

James C. Goss

Barrington Research Associates, Inc.

Edward T. Hatch

SG Cowen Securities Corp.

Richard J. MacDonald

J.P. Morgan Securities

Entertainment Industry



JAMES C. GOSS is a Vice President and Senior Investment Analyst with Barrington Research Associates, Inc., where he covers the media and entertainment industries. A Chartered Financial Analyst, Mr. Goss holds a Bachelor's degree with High Honors in Mathematics from Lewis University, as well as an MBA in Finance and Accountancy from the University of Illinois. Prior to joining Barrington Research Associates, he was associated with Nesbitt Burns Securities, Inc. and Duff & Phelps, Inc. Mr. Goss is a past President and Director of The Investment Analysts Society of Chicago and a member of the AIMR.



EDWARD T. HATCH is a Managing Director and Head of Media & Entertainment Equity Research at SG Cowen Securities Corp. Prior to joining the firm, he was Managing Director and Head of Media & Entertainment Research at UBS Securities and the newly merged Warburg Dillon Read. He has also worked at Nomura Securities, Merrill Lynch & Co., and Lehman Brothers. Mr. Hatch holds an MBA from Syracuse University and a Bachelor's degree from Colby College.

RICHARD J. MACDONALD is a Managing Director at J.P. Morgan Securities. He previously served as Global Research Director at TD Securities, Inc., as well as a Broadcasting and Cable Analyst with First Boston Corporation. Mr. MacDonald is a graduate of Yale University and has conducted graduate work in Economics at McGill University in Montreal. A Chartered Financial Analyst, he was awarded a Freedom Forum Fellowship to study Media Entrepreneurship.

SECTOR – ENTERTAINMENT

Moderator – Juliet Milkens

Investment Approach

(KAM460) TWST: Tell us first about the approach that you take to investing in the entertainment industry. Which companies do you follow most closely, Ed?

Mr. Hatch: We focus on the major diversified entertainment companies: **Viacom** (VIA), **Disney** (DIS), **Time Warner** (TWX), **Seagram** (VO), **Liberty Media** (LMGA), **USA Networks** (USAI), and also a number of the radio broadcasters like **Infinity Broadcasting** (INF), **Clear Channel Communications** (CCU), **Westwood One** (WON) and **Emmis Communications** (EMMS). My colleagues Peter Mirsky and Rob Stone cover **Gemstar-TV Guide** (GMST), an intellectual property play and electronic program

guide company. We take both a top-down and a bottom-up approach. Looking at the group, we like to focus on the fastest growing segments of the media industry, which we identify principally as the cable network business and the radio business, which leads us to the focus in our universe. We also like to take a bottom-up approach, which enables us to monitor the market position each company has in its industry, its management and its track record, in terms of both performance and share ownership. This approach helps insure that management's interests are closely aligned with public shareholders' interests, all the while keeping an eye on valuation.

TWST: Rich, what distinguishes the approach that you take to entertainment?

Mr. MacDonald: We follow pretty much the same approach that Ed does. We follow a mix of mega entertainment

companies. I think the wrinkle between his approach and our approach is, we tend to look for out-of-favor companies, where for whatever reason there's a disconnect between fundamentally capable management and a disaffected investor base. I think the best example this year was **Disney**, where we decided that the selling had been overdone, that there was too much skepticism, that there was an opportunity there.

I think Ed also focuses on free cash flow, as we do. We look for early signs of a turn in free cash flow or rapid growth of free cash flow, because of either operational improvements or getting past a capital spending cycle.

TWST: Jim? How do you look at the entertainment industry?

Mr. Goss: I would agree that management is very important, so I tend to focus on the quality of management. I look at core strength of market positions. I also approach the industry from a broader sense by following some publishing and cable stocks, in addition to the entertainment companies and the broadcasters. So I'm trying to put them all together in relationship to one another, and in some cases, as with the newspapers, I occasionally discover more of a value play. But I primarily focus on growth stories, and if there is a value element, it is in the context of a growth-at-a-reasonable-price approach.

Stock Performance

TWST: Rich, will you look back over the past year and just review the performance of these stocks for us? Tell us, among those that you follow, which have performed in line with your expectations or have exceeded them.

Mr. MacDonald: Well, I think everybody has to be happy with the performance of **Viacom** this year. The company started off the year in January somewhere around the \$48 level, and it's up around the mid-\$60s now. I think management clearly had a vision of what their year would be like, and they've been able to communicate that to investors. In a word, the vision is that they're going to be producing several billion dollars of free cash flow, probably within the year. And then all their opera-

tions are directed toward either improving free cash flow production or finding businesses for sale that have good free cash flow production. So I think that's one.

I think **Disney** performed, at least initially, better than people's expectations. Certainly in terms of financial performance, they have done significantly better than expectations. At the beginning

of the year earnings per share estimates were somewhere close to being flat with last year, which was pretty much in line with company guidance, and now they're up to between \$0.80 and \$0.85 versus the high \$0.60s.

Time Warner either performed in line with expectations or slightly below. They didn't grow as fast as their peer group. They'll probably grow at the low end of their expected range (13%-15%), which they've been talking about for several years now.

And **News Corp.** has performed better. Certainly the stock has acted extremely well and they've been able to garner value from initial public offerings of **News Data Systems**, and **Fox Kids Europe**, and additional value from TV Guide after the merger with **Gemstar**. In the near future, they're going to find new value in their satellite platforms with their Sky Global Networks offering.

TWST: Jim, looking at your group of stocks, which would you say has been the outstanding performer in the group?

Mr. Goss: Viacom has to be considered the star of the year. The performance of the stock year to date has been pretty well in line with that of **Time Warner**, except **Viacom** has made a major purchase while **Time Warner** has been on the receiving end of an acquisition bid. To the extent that the acquiring company tends to take some sort of hit, it hasn't really shown up in **Viacom**, or at least they've been able to overcome it. And relative to other pretty good quality groups like the radio broad-

casters, the entertainment stocks are the ones that have really outperformed. They have shown gains year to date, as opposed to declines of various magnitude for the broadcasters.

Highlights

Entertainment stocks have done quite well over the past several years and our panel anticipate continued investor enthusiasm. Technology continues to be a driver to create new formats or easier ways to distribute media. The convergence of media and telecom is also creating new products and services for the consumer. Costs of service and electronics are falling rapidly. What was traditionally an industry led by US companies has become increasingly global. Foreign companies are pairing up with each other and with US companies. The European market, in some cases, is almost as important as the US market as a revenue source for films and television products. As these companies continue to merge, there are great economic opportunities for investors, both fundamentally and in terms of the values created from mergers. Topics include:

- Management performance
- Investment approach
- Stock performance
- Outstanding performers
- Spending trends
- Growth segments — advertising, radio
- Outlook for music and films
- Advertising revenues
- Market share
- Digital television
- Mergers and acquisitions
- Vivendi's bid for Seagram
- Outlook for AOL/Time Warner
- Strengths and weaknesses of Disney
- Differences between entertainment companies
- Investor interest

Companies include: Viacom (VIA); Disney (DIS); Time Warner (TWX); Seagram (VO); USA Networks (USAI); Liberty Media (LMGA); Gemstar-TV Guide (GMST); Clear Channel Communications (CCU); News Corp. (NWS); MGM (MGM); Cox Communications (COX); Infinity Broadcasting (INF); Nelvana (NTV.T); Entercom Communications (ETM); EMI (EMIPY); CANAL+ (CNPLY); BSkyB (BSY); Emmis Communications (EMMS); SFX Entertainment (SFX).

TWST: Ed, which have been the outstanding performers and which the weaker performers, in your view?

