



Thursday, January 08, 2009

Media/Entertainment Outlook: You can't buy the sector! Stick with prudent stock selection among content-tilted names with clean balance sheets, franchise value, high ROIC, and sustainable competitive advantages.

Summary and Recommendation

The following is our 2009 sector outlook for Caris' Media/Entertainment Universe, specifically price action and long/short opportunity taking into account a modest bounce in the economy in the back half of 2009. In general, we are biased towards the long side on any name in our space with a #1 or #2 market share position, a sustainable competitive advantage, high returns on capital, a clean balance sheet, and noticeable operating leverage. Since media is essentially a consumer discretionary endeavor and comes in many forms, our formal outlook is divided into four silos: **1.** The Large-Cap bellwethers; **2.** The pure SMID-cap plays; **3.** The Outdoor Media names, and **4.** The Exhibitors.

Key Points

- **Large cap bellwethers - Enthusiasm for DIS remains, but we remain cautious on VIA'b & CBS.** The core culprit behind such a tough year for the vertically-integrated bellwether media names has been the outlook for advertising in 2009 – and yet – Disney (**DIS-2**) derives 20% of revenues from advertising, as opposed to 57% for Viacom (**VIA.b – 3**) and 70% for CBS (**CBS-4**). Therefore, at 10 times our F2009 EPS assumption of \$2.22, we recognize that DIS trades at a premium to other names considered “comparable” in the space but once again espouse the view that there really are no comps to DIS, as DIS has the most attractive balance sheet, the most enviable asset base, the least number of businesses in secular decline, and the most respected management team of the Big 5 media set.
- **SMID-cap plays - Trio of pure content names provides greatest long opportunity.** In general, value-priced, media-related consumer discretionary categories remain healthy - domestic box office in 2008 finished flat versus 2007, which was a record year. VOD consumption was up 24% over last year, video game sales were up 10% in 2008 versus 2007, and home video rental was up 4% year-over-year. Content media has proven over time to be “recession resistant” activities, so pure-play film names such as DreamWorks Animation (**DWA-2**), Marvel Entertainment (**MVL-1**), and Lionsgate (**LGF-2**) are very well-positioned going into the next 12 months.
- **SMID names all event-driven over next 12 months.** The aforementioned three names all have unique catalysts/events on tap over the next year which could serve as tenets for benchmark outperformance. MVL will see its owned film properties *The Incredible Hulk* and *Iron Man* cycle through the international DVD and Pay Television windows, and will derive licensing fees off the June release of *X-Men Wolverine* from News Corp. (**NWS-NR**). LGF will have three film releases over the next six weeks, including the first horror film ever released in stereoscopic 3-D. For its part, DWA is chock full of catalysts going into the next year, including the domestic and international home video release of *Madagascar 2*, the domestic and international theatrical release of *Monsters vs. Aliens* in 3-D, and the possible expansion of *Shrek the Musical* into multiple productions playing worldwide, which would force the Street to essentially model the economics of another film into F2009 projections.
- **Outdoor Media - Cautious view remains, especially in light of valuation.** We continue to believe Lamar (**LAMR-4**) is the higher-quality name versus Clear Channel Outdoor (**CCO-5**), in the Outdoor advertising sub-space, and should a back-half 2009 economic recovery occur, LAMR will likely outperform CCO in long-side price action. However, though LAMR is the cleaner name among the two and maintains a focus on North America where there are no complicated revenue-sharing arrangements, LAMR still remains expensive at 9.6x consensus 2009 EBITDA on an EV basis.
- **The Exhibitors - DCIP is an issue, but it's not the end of the world.** The next 12 months will be critical to the notion that digital cinema, and hence 3-D, will serve as a multiple expansion engine for all three public names in the space, those being Regal (**RGC-2**), Cinemark (**CNK-2**), and small-DMA comp Carmike Cinemas (**CKEC-2**). While DWA's *Monsters v. Aliens* is sure to be the catalyst that validates the 3-D opportunity, our stance is that the issue with 3-D screen counts is overblown, as we believe audiences will eventually find their way towards whichever format matches family budgets, coupled with consumer urgency.

The Large Cap bellwethers . . . Enthusiasm for DIS remains, but we remain cautious on VIA'b & CBS

At current levels, **Walt Disney (DIS-2)** is still unfortunately lumped in with other large-cap media names that are considered “comparable” companies by the Street, yet are nothing of the sort. DIS is the only one of the Big 5 media companies with such an integrated theme park operation which allows for a unique vacation experience, and therefore, a logical brand extension. DIS is also the only large-cap media name with such a deep roster of enduring characters, which add an immense amount of intangible asset value to the balance sheet. Furthermore, DIS is arguably the only one of the large-cap set that benefits so handsomely from a weak dollar, as current for-ex translations make an American vacation cheaper for overseas travelers. In addition, with the exception of 10 owned and operated (O&O) TV stations, DIS does not own distribution assets, and with good reason, as distribution always becomes commoditized over time.

But more importantly, DIS has ESPN. Unlike scripted series, which have a higher repeat quotient, the experience of watching a live sporting event is much more flush with emotional stickiness than watching it after the fact on a DVR. In effect, therefore, sports are essentially the ultimate reality show. With ESPN having secured the rights to a myriad of high-profile properties, including Monday Night Football, the NBA Playoffs, the first 2 rounds of The Masters, Big Ten Football, and the BCS College games, feedback from select sources within the media-buying community confirm that buyers continue to pay an above-market CPM for sports-related programming that captures live audiences. Because ESPN is so uniquely positioned to capture value from these developments, we are pegging ESPN to outperform the cable industry advertising sub-sector by 4% in 2009, and that is not a sustainable competitive advantage currently afforded **CBS** or **VIA'b**.

