entirely speculative, the commission costs were kept stable at the first year rate. This method undoubtedly results in an underestimation of advertising costs, thus erring toward financial success (a conservative error in the context of this article).

In normal operations circulation expenses would be expected to increase over the period because of the greater number of subscribers and single copy sales projected for the period. In its first year, the entry paper would be expected to have to bear the expenses of distribution throughout the market so the additional circulation overtime would primarily add expenses associated with distribution density and supplies. Because there is no standardized method upon which to base a projection of those costs, the author chose to keep the costs stable at the first year rate. This method undoubtedly results in an underestimation of circulation costs over time, thus erring toward financial success (a conservative error in the context of the model and projections).

In normal operations general production expenses (not including newprint and ink) would be expected to increase over the period if the number of pages or sections increased. Because the new paper would be expected to enter the market with a fully developed paper, it is impossible to estimate what might be added and the additional costs. It would be expected that variable costs associated with the increasing number of papers printed would rise, but it is impossible to estimate these costs in a reasonable fashion so the author kept general production costs constant across the projection period. This method can be expected to result in an underestimation of such production costs, thus erring toward financial success (a conservative error in the context of this article).

Marketing and promotion costs are held constant throughout the period of the projections. This was done because significant marketing and discounting would be necessary to introduce the paper. As competition increases when circulation and advertising shares are gained by the entry paper, the paper would need to maintain significant marketing and promotion efforts. These costs are not fully predictable and would be expected to be greater than the promotion and marketing costs of a paper in a one-newspaper city. The expenditure level is kept constant throughout the projection period. The potential error introduced into the projections increases operating costs and skews the projections toward the side of failure (unlike the other errors). The error would range from $50 to approximately $7 million per year depending upon the competitive situation and the choices of management.

The projections introduce normal costs increases for two measures: newprint and ink, and general capital expenditures.

Costs for newprint and ink, the primary variable costs associated with increasing circulation and advertising, are increased in the projections rising 250 percent during the projection period in proportion to the increased market penetration of the paper.

Expenses for general capital expenditures, that is, costs for new equipment, replacement of obsolesca, worn out or broken equipment, etc., were increased in the fifth year of the projections. This was done primarily to account for the need to replace vehicles and other equipment that has a useful lifespan of 5 to 10 years.

The projection assumes that capital will need to be acquired for the venture for land, buildings, furnishings, production equipment, vehicles, etc., and to cover first-year operating costs. The projection assumes that $100 million in capital would be required and divided nearly equally between expenditures for fixed assets and the first-year operating expenditures.

The acquisition of capital generates capital costs that are a non-operating expense. The expenditure of the capital for the newspaper facility and equipment in the first year is treated as a non-operating expense as well. The projection assumes that any losses would be financed by the firm attempting the entry without borrowing additional capital for operations after the first year. This assumption was again made to keep the model conservative in its analysis. If operating losses are not covered by the firm attempting the entry, additional capital will have to be acquired and additional costs will be incurred.

The projection assumes that capital for the venture would be available at 9 percent, slightly above the current prime rate, with a 10-year bank loan. This calculation highly understimates the cost of capital because a de novo entry would be considered a highly risky investment, and it would be unlikely that capital would be available from banks but would come instead from the venture capital market if it were available at all. The use of the bank rate is made because there is no way to estimate the rate at which the venture capital market might
provide financing for such a market entry. The use of the bank rate scenario thus utilizes lower-than-expected real-life capital costs and makes the projections err toward the side of success in terms of the potential profitability of the venture. Its use thus makes the capital cost projections of the model conservative.

**Results**

Projecting the cost of de novo entry, and using the most optimistic scenario possible, the enterprise would incur an operating loss of $286.1 million and a net loss of $440.5 million over a 10-year start-up period. (see Table 1) It would not operate profitably at any point. (see Figure 1)

For ease of use and interpretation, the projection is made using constant dollars, ignoring the effects of inflation. Inflation would be expected to have similar offsetting effects on both revenue and expense portions of operating statements.

Even with the de novo entry achieving success in circulation (that is, parity with the pre-existing newspaper) in the tenth year of the startup period, the enterprise would still incur an operating loss of $112.2 million and a net loss of $26.7 million for that year. Operating losses of this magnitude would be expected to be incurred in subsequent years as well, but the net loss would be reduced, because the cost of capital would end unless additional capital was borrowed.

The potential error in advertising revenue because of price cutting would increase the losses found in the projections. The results of the projections are thus conservative estimates.