Mr. Hatch: Rich made a great call on **Disney**. That was the phoenix that rose from the ashes at the end of last year and it has been one of the best performers this year. **Viacom**, which is our top pick, has really been the first horse out of the gate for this year. **Viacom** is simply the fastest growing major media company with some of the best businesses, a great management team, and they have the highest percentage of free cash flow of EBITDA of the major media stocks.

Looking ahead, one company I like going forward, which could be the **Disney** of 2000 in terms of stock performance, is **USA Networks**. It had several years of outstanding fundamental and stock performance. Right now investors look at management and see Barry Diller as being hampered by **Seagram's** 43% ownership of the company which has blocked **USA Net-**

works' ability to make major acquisitions due to the veto power that **Seagram** has in the shareholder agreement. That has prevented **USA Networks** from elevating itself into the major media company status of **Viacom** and **CBS**, and investors have been questioning if **USA Networks** will be competitive long term. This is Diller's moment in terms of the event with **Vivendi** (VVDIY) and **Universal**, and he will find a way to either gain greater financial freedom, or perhaps disengage **USA Networks** from the encumbrance of **Seagram**. **Liberty Media**, which owns 21% of **USA Networks**, is strongly behind Diller gaining more financial flexibility to grow and develop the company. He has literally batted 1.000 in terms of the acquisitions he's made with **Ticketmaster**, **Hotel Reservations Network**, **Silver King** and others.

So that's a company which has been down this year, as **Disney** was, but we believe there are catalysts ahead, such as a change in ownership structure or acquisitions, that could propel the stock forward, while in the meantime fundamentals are very strong. I would parallel Richard's comments that **Time Warner** has performed well, but probably not up to par in terms of performance of general investor expectations.

TWST: Ed, if **Vivendi** does go ahead and buy **Seagram**, would that be the catalyst that could free **USA Networks** and **Barry Diller** from their financial relationship with **Seagram**?

Mr. Hatch: Yes, we think so. We think that investors expect that will be the case. However, under the terms of the shareholder agreement, there is no change-in-control provision that instantly provides **USA Networks** with financial freedom. So it will be up to Diller to negotiate that freedom with Messier of **Vivendi** and **Universal's** Bronfman.

Spending Trends

TWST: Moving on, gentlemen, how much are Americans spending on entertainment these days, and how is the entertainment dollar being spread among the various segments of the industry? Jim?

Mr. Goss: Music seems to have stagnated to some extent, although I think there is a major opportunity going forward. The dollar value of recorded product shipments has begun to pick up over the past year or two following several years of flat results. However, the industry must now deal with threats to its livelihood from piracy concerns, which now include the Internet.

There has been a compression of the dollars spent on movies into a fairly short cycle from release, which is somewhat of a change in the dynamics in that industry. Also, it has been somewhat of a tough

summer in the movie industry. Industry-wide box office gains were respectable through the spring, but have softened during the summer. Also, there have been very few major hits, notably *Mission: Impossible 2* and *Gladiator*.

A lot of the growth really is in radio, and a company like **Clear Channel Communications** is increasingly becoming a larger and more diversified growth enterprise with activities that now

include entertainment, with the addition of **SFX** (SFX). **Clear Channel** will certainly compete with **Viacom** as the **CBS** acquisition includes **Infinity** in the radio and the outdoor segments, but there is a lot of competition for time and attention that goes beyond just entertainment, including the Internet and various other options people have to occupy their time. So it's a very competitive climate, I would say.

Goss: Viacom has to be considered the star of the year. The performance of the stock year to date has been pretty well in line with that of Time Warner, except Viacom has made a major purchase while Time Warner has been on the receiving end of an acquisition bid. To the extent that the acquiring company tends to take some sort of hit, it hasn't really shown up in Viacom, or at least they've been able to overcome it.

1-Year Daily Chart of Viacom, Inc.



Chart provided by www.BigCharts.com

TWST: Rich, what do the global trends suggest about spending on entertainment in Europe, Asia and Latin America, and to what extent are the mega entertainment companies — **Disney**, **Time Warner** and **Viacom** — beneficiaries of spending internationally?

Mr. MacDonald: As Jim pointed out, there are a great number of different categories. There are enormous cultural differences and differences in personal income and distribution of income as well.

Having said that, there's been a trend in Europe since, oh, the mid-1980s, to forge a new landscape for European media which would introduce both private television networks and a broad, pan-

European regulatory structure. Since the publication of *Television Without Frontiers*, two things have happened. First, pay television was born in Europe. You've seen the growth of enormously valuable enterprises like CANAL+ (CNPLY) and BSkyB (BSY), Leo Kirsh's business, Kirsh group in Germany, and Tele Piu in Italy and a variety of others around the Continent. And those businesses now mirror to some degree the kind of spending levels you see in the United States, with penetration levels that are about the same. The Europeans have established a substantial lead in terms of direct-to-home satellite distribution, and a number of interesting 21st century kind of businesses like interactive TV, under the rubric OpenTV, which is going on in Britain right now, and a variety of different experiments around the Continent.

At the same time, advertising, which had been about one-tenth the per capita level in the United States, has grown to a level where it's probably 65%-70% of US per capita levels. Europe will continue to outpace the US in terms of consumer take-up and penetration, especially on the advertising side.

In South America, Europe and Asia, there is still enormous potential, because those industries are at an even earlier stage of emergence than the European industries. So there is vast potential opportunity for both the US media and entertainment companies as well as for the powerful European and Asian companies. In the 40 years he's been in business, Rupert Murdoch has had probably the best grasp of emerging electronic media around the world, and he has platform positions virtually in 24 time zones, and has a significant lead, even if he's a little bit subscale, in terms of financial power. But all the major media companies now, including Vivendi, in partnership with CANAL+, have very powerful international positions, and that can be exploited.

Advertising Revenues

TWST: Ed, as we look out through 2000, 2001, will robust advertising revenues continue? While it appears that the flood of dot-com advertisers has subsided, will election and Olympics-related advertising take up the slack?

Mr. Hatch: There are two or three issues facing the industry. First, advertising strength for the last few years has been so strong that the industry comes up against extremely difficult second half comps this year, notwithstanding the elections and a strong upfront season for the broadcast and cable networks. The bar has been set so high from the second half of 1999 that radio advertising, rather than being up 15%-20%, may be up just in the 10%-12% range. In television, rather than 12%-15% gains, growth will ease as well. And in terms of dot-com, we feel it will be a slow attrition, as dot-com companies that were funded by essentially public venture capital head into the sunset. Both individual and professional investors are seeing that they need to be much more selective today.

TWST: Jim, historically, has entertainment been vulnerable in a slower economy or has it generally proved to be quite resilient? What happens if the economy slows?

Mr. Goss: I think there is a contraction of spending to some extent, although the degree of volatility might be less than in some other areas. Movies still provide relatively cheap entertainment. Music is still fairly inexpensive also. There is some kind of cyclical to it, but not enough for it to be greatly affected. In both cases, the release of hit product that captures the public interest is the primary driver of success.

I might also add some thoughts related to foreign activity.

1-Year Daily Chart of Walt Disney Company



Chart provided by www.BigCharts.com

TWST: Yes, go ahead.

Mr. Goss: What we've seen over the past few years is an increase in foreign ownership participation within the entertainment businesses. At the same time, US companies have made increasing inroads into foreign territories. MTV is probably the best example. It is the world's largest television network, accessing 325 million households worldwide, out of a total of one billion television households. Entertainment is clearly a global business. It's important to remember the global economy issue, not just the US economic component, even though the US remains the primary driving force in the industry.

Market Share

TWST: Ed, will you provide us with some perspective on how the battle for eyeballs is shaping up as we move through the second half of 2000 and into 2001? Have there been any surprising shifts in market share? Who appears to be winning and who is losing share?