The Pure ‘SMID’ Content Plays . . . DWA, LGF and MVL chock full of catalysts:

Clearly, much of the growth seen in the GDP over the last four years has been financed through leverage. With lending standards now much tighter, one would think that the bulk of leisure activities would see a downturn. However, that does not appear to be the case, and that is reflected in the almost-daily volatility we see in the media space. In general, value-priced, media-related consumer discretionary categories remain healthy - domestic box office in 2008 finished flat versus 2007, which was a record year. VOD consumption was up 24% over last year, video game sales were up 10% in 2008 versus 2007, and home video rental was up 4% year-over-year. Movie and television consumption have proven over time to be “recession resistant” (though not recession-proof) activities, so pure-play film names such as DreamWorks Animation (**DWA-2**), Marvel Entertainment (**MVL-1**), and Lionsgate Entertainment (**LGF-2**) are very well-positioned going into these next 12 months.

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The Outdoor names . . . LAMR very well positioned if evidence surfaces that economy has turned:

Price action in our two outdoor media names will not necessarily correlate to FQ4 2008 results, but instead, reflect broader outlooks for 2009, particularly if there is a back half recovery. Should raw economic data surface over the next six months suggesting greater business confidence levels going into the second half, Lamar (**LAMR-4**) is much better positioned than Clear Channel Outdoor (CCO-5) due to its superior digital platform, which continues to outperform its static brethren using most benchmarks. As of last quarter, LAMR posted a digital unit number of 1,012 units, a 12% bump higher sequentially. (In contrast, large-market competitor CCO installed only 150 digital displays in C2008.) The overall capital cost to deploy digital technology to Outdoor structures continues to decline as the market expands – just \$201,500/unit, versus \$301,000 just 24 months ago, representing a decline of 33%. The bottom line? As LAMR keeps digital cap-ex constant, they are getting for their money.

We continue to believe LAMR is the higher-quality name, versus Clear Channel Outdoor (**CCO-4**), in the Outdoor advertising sub-space, and would be the first among the two to receive an eventual positive rating change. Our rationale is based on five key tenets: a focus on North America, where there are no complicated revenue-sharing arrangements on bulletins/posters; aggressive deployment of digital boards, the ROIC of which is 40%+; a greater weighting in the asset base

of bulletins/posters, which carry higher margins; displacement of media dollars out of other ad platforms and into Outdoor; and no secular threats on the horizon.

The exhibitors . . . DCIP is an issue, but it's not the end of the world

The next 12 months will be critical to the notion that digital cinema, and hence 3-D, will serve as a multiple expansion engine for all three public names in the space, those being Regal Cinema (**RGC-2**), Cinemark Holding (**CNK-2**), and small-DMA comp Carmike Cinema (**CKEC-3**).

To review, the domestic motion picture industry is still in the process of converting from film-based media to electronic based media, the core beneficiaries of which will mostly be the content players, as the age-old practice of converting film to multiple "prints" will eventually become obsolete. Riding on top of that technology is 3-D capability, one of the most exciting technological developments in three decades, and a sub-technology which cannot exist unless the projector and screen are retrofitted for digital in the first place. To that end, on February 12, 2007, RGC, along with AMC (private) and Cinemark (CNK-NR), formed a joint venture company known as Digital Cinema Implementation Partners, commonly referred to as "DCIP", to explore the possibility of implementing digital cinema in all owned theatres among those three entities, and to establish agreements with major motion picture studios for the implementation as such. That said, whereas comparable company Carmike Cinemas (CKEC) has chosen to bypass DCIP and go it alone, future digital cinema developments with RGC, CNK and AMC will be managed by DCIP, a third party which has had trouble achieving the required financing to deploy the necessary upgrades because of the credit crunch. As a result, out of some 38,000 screens in the U.S. and Canada, apx. 5000 are digital, with apx. 1,300 upgraded for 3-D capability.

DCIP results in interesting dichotomy: At the individual company level, CKEC has the most interesting dichotomy in the space as being the player with one of the lowest yields per screen, yet the exhibitor that is best positioned to capture the majority of incremental share posed by 3-D up-charges. Out of a total of 6,776 screens, RGC has only 139 screens retro-fitted for digital, with 100% of those 139 converted to 3-D. Out of a total of 3,672 domestic screens, blue-chip competitor CNK has only 150 screens retro-fitted for digital, with 57 of those converted to 3-D. In contrast, small-cap comparable Carmike Cinemas (**CKEC-2**) operates 279 theatres with 2,349 screens. Out of the 2,349, 2,174 have been converted to digital and 429 have been converted to 3-D. RGC and CNK therefore have the unfortunate irony of being the blue chip operators in the space with the most scale, yet well behind the curve on digital/3-D.

Media & Entertainment

Ratings Distribution Chart:

Total Securities Rated			
136			
Buy			
Number of Ratings	% of Ratings	No. Provided IB Services	% Provided IB Services
75	55.15%	0	0.00%
Hold/Neutral			
Number of Ratings	% of Ratings	No. Provided IB Services	% Provided IB Services
44	32.35%	0	0.00%
Sell			
Number of Ratings	% of Ratings	No. Provided IB Services	% Provided IB Services
17	12.50%	0	0.00%

First Call ratings are adapted to the above chart as follows: 1 & 2 = Buy, 3 = Hold/Neutral, 4 & 5 = Sell

*Note: Caris & Company utilizes the First Call rating system when assigning ratings in equity research reports. The following is a list of each numerical rating and its respective definition.

- 1 Buy
- 2 Above Average
- 3 Average
- 4 Below Average
- 5 Sell

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