Two additional issues need to be considered: sunk costs and opportunity costs.

Sunk costs represent that portion of an investment that cannot be recovered, or more precisely, costs incurred "that cannot be changed by present or future action... the amount of money has already been spent and cannot be recovered." Nearly all of the investment in a de novo entry would be sunk costs, except a portion of the capital investment in plant and equipment. Assuming normal depreciation, only about $30 to $50 million of the $540.5 million that would have to be invested in the de novo venture would be recoverable at the end of the 10-year period.

The second issue is opportunity cost, that is, the "highest price or rate of return an alternative course of action would provide." The opportunity cost of the de novo entry investment project in this article would be enormous. Assuming that instead of making the investment in the unprofitable de novo entry, the firm or investors placed what would be the operating losses in Treasury bills, a stable and highly conservative investment, at an average annual rate of return of 6 percent. In that case, the opportunity cost of the entry would be a minimum of $423.7 million for the 10-year period. (see Table 2)
Table 2: Opportunity cost of the De Novo entry

<table>
<thead>
<tr>
<th></th>
<th>Year One</th>
<th>Year Two</th>
<th>Year Three</th>
<th>Year Four</th>
</tr>
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<tbody>
<tr>
<td>Net Income</td>
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<td>$(56,593,630)</td>
<td>$(51,983,130)</td>
<td>$(47,372,630)</td>
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<td>costs</td>
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<tr>
<td>Investment in de novo</td>
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<td>$(41,152,000)</td>
<td>$(36,541,500)</td>
<td>$(31,931,000)</td>
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<td>entry</td>
<td>costs</td>
<td>costs</td>
<td>costs</td>
<td>costs</td>
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<tr>
<td>Opportunity cost of</td>
<td>$381,851,485</td>
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<td>compounded for</td>
<td>remainder of</td>
<td>remainder of</td>
<td>remainder of</td>
</tr>
<tr>
<td></td>
<td>10 years</td>
<td>10 years</td>
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<td>10 years</td>
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<tr>
<td>Net Income</td>
<td>$(45,328,930)</td>
<td>$(44,562,630)</td>
<td>$(40,085,130)</td>
<td>$(35,607,630)</td>
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<td>$15,441,630</td>
<td>$15,441,630</td>
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<tr>
<td></td>
<td>10 years</td>
<td>10 years</td>
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</tr>
<tr>
<td>Net Income</td>
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<td></td>
<td>10 years</td>
<td>10 years</td>
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Conclusions

De novo entry cannot be the solution to local newspaper monopolies because it does not provide mechanisms that overcome existing strong barriers to entry or alter the preferences of advertisers for the local newspaper with the largest circulation. For these reasons no clearly successful de novo entries of newspapers have been made in major metropolitan areas for 50 years. As the model and projections used in this article show, profitability cannot be achieved in any reasonable time period and the opportunity costs would prohibit a publisher from choosing de novo entry if the decision is based on economic and financial factors.

The history of the newspaper industry in the last half of the 20th century has been marked by the exit of newspapers from existing markets rather than their entry. Not only have markets been unable to maintain competing papers, but papers enjoying the noncompetitive benefits of being an evening publication owned by a morning paper, as well as those with noncompetitive joint operating agreements, have been disappearing at a steady pace because economic conditions and advertiser choices make it nearly impossible for markets to sustain more than one paper.

As a result of these conditions and the kinds of financial failure shown by the model and projections, no major newspaper companies are willing to even consider the enormous risk to capital that would be required to attempt a direct de novo entry, although the possibility of the risks of attempting indirect de novo entry might sometimes be considered by investors. This indirect route, however, can only be expected to succeed in a very few, unusual cases. Only investors who have unusual reasons to believe their potential revenues, operating costs, and capital costs in the entry will produce a more positive result than shown in the projections or experienced in the major cases of indirect de novo entry discussed above would give such a strategy significant consideration.

If, as this article concludes, de novo entry - both direct and indirect - is not a practical or reasonable solution to local daily newspaper monopolies, what possibilities are there for improving the flow of local information, ideas, and advertising? Because of their differences in cost structure and capital costs, nondaily and alternative newspapers, city magazines, and - as interest and use grows - online publications have far better prospects. These other information, idea, and advertising sources, just like the de novo entry of a daily, present competitive threats to existing dailies, but the level of threat to finances is far lower than that presented by de novo entry, however unlikely it is to ultimately succeed.

Notes