Mr. Hatch: We wrote a short piece at the beginning of the week talking about the broadcast networks, called *If You Can't Beat*

Them, Join Them. This meant that the broadcasters are taking a page out of the cable network industry in terms of developing programming that is new and different and risk-taking through *Survivor*, *Big Brother* and *Who Wants to Be a Millionaire*. While the *Millionaire* game show is not a new concept, it's the first game show that has been put on prime time since probably the 1960s.

Goss: What we've seen over the past few years is an increase in foreign ownership participation within the entertainment businesses. At the same time, US companies have made increasing inroads into foreign territories. MTV is probably the best example. It is the world's largest television network, accessing 325 million households worldwide, out of a total of one billion television households. Entertainment is clearly a global business. It's important to remember the global economy issue, not just the US economic component, even though the US remains the primary driving force in the industry.

So the broadcast networks, seeing that their viewer shares were continuing to fall, were willing to step up to say, "Let's look at the successful programming genres and event programming — look at what cable has developed in order to grow." Whether it's an MTV's *Real World*, or looking outward to Europe where *Big Brother* and *Survivor* shows originated, these shows have been a huge success in getting younger viewers and attracting viewers back from cable. But I think it's probably too early for the broadcast networks to declare victory. The cable networks continue to gain distribution reach, and they have a better balanced business model with the split of revenues between subscription fees and advertising. They have powerful partners and backers in the cable industry to help to insure that those channels succeed.

1-Year Daily Chart of Time Warner, Inc.



Chart provided by www.BigCharts.com

TWST: Rich, how do you see the battle for market share shaping up as we go through the year?

Mr. MacDonald: I don't think there are going to be huge shifts this year. I think Ed's point of view about who is being creative with programming is key on the broadcast side. I think NBC, unfortunately, has come a little late to that party.

To add a wrinkle to what Ed said about cable networks, that the big broadcast networks are in fact using their retransmission rights to create new cable network programming opportunities for themselves, these new services offer formats developed on broadcast TV such as soap operas and that kind of thing, which can be migrated to a cable platform.

Strategically, I think the more interesting question will be, "Well, is it likely that the introduction of digital broadcasting will attract new viewers, or a different kind of viewer, or are we likely to see additional over-the-air broadcast networks?" — in other words, a CBSII or an ABCII. Will we see a FoxII or even III; and how will they redefine what network television will look like for the next five years or 10 or 20 years? I'd say those are pretty exciting developments.

And finally, everybody is doing a lot of work to try to figure out how quickly broadband distribution over the Internet will occur, and whether there are new forms of television that will

emerge, and how the older networks will respond to all of that. So the battle for eyeballs isn't likely to change very much this year, but big, strategic bets are being placed now that will have an impact three, four, five or 10 years from now.

TWST: You raise the issue of digital television. Are all the networks developing programming that will be available on HDTV?

Mr. MacDonald: It's not ubiquitous at the moment, and it's not 24 hours, but CBS, HBO, ABC and some local TV stations are doing it. Yesterday, I was talking to somebody who said, "Well, you can get digital TV from Hartford or from a number of places around here. CBS and ABC are both broadcasting a number of programs in the HDTV format and it's beginning to happen." I'd say it's a five-year process, but the fact is, you can buy an HDTV today and actually get HDTV programming on it.

TWST: How many people are actually buying HDTV sets?

Mr. MacDonald: Not many. They're still \$5,000-\$10,000 items.

TWST: Ed, do you have any comment on this or can we move on?

Mr. Hatch: I think Rich made some great points. High-definition and the Internet will be changing the paradigm for the competition for eyeballs. It is still probably many years away before the broadcast industry gets behind this in a big way and is willing to make major investments in high-definition because nobody sees the payback right now. With the creation of numerous new digital channels, there needs to be content to fill them, and that's going to be very expensive. It will create a lot of excess channel capacity that may better be left dormant.

Outlook for Film Product

TWST: Jim touched earlier on softness in the movie sector. What's happening to movie audiences? Are the numbers for theatrical attendance dropping, Rich?

Mr. MacDonald: No, actually, they're going the other way. It's perhaps becoming more concentrated, and you get different seasonal patterns depending on the types of movies that are on. The box office results have been going up for the last three years. It's breaking out of a 20-year pattern of roughly 7 million admissions.

But I'd say that the other key factors that have been showing up in the film business are twofold. Fewer films are being made. Capital is exiting the market. There is a transition from videotape to DVD. There continues to be growth in overseas spending on pay-TV and home video.

These can be very positive for the film business as a whole.

TWST: Jim, is the reason why you say that this is a soft summer because there just don't appear to be many hit movies?

Mr. Goss: I just didn't think there were many big hits. *Mission: Impossible 2* has done about \$200 million domestically so far this year, but unless I'm mistaken, I think that's the only one in that category — *Gladiator* and possibly one other are in the \$100-\$150 million or so area. Rich, do you know of any others?

MacDonald: Fewer films are being made. Capital is exiting the market. There is a transition from videotape to DVD. There continues to be growth in overseas spending on pay-TV and home video. These can be very positive for the film business as a whole.

Mr. MacDonald: *The Perfect Storm* will probably get in there, too.

TWST: Jim, what's the outlook for the supply of film product and what are the factors that govern the distribution of movies to theaters?

Mr. Goss: The economics of film production and distribution have not been particularly favorable in the past few years because the cost of producing and marketing films has been increasing. The challenge for the studios has been to continue to produce and distribute an adequate supply of films to fill the pipelines (i.e., the theatres) and expand their libraries while maintaining control over film budgets that are being held flat or increased only moderately.

The one positive for distributors is partly at the expense of the theater operators. The multiplexes have generally tried to compress the films into the first few weeks of a theatrical release at multiple screens. That effectively has shifted dollars to the distributors, because the producer/distributor cut is greatest in the earlier weeks of release.

But the other aspect is that even as the overall costs of making films have gone up, major film companies such as **Time Warner**, **Viacom** and **Disney** desire to keep building the inventories of films in their catalogs. At the same time they have to find ways to not get overly exposed to increased risk with this relatively lower return business. An important strategy has been to effectively flatten film budgets, produce and own fewer films at 100%, and take on more production partnerships and deals exclusively for domestic or foreign distribution. I think this has been a smart route to take to effectively control the costs in a part of the business where returns are currently less attractive.

1-Year Daily Chart of The Seagram Company Ltd.



Chart provided by www.BigCharts.com

TWST: Ed, will we see fewer films being produced as the companies exercise greater control over production?

Mr. Hatch: The studios are trying to do a balancing act of having a diverse portfolio of films from low budget to high budget

and having marquee stars or directors. To Jim's point, they have to balance the financial risk. The studios would like to limit their output to a more rational number.

Disney has significantly decreased the number of films it's producing, as had **Time Warner** earlier. Recently, **Disney** rolled up, or essentially shut down, its Hollywood Pictures Studio and combined it with the Walt Disney Studio. Feature film-making is a grueling business because a major star such as Tom Cruise will command \$20 million or more for a film upfront, plus get a significant portion of the

back end. Studios hate to pay it, but if they don't, another studio will. There are few actors that can almost guarantee a film. It's like the professional sports business in that the talent makes huge amounts of money, but it's very hard for the owners to make those same sums, or ROIs.

A case in point: **Disney** once was the preeminent studio in both animation and live action. But it lost its direction and profits have gone from \$890 million just two years ago in 1998 to potentially \$90 million this year because production costs and overhead have eaten the studio alive.

Mergers & Acquisitions

TWST: How are the mega-mergers, those that have been completed and those that have not, changing the face of the entertainment industry, and the approach that investors should take to this sector. Rich?

Mr. MacDonald: First, to correct a misconception, **Disney** has been lowering its overhead and financial commitment to the film business to the tune of \$500 million annually, which is pretty significant. Regarding the recent mergers, they are mega-mergers and they each have their own specific rationale. In order of strategic clarity, the ones that have occurred over the last year would be ranked **Viacom-CBS**, then **Time Warner-AOL** and then **Vivendi-Seagram**.

Viacom/CBS

TWST: Let's start with the acquisition of CBS by Viacom. What was the driving force there? What does the combined company bring to the table?

Mr. MacDonald: The driving force there was that CBS saw a fabulous fit with **Viacom**; essentially there were a number of complementary businesses which they could bring in-house. In cable networks, CBS had made a good start in the country music business, and they could easily match that up with **Viacom's** MTV and VH-1. In broadcasting, CBS management saw the potential for terrific duopoly combinations with **Viacom's** Paramount Stations in various markets. And, at the same time, they probably also saw a way to solve the massive losses that were coming out of UPN.

I think they also saw a theatrical engine in Paramount. From **Viacom's** side, they saw that they had great access to the national advertising markets, and CBS also had great access to local markets. CBS was already dominating very important markets — virtually the top 20 markets in radio, television and outdoor. So the

leverage that they could gain over advertisers was dramatically improved. There were also cost-cutting reasons in terms of rationalizing businesses, as both had overheads in cable networks and in TV stations. On top of that were the opportunities for new growth. **CBS-Viacom** is a way to get exposure to the international marketplace and latch onto a very strong management.

The clarity in the **CBS-Viacom** merger was immediate; investors got the trade right away.

1-Year Daily Chart of News Corporation Limited



Chart provided by www.BigCharts.com

TWST: Ed, what will the key areas be for **Viacom** going forward?

Mr. Hatch: I think that the two growth drivers at **Viacom** are the cable network business (the core **Viacom** cable networks, coupled with the two cable networks, TNN and CMT, that **CBS** brought to the merger) and the **Infinity** radio broadcasting and its outdoor advertising. Those are the two growth drivers.

What is driving a lot of these mega-mergers is size, scale and clout. It is a twofold strategy of becoming more important to your corporate customer and the consumer, the viewer. It is the goal of being the most important vendor to your customer. It is being able to go to a **General Motors** or a **Coca-Cola** and say, "We can take care of all your needs. We have the **CBS** network for you. We can put you on the TV stations. Do you want to run a car campaign geared to young people? We can put that out on **MTV** and **Nickelodeon**." As a matter of fact, **Viacom** already has a joint venture with **Chrysler** to sell minivans using **Nick's The Rugrats** characters.

In addition, at **Viacom-CBS**, there was the natural television duopoly out of combining each other's TV stations. So, right away, the new **Viacom** has made itself more important to that advertising customer. Another good example, which came at **USA Network's** expense, was that **Viacom** made itself more important to its programming customer when it took away the **World Wrestling Federation** programming rights from **USA Networks**. **USA Networks** essentially offered **World Wrestling** one or two venues, or

outlets. **Viacom** then went to **World Wrestling** and said, "Hey, we put you on **UPN**, we could put you on **TNN**. We'll do more promotions. We'll do **World Wrestling** shows on **MTV** as well. By the way, we could also promote you on our **TDI** and **Outdoor Systems** billboards. We could do a **World Wrestling Federation** motion picture at the **Paramount Studio**." Instantly the dollar signs lit up in **World Wrestling** management's eyes. **Viacom** can simply ring the cash register more for them than **USA Networks**. They became more important than **USA Networks**, end of story.

TWST: Jim, what, in your view, is the greatest benefit that emerges from the **Viacom** acquisition of **CBS**?

Mr. Goss: Well, I think it could be summarized with the words advertising and distribution. It strengthens the combined position of the new companies in both areas. **Sumner Redstone** is fond of saying "content is king," but I think there is a recognition that distribution is vitally important as well. So now this gives more shelf space to the product that **Viacom** creates. Also, this combination can at least potentially solve the **UPN** issue, because it can take out a lot of the duplicate cost of running the second network. And I think it is generally understood that either **Viacom** owns the **UPN** network, or it's dead. There are good reasons to keep it alive, as it does serve a viewership niche. But there were no takers for a potential joint venture position at half of the \$5 million price that **Viacom** named in its buy/sell offer to **Chris Craft** several months ago. No one was interested in taking on the continuing start-up cost burden. So it's clear that if **UPN** is going to survive it's going to be in this form.

I don't think **Viacom** will make **UPN** a clone of the **CBS** network. However, there might be ways to leverage some of the **CBS** programming on the **UPN** network, while retaining a separate identity that broadens the reach into a younger audience than **CBS** has traditionally been able to garner, at least pre *Survivor*. I feel the addition of **KingWorld** is also very important. **KingWorld** was always a very interesting company in its own right — certainly the most successful syndicator in the business. So to have it there for both the **CBS** and **Paramount** products is very good.

Hatch: I think that the two growth drivers at Viacom are the cable network business (the core Viacom cable networks, coupled with the two cable networks, TNN and CMT, that CBS brought to the merger) and the Infinity radio broadcasting and its outdoor advertising. Those are the two growth drivers.

Viacom will now have a number of major growth businesses such as the cable networks and the **Infinity** radio and outdoor operations, along with several other businesses, such as **Paramount** films and television production, which remain important in creating that life blood of

content. With regard to the growth potential from cable networks, an important element is pricing potential. The larger cable networks of **Time Warner** and **Viacom** have grown large enough in audience size that the traditional pricing gap between the ad spots on cable and broadcast are starting to close. The major cable network operators are becoming able to offer more of an efficient buy to major national advertisers. They are reaching the point at which they would like to push cable as a primary buy in the upfront market rather than as a fill-in. This would reverse cable's traditional role vis-à-vis the major broadcast networks. I don't know that it will become the norm right away, but certainly this has been a very

favorable growth trend for the cable networks that will continue. So **Viacom** has a lot going for it right now, in my view.

TWST: Jim, did you have any reservations about the merger and if so, have they been resolved or is it something you fell in love with right from the start?

Mr. Goss: I don't know if I'd use the "fall in love" part with anything. But if there is a reservation, it's that there has been some erosion in the network television market share. However, if broadcast networks lose market share, it is generally to cable networks including the ones **Viacom** owns. Broadcasting remains a very profitable business to be in, although the greatest source of profits is typically through the owned and operated station group. Also, with duopoly potential, whether broadcasters get station ownership limitation relief that allows **Viacom-CBS** to add new markets, or they swap stations out to get duopolies in a lot of the markets in which they now own stations, the broadcast station group should be helped on the network side. **Viacom** will have both CBS and UPN, potentially providing complementary strength. The strength of the network business has traditionally been in its station groups and no competitor will have a more concentrated effort. So if there was a reservation, that could have been it. In addition, **Viacom** has two strong leaders, Sumner Redstone and Mel Karmazin, running the show, and they have a knack for doing it right.

TWST: Ed, how about you? Did you have any reservations about the **Viacom** merger with CBS?

Mr. Hatch: What's not to like? I think Sumner Redstone and Mel Karmazin are soul mates in their unbelievable focus on the stock price and building shareholder value. If there's anything investors tend to look at, it is "can two strong personalities, like these two, be compatible?" Redstone likes to focus on strategic issues and Karmazin is a "roll-up-the-sleeves" operator. They both have the stock price and shareholder value to focus on, so I think it's a good combination.

TWST: Rich, did you have any reservations about the merger?

Mr. MacDonald: No, not on this merger.

AOL/Time Warner

TWST: Moving on to AOL/Time Warner, Ed, what does the combination achieve and when is the deal targeted for completion?

Mr. Hatch: AOL/Time Warner should be a great combination of the distribution and content in both companies and, on paper, a terrific merger. It should close by the end of the year. Most of the businesses are complementary so there should be little concern, in terms of the Justice Department issues. As it relates to the cable industry, there has been a lot of talk about the potential open access issues. Recently, the City of Portland, Oregon appealed the original case; the FCC reminded everybody that the jurisdiction is up at the national

level. There's no room for the co-location of facilities and other issues. I think the FCC may look at tweaking the cable modem business to try to provide a little guidance to the industry in that respect. That is the fear of regulation creeping back in. But one's head spins when one thinks of the synergies between AOL and **Time Warner**. This comes from

whether immediately upgrading their AOL users from telephony to using cable modem, which would instantly double the revenue per home from \$21 to around \$40 per month, or from something as simple as taking *Fortune* magazine and better platforming it on AOL at the expense of its competitors *Business Week* and *Forbes*. This combination could make *Fortune* a better competitor and serve its customer better than its peers. One could pick 100 examples throughout the AOL/Time Warner system.

MacDonald: There are presumably ways that AOL can favor Time Warner content franchises on its Websites and presumably Time Warner can favor AOL in its cable positioning. I think the Justice Department will look to see if these are anti-competitive practices; certainly competitors have been talking about these fears here. They made a serious public relations error when they took ABC off Time Warner's cable systems. Investors knew that there would be a "battle royale," but didn't quite think that Time Warner would take the bait on that one.

1-Year Daily Chart of USA Networks, Inc.



Chart provided by www.BigCharts.com

TWST: Rich, how do you see the AOL/Time Warner merger? Are there concerns that investors have or should have?

Mr. MacDonald: I think there's less clarity in this one. First of all, there is some question in investors' minds about what the real growth rate is going to be after combining the companies. Ed brought up a good example of what potential synergies could be like, and there are presumably ways that AOL can favor **Time Warner** content franchises on its Websites and presumably **Time Warner** can favor AOL in its cable positioning. I think the Justice Department will look to see if these are anti-competitive practices; certainly competitors have been talking about these fears here. They made a serious public relations error when they took ABC off **Time Warner**'s cable systems. Investors knew that there would be a "battle royale," but didn't quite think that **Time Warner** would take the bait on that one.

Also, I would like, and I'm sure other investors would like, to hear the specifics about the potential synergies from the deal. So far they have just hinted at the great things that will come out of the merger but have failed to provide specifics beyond the superfi-

cial. But at current prices, it doesn't really matter to what extent they are successful in gaining synergies. The two share prices are both very attractive, each in terms of its own specific business and if there are synergies, everybody is a big winner.

But I do have some concerns, that the synergies not turn out to be based on anti-competitive practices, or not provoke any anti-competitive review, and that they actually enhance the growth rate for both companies.

Seagram/Vivendi

TWST: Ed, how do you like this merger?

Mr. Hatch: I'd say probably the biggest hurdle facing

Time Warner and **AOL** is integrating two different corporate cultures, getting a buy-in from both management teams to take ownership on projects and executing them. **Viacom** and **CBS** have more similar corporate cultures, given the entrepreneurial leaders of both companies, and both are relatively new organizations. **Time Warner** has a much longer history and a more traditional corporate structure than **AOL**. There may be some issues

that they will need to address to merge those cultures — everything from working together to common pay structures — and get everybody on the same page. But the businesses and brands are so strong that it is their business to lose.

TWST: Jim, is the AOL acquisition of Time Warner a perfect match, in your view, or do you possibly share some of the concerns that Rich talked about?

Mr. Goss: I do like the deal, in total, but I would say there are a couple of things to consider. First, it's a complicated deal. Clearly there have been valuation issues as one company is contributing most of the revenues and cash flow and the other one is getting most of the value because of the underlying growth and high valuation of its business. I'm sure that it was a very difficult balance to strike. For investors, both stocks have bounced around quite a bit over the past several months since the deal was announced, probably reflecting concerns about how it should be priced. But I do think **AOL** and **Time Warner** are complementary companies which share a "push the envelope" mentality. They are both heading in the direction that the other wanted and provided. **Time Warner** has been struggling to improve its Internet presence for several years, starting with **Pathfinder**, and **AOL** obviously desired content. **AOL** has generally been trying to redefine itself every few years anyway to go beyond what it had done before.

Goss: AOL and Time Warner are complementary companies which share a "push the envelope" mentality. They are both heading in the direction that the other wanted and provided. Time Warner has been struggling to improve its Internet presence for several years, starting with Pathfinder, and AOL obviously desired content. AOL has generally been trying to redefine itself every few years anyway to go beyond what it had done before.

Hatch: We view the Vivendi merger very much like the position of Westinghouse five years ago as it transforms itself out of slower growing industrial businesses into the fast growth world of telecom and media. They've been steadily executing on that plan. As for Seagram, you'd have to give their management good marks over the last 18 months for divesting themselves of businesses that they have had a small share in.

On the management issue, I think there is some good potential that it will work. Jerry Levin is a broad thinker who is able to deal with a lot of different personalities and egos and also see both the forest and the trees at the same time. And with **Bob Pittman** involved, **AOL/Time Warner** will have someone who has experience in both companies, and for quite some time in each. So he's probably the real link that can join the companies together, and ultimately he is a very strong heir apparent candidate.

As to operations, cable networks will be very important for the combined **AOL** and **Time Warner** going forward. Music is one of the areas that should develop some synergies and broaden that whole market once the **Napster**, **MP3**, and other such issues are settled. The music industry must determine how to redefine its business in the Internet age. I think there are a lot of opportunities and **AOL/Time Warner** will certainly play a major role in the new dissemination of music, especially since this combination will be further enhanced by the addition of **EMI** (**EMIPY**) to its mix.

TWST: Rich, three to five years down the road, which areas do you think will contribute most to earnings for the combined company?

Mr. MacDonald: It depends on how fast **AOL's** subscriber base is growing. Possibly five years from now, both sides could be contributing about equal amounts, based on the way the arithmetic works today. If they are successful in coming up with a new paradigm, as Ed called it, where they can take their old businesses and creatively accelerate them, particularly in a broadband world, then you won't know which is contributing the greater or lesser amount. At that point, the company will be completely intermeshed, especially in the entertainment, cable, cable programming and Internet streaming businesses that they both are looking to exploit. I'd say there's even an opportunity that some minority interest in publishing could get sold off at some point, but it's a tough play. It would be very tough five years from now, if they succeed in properly integrating their businesses, to sort out who is contributing what.

TWST: Ed, how do you view the proposed acquisition of Seagram by Vivendi and what are the implications for the future of Universal?

Mr. Hatch: We view the **Vivendi** merger very much like the position of **Westinghouse** five years ago as it transforms itself out of slower growing industrial businesses into the fast growth

world of telecom and media. They've been steadily executing on that plan. As for **Seagram** (VO), you'd have to give their management good marks over the last 18 months for divesting themselves of businesses that they have had a small share in. Tropicana is a good brand, but a small industry factor. In executing the PolyGram merger, it elevated Universal to be number one in a media category, music. So on that basis, **Seagram** has had a nice transformation, made itself a more attractive company. Along the way, it picked up a 43% equity stake in **USA Networks** through an asset exchange. I would expect that Universal will, in the United States, continue to be run effectively on its own. **Vivendi** will attempt to integrate some of the content, primarily music, through its Vizzavi multi-access portal (MAP), and help try to stimulate the sales of Universal Music Group's titles and partially help promote other Universal products in motion pictures and television.

TWST: By the way, Ed, do you have any question as to whether this deal will go through?

Mr. Hatch: We happen to think that the odds are very high that it will go through. Both managements are committed to it. It appears that the **Seagram**, **Vivendi** and **CANAL+** shareholder vote will go very positively. Each management is incented to close, given the fact that if either firm backs out, the other receives an \$800 million break-up fee. For **Seagram** it is a partial exit strategy for the Bronfman family as much as the fundamental merging of the two companies.

TWST: And some would say that's something that the Bronfman family has wanted.

Mr. Hatch: Yes, I would agree.

TWST: Jim, how do you see the Seagram-Vivendi deal? What are the advantages and the disadvantages for investors?

Mr. Goss: I should preface this by noting that I don't follow it on a published basis. But I think it creates an interesting blend of businesses that in a way is somewhat similar to **Disney** with the motion picture and theme park elements and also the interest in **USA Networks**. But it also has the music element, which **Disney** largely lacks. So it differentiates itself in that way and also with its increasing international presence. And assuming the beverage area does get sold off at some point, the business mix will provide a multifaceted, global presence that will compare well in a lot of ways to many of its competitors.

Outlook for Disney

TWST: This should bring us to a discussion of what is happening at Disney and how you view the current strengths and weaknesses of the various businesses in the Disney portfolio. Ed?

Mr. Hatch: Sure, we've recently reinitiated coverage of **Disney** with a buy rating and a \$45 price target. **Disney** had a very good recovery both in its stock price and fundamentally, since last fall, but we view the company as still in the early stages of a transformation and two of its four divisions are still in transition. Earlier

we referenced how the studio entertainment division saw its cash flow go from \$890 million in 1998 to an estimated \$90 million for fiscal 2000. **Disney** is completely restructuring the live action, animation and home video components of that business. The consumer products division, which is involved in merchandise-licensing **Disney** brands and characters as well as operating the Disney Stores,

has also seen a material decline in profits over the last couple of years. That brings us over to the theme park division, which is a steady 9%-12% growth company with underlying 2%-3% unit growth that accounts for about 40% of total **Disney** cash flow. At Media Networks, which is about 45% of total cash flow and evenly balanced between ABC Broadcast Network, the TV station group and the cable networks

(ESPN group, Disney Channel, Toon Disney and equity interests in A&E, Lifetime and others), a great part of the growth has been through the singular success of *Who Wants to be a Millionaire*, which accounts for about 40% of the profit of the entire broadcast division and virtually all the profits at the network. As we get into next year, the comparisons are extremely difficult and this momentum may not be sustainable.

So we have what we call a "mild" buy on **Disney** given the fact that it's in the early stages of this transition. It is a challenging world out there for all media companies, not just for **Disney**, and the ability to be "cutting edge" and compete with multiple new children's franchises and activities out there, from Pokeman to Digimon to Nintendo to the Internet, is where **Disney** has been slow off the mark.

Goss: ESPN (and its progeny) remains a franchise player among cable networks and strengthens ABC's ability to generate favorable sports deals. ABC may be overly dependent on Millionaire, but the program did bring ABC the benefit of getting the network back in the game from its former third place position, and it does provide ABC with potential sampling of other shows.

1-Year Daily Chart of Clear Channel Communications, Inc.



Chart provided by www.BigCharts.com

TWST: And *Harry Potter*. Ed, what's happened to theme park revenues?

Mr. Hatch: Theme parks have been a steady performer for **Disney**. Two years ago they opened up the Animal Kingdom Park and that now accounts for about 24% of theme park revenues down in Walt Disney World in Florida. It initially cannibalized attendance from the other parks, but overall has been additive and

quite successful. That's the core business of **Disney**. It gets fed through the development of new animated and live action franchises at the studio. As they succeed, **Disney** is able to exploit them, not only directly through videocassettes, but also by creating and developing new attractions for the parks, which provide one more reason for a consumer to make that trip.

TWST: Is this still a growth business?

Mr. Hatch: Relative to some other business, the theme park business is relatively mature. It's a 10% growth business compared to 15%-20% growth for the radio business and the cable network business.

1-Year Daily Chart of Gemstar-TV Guide Intl. Inc.



Chart provided by www.BigCharts.com

TWST: Jim, what do you think will be the areas of greatest strength for Disney over the next one to three years?

Mr. Goss: ESPN (and its progeny) remains a franchise player among cable networks and strengthens ABC's ability to generate favorable sports deals. ABC may be overly dependent on *Millionaire*, but the program did bring ABC the benefit of getting the network back in the game from its former third place position, and it does provide ABC with potential sampling of other shows. So even if the show itself runs out of steam at some stage, and it doesn't really look like it's getting there yet, it will have done a very good service to **Disney**. It has helped solve what had been the biggest problem **Disney** had been facing, while turning ABC into one of **Disney's** areas of strength at the moment.

Also in the parks area, I think it's very encouraging to see that **Disney** is taking aggressive action to add some new gates. Notably, the second gate, **Disney's** California Adventure, will open in Anaheim, I believe in early next year. And they have plans for new parks in Asia too, in Japan and Hong Kong. So that's an expanding business. **Disney** does not get the same cuts in the Asian parks that it does in the United States, but I think it's still a plus. Consumer products obviously have been a problem to the extent that **Disney** had to take a write-down, just

as **Time Warner** eventually did in the same area. I think Ed described the situation very well. Some of the animated films, **Disney's** traditional major strength, have also provided challenges in that they cost a lot to produce and market, and required a lot of young eyeballs to really make up for those costs. But ultimately, something like *Dinosaur* will create one of those new classics that **Disney** can re-market over time. And I have always believed that **Disney** would be one of the chief beneficiaries of DVD, because DVD provides a much better experience than VHS, and the younger audience will watch and rewatch the product. So I think that's a big plus for **Disney**, even though children might not appreciate the distinction in quality as much as adults will.

Mr. Hatch: I would just like to add one thing and expand on Jim's thought.

TWST: Go ahead.

Mr. Hatch: Jim brought up a very good point on the new park openings, particularly the foreign ones. There **Disney** will receive a license fee and will not be a day-to-day operator. This platform provides them a great vehicle to sell more merchandise. One of the strategies in animated television is that if you can essentially generate enough fees to pay for the cost of the show, then it becomes a gold mine for selling merchandise. Children's television has essentially become a 30-minute commercial to sell merchandise. The park analogy is, in Japan and Hong Kong, having the theme parks there becomes a massive promotional vehicle, in which **Disney** has little financial risk and brings in a royalty fee. This should greatly enhance their ability to sell more merchandise.

Company Differences

TWST: Jim, from an investment perspective, what are the commonalities and what are the differences between the companies in the entertainment space today?

Mr. Goss: The commonality would be that they all have blends of different components of entertainment. They provide different ways to get consumers' attention or provide uses for their time in attractive ways. But the differences are that the mixes vary from one company to the next. So some might be more advertising-driven and some might be more fee-driven, to the extent that you pay a price to watch a movie or buy a CD.

So the entertainment companies are really blends of media and entertainment. And the mixture is going to be different from company to company. I think you have to individually look at

which growth avenues each company provides and where the biggest exposures are. A commonality with **Time Warner** and **Viacom**, for example, is that cable networks, basic cable networks in particular, provide a key source of growth. I noticed **MGM** (**MGM**) is talking about developing cable networks for some of its library. This is the way you effectively monetize that asset, by creating some way of bringing dollars home from the library that you built at fairly high cost over time.

TWST: Ed, what in your view are the most important commonalities and the most important differences between these companies, from an investment perspective?

Hatch: The companies that investors would define as media entertainment in television and film develop a product that can be sold over and over again. It is a software content product, and can be re-purposed in many different formats. The challenge for the companies is to be able to do this economically, and the challenge for the investors is to find those companies that are doing it best at the best valuation.

Mr. Hatch: The companies that investors would define as media entertainment in television and film develop a product that can be sold over and over again. It is a software content product, and can be re-purposed in many different formats. The challenge for the companies is to be able to do this economically, and the challenge for the investors is to find those companies that are doing it best at the best valuation. So when **Viacom** produces *Mission: Impossible 2*, it goes from domestic to Europe to Asia to South and Latin Americas, then it goes onto a videocassette and DVD. It may be promoted over the Internet, then sold in future windows to pay television and cable networks and broadcast TV, where it has a very long life. There may be some meaningful merchandise licens-

ing income, too. In the broadcasting business, especially radio, you have extremely high free cash flow characteristics. **Disney**, for example, has 25%-30% of its cash flow as free cash flow after taxes, interest, cap ex and dividends. **Infinity Broadcasting** has about 60% of its cash flow free after all those obligations. So the radio broadcasters have been pure money machines, and that has not gone unnoticed by investors over the last several years, as radio has been one of the best performing groups.

Over at **Disney**, while the theme parks may generate about \$2.4 billion in cash flow, capital spending is around \$2 billion for that division, but that will temper in another year when the California Adventure Park is fully completed. But the capital spending requirements are quite high. At **Infinity**, cap ex is only about \$50MM for close to the same cash flow of \$1.9B. Those would be the commonalities and differentiating factors.

1-Year Daily Chart of Metro Goldwyn Mayer, Inc.



Chart provided by www.BigCharts.com

TWST: Rich, how would you compare **Disney**, **Time Warner** and **Viacom** as investments today? What guidance are you giving to investors?

Mr. MacDonald: **Disney** is a turnaround story with significant upside potential from current levels. The company is progressing well in its cost reduction strategy, return on investment has become a key yardstick to measure segment financial performance,

it continues to work on fixing underperforming businesses, and it has become much more investor friendly. Also, advertising strength and *Millionaire* have accelerated the turnaround process probably by as much as a year.

For **Time Warner**, we have some concerns that the **AOL** deal was two years too soon because the company does not have its broadband platform in place yet. Having said that, we still like the shares on a stand-alone basis: the fundamentals are strong, but the shares would likely have traded at current levels without and (potentially despite) the deal.

Viacom is a “here and now” stock. The company is growing 80% of its EBITDA at 20% plus and will generate increasing amounts of free cash

flow, starting with about \$2 billion this year. Also, the **CBS** merger was a strategic home run with potentially significantly less execution risk than either **AOL/Time Warner** or **Vivendi-Seagram**.

TWST: Jim, what guidance are you giving to investors today as to how they should be looking at **Disney**, **Time Warner** and **Viacom**?

Mr. Goss: I don’t have a current published opinion on **Disney**, so I’ll beg off of that one for the moment.

TWST: Time Warner and Viacom.

Mr. Goss: With **Time Warner** and **Viacom**, I think they’re both attractive. If there is a problem in both cases, it is due to their own success. They’ve done so well so far this year in terms of relative stock price performance that I think the market has reflected some of their prospective gains to a greater extent than, for example, with some of the radio companies like **Clear Channel**, **Entercom Communications (ETM)** and **Emmis**, as well as some of the publishing and cable stocks. But between **Viacom** and **Time Warner**, I’d say there’s a greater clarity with **Viacom** right now, in that a lot of the decisions already have been made. The businesses that have merged aren’t quite so dissimilar in terms of what they do and how they’re valued as with **AOL/Time Warner**. So the ability to understand what’s going on and how they’re choosing which areas to be in appears greater. Both companies have an ability right now to define, to a certain extent, how investors will evaluate their performance, and they’re both restructuring along those lines. And I think **Viacom** is taking a very active approach in trying to focus on its growth areas and recognize which ones are really seed divisions, like **Paramount**, where they will effectively get their payback in some of their other areas.

But **Time Warner** is a good stock to own also. They’re both very core holdings. But there will be an additional period in which investors will have to digest what’s happening with the **AOL/Time Warner** merger and make sure they’re satisfied with how the relationships are going to grow together. A lot of the **AOL** holders aren’t crazy about being slowed down by the slower traditional media operations. And a lot of the traditional **Time Warner** holders are probably upset at the notion that while **AOL** might offer faster growth and good cash flow characteristics for its relative revenue size, it is still a younger and smaller business. So this blend has

to take place and investors have to get comfortable with it. But I think that over time it's going to be a terrific combination.

Stock Recommendations

TWST: Ed, what guidance are you giving investors today?

Mr. Hatch: **Viacom** continues to be our top pick, and as we indicated earlier, it's a combination of simply the best businesses for the diversified media companies, a terrific shareholder focused management, and great free cash flow generation. One thing investors have to avoid is trying to outsmart themselves looking for the "clever" play. Often simple is best. **Time Warner** and **AOL** is a terrific complementary merger, but there is greater risk in execution. But the good news there is that the brand franchises are so strong that management should have plenty of time to figure it out and make it happen. And it's a wonderful blend of new media through **AOL**, which is the **Coca-Cola** of its space. For investors looking for an Internet vehicle, **AOL** is the brand franchise in the area. So why outsmart yourself looking for a clever alternative? **Time Warner** has strong leading brands across the board and **AOL** has a loyal customer base.

On **Seagram**, we feel very positive toward the merger being consummated. The uncertainty in the marketplace creates a great buying opportunity. **Vivendi's** management is unfamiliar to US investors, and pro forma financials remain sketchy, but what is known is that we expect **Seagram** and **Philips** to pledge their 36% of the vote toward the deal. **Vivendi** has 49% of **CANAL+** vote and there are no major blocks of stock held by **Vivendi's** shareholders that look troublesome. So there's a high probability the vote goes through and the regulatory concerns are very minor. After the close, it gets tougher, as executing the "wireless" vision will have to begin.

TWST: Are there any other companies that investors should be looking at in the entertainment world Ed, perhaps some smaller companies?

Mr. Hatch: I would reemphasize **USA Networks**, a "small" \$15 billion equity market cap company. We believe investors are being somewhat irrational in worrying whether **USA Networks** can continue to compete. They're small relative to the \$100-\$200 billion companies, but they certainly have enough clout to proceed on their own. Management owns about 10% of the stock and has been shareholder focused. **Liberty Media** owns about 21% of the shares as well. **USA** is in the sweet spot of media, which is in the cable network business and electronic retailing through Home Shopping Networks. It has had three or four great years of performance and is in a trough right now. It hasn't missed a beat fundamentally. This is a great buying opportunity.

A new company on the scene is a small cap children's content company called **Nelvana** (NTV.T). It's a company with a blue chip roster of program franchises, and a blue chip list of customers. It owns franchises such as Little Bear, Franklin, a new series called *Maggie and the Ferocious Beast* on Nickelodeon, *Rolie Polie Olie* on the Disney

Channel, *Corduroy Bear* on PBS, a whole host of other franchises, and a growing program library. It's a Canadian company that just listed on the NASDAQ and simultaneously did a 3 million share offering. For full disclosure, we were one of the underwriters, which I was pleased to be involved in given the high quality of their product, their great customer base and management team. It's certainly one to keep an eye on. Our price target is \$24. The newly merged **Gemstar-TV Guide International** owns the most valuable intellectual property and patents in electronic program guides. **Gemstar** created the VCR Plus codes to automatically program VCRs. Again, my colleagues Peter Mirsky and Rob Stone are the experts here and believe that it could be a \$100 stock.

Liberty Media (which we also recommend) and **News Corp.** (NWS) each own about 20% and are motivated to see its products distributed.

Infinity Broadcasting is the simplest story in radio. Our target for **INF** is \$44. It owns 170 major market radio stations, the highest revenue per station by a wide margin. Its **TDI** and **Outdoor Systems** billboards complement this business well by leveraging

out-of-home presence. **INF** has great management and a track record to back it up.

Liberty Media is a play on media, technology and wireless, as 66% of its value is in public companies like **Time Warner**, **News Corp.**, **Motorola** (MOT), **Sprint PCS** (PCS), **Teligent** (TGNT), **Liberty Digital** (LDIG), **Gemstar-TV Guide** and **USA Networks**. The other 33% is in Discovery Cable Networks, QVC and Starz/Encore Pay TV. Management has an uncanny way of nudging these companies to co-operate and build value. We have a \$30-\$35 target on **Liberty** shares.

Hatch: Infinity Broadcasting is the simplest story in radio. Our target for INF is \$44. It owns 170 major market radio stations, the highest revenue per station by a wide margin. Its TDI and Outdoor Systems billboards complement this business well by leveraging out-of-home presence. INF has great management and a track record to back it up.

1-Year Daily Chart of Cox Communications, Inc.



Chart provided by www.BigCharts.com

TWST: Jim, what are some of the other companies that you would like to mention? You have referred to radio stocks.

Mr. Goss: I would mention again **Clear Channel Communications**. It obviously would be the primary competitor to the **Infinity** component within **Viacom**. And it also has this presence with **SFX Entertainment** that not everyone has embraced warmly.

My feeling is that on a platform of the size and extent that **Clear Channel** has now developed, **SFX** can actually be a leverageable asset. I think radio continues to be one of those good industries that will be increasing its share of advertising dollars, although perhaps not at the pace at which it has been increasing recently. Their competitors would include **Entercom** and **Emmis Communications**.

1-Year Daily Chart of Infinity Broadcasting



Chart provided by www.BigCharts.com

TWST: Will you tell us about Entercom?

Mr. Goss: **Entercom** is a pure-play radio company. It is one of the top five radio group operators in terms of revenues. It operates in several key markets, Seattle and Boston being the largest of them. It's not involved in outdoor or television, or anything else, just radio. Management has focused on clustering properties in larger markets. It has recently been in an expansion mode. The acquisition of **Sinclair's** (SBGI) radio properties was the biggest such event since **Entercom** went public in early 1999. The **Sinclair** transaction nearly doubled **Entercom's** operating base. **Entercom** is a high quality company based in Philadelphia, although they have no stations there. For those desiring pure play radio exposure with a large market orientation but in a mid-cap package, this is a very nice stock.

Another area that is tangentially related to entertainment in the distribution business is cable television systems that compete with Time Warner Cable. **Cox Communications** (COX) comes to mind as one that is benefiting from the rollout of various alternative services like cable modems and digital cable as well as telephony service over its cable system.

Digital opportunities are going to help transform, or at least affect, television and radio. And just yesterday, Lucent Digital Radio and USA Digital Radio announced they would be merging. Digital radio represents an effort to provide a better quality reception for traditional radio channels. USA Digital Radio is a joint venture of a lot of the major radio group operators. This is not the type of radio that would offer brand new, commercial-free channels. It

would provide the channels we hear right now, but with a better quality signal.

Beyond the signal quality issue for both digital radio and digital television are the potentially new business opportunities that may become available to the owners of stations, whether they be radio or television. **Viacom** and **Disney**, for example, will benefit from new digital spectrum opportunities for **CBS/Infinity** and **ABC Television/ABC Radio**, respectively. Even if television programs are broadcast in high definition, there will still be excess bandwidth that will allow for some additional business opportunities. These could involve either additional channels or other information through involvement with a couple of consortia that have already been created: **Geocast Network Systems** and **iBlast Networks**. But even if HDTV does make its presence felt, there won't be 24 hours of high definition programming, in my opinion. It will probably be confined to things like prime time and sporting events, where the differences in quality are going to be more appreciated. So that will allow some additional bandwidth to create new business opportunities that will benefit a number of these companies.

TWST: Rich, are there other companies that you would like to highlight?

Mr. MacDonald: **News Corp.** has the best positioning on a global level in terms of digital media, but potentially could use more scale in the domestic entertainment business (**Fox**). There is significant value in the worldwide satellite platforms that the **Sky Global Networks** offering should unlock and they are doing a lot of interesting things in the new media arena. Also, they have a bullet-proof balance sheet and visionary leadership.

MGM is also a good stock to own right now. We think the share price will begin to reflect the major initiatives implemented by the new management over the last year. The company has assembled the largest library of movies and television programs in Hollywood and is managing it very aggressively to enhance returns; it has implemented a very disciplined green-lighting process for new film projects, and the new **Fox** international distribution agreement for film and home video (which replaced **Warner Home Video** and **UIP**) is a significant improvement both financially and strategically. There is significant untapped value or at least value-generating potential in the company, such as with the planned **MGM-branded** cable networks.

TWST: Ed, what's a final thought that you would leave with investors?

Mr. Hatch: The final thought I have is that investors should focus on management, its ability to execute, its track record, and share ownership to see that management's interests are aligned as much as possible with the public shareholders'. Also, keep it simple. Try not to outsmart yourself.

Investor Interest

TWST: Ed, what kind of investor interest are you seeing in the group these days, and where's it coming from?

Mr. Hatch: Investor interest continues to be very, very high. The group is coming off the heels of several years of economic benefits from deregulation. Technology continues to be a driver to create new formats or easier ways to distribute media. And then there is the convergence of media and telecom, which is creating new products and services for the consumer. There will be a lot to come in the wireless area. Costs of service and electronics are falling rapidly. Consumers want it now. As these companies continue to merge, there are great economic opportunities for investors, both fundamentally and in terms of the values created from mergers. What was traditionally an industry led by the US companies has become increasingly global. Foreign companies are pairing up with each other and with US companies. Older infrastructure overseas, such as the theatrical exhibition business, has boomed and TV station groups are merging or aligning, which has created greater scale economies. This has made the European market, in some cases, almost more important than the US market as a revenue source for films and television product.

TWST: And Jim, what kind of investor interest are you seeing, and where is it coming from?

Mr. Goss: I would echo a number of the things Ed said. I do agree that management is the highest priority. So if you're picking your investments, pick ones where you agree with the vision and the ability to deliver on promises of the management teams. I think it is also important to remember that entertainment has traditionally been one of our country's top exports. It's a US-driven business in that Hollywood and New York tend to set the tone and create much of the product for entertainment around the world. There is a certain amount of indigenous product in any given country. But the product that gets distributed globally tends to be either a US product or a US-driven or copied product, typically from some other English speaking country.

So I feel that even though the industry has become more global, the US presence remains felt, including the impact that our

culture has on much of the rest of the world. There are a number of great opportunities for investments, and those opportunities are being enhanced by the changes in technology that allow greater leveraging of the content that continues to be made and has been aggregated in the libraries or catalogs of the entertainment companies. The stocks have done quite well over the past several years, and I would anticipate continued investor enthusiasm.

TWST: Thank you.

Note: Opinions and recommendations are as of 7/25/00.

JAMES C. GOSS
Barrington Research Associates, Inc.
161 North Clark Street
Suite 2950
Chicago, IL 60601
(312) 634-6355
jcg@brai.com

EDWARD T. HATCH
SG Cowen Securities
Financial Square
28th Floor
New York, NY 10005
(212) 495-6545
hatche@sgcowen.com

RICHARD J. MACDONALD
J.P. Morgan Securities
60 Wall Street
11th Floor
New York, NY 10260-0060
(212) 648-6958