

PALI RESEARCH

February 7, 2008

Warner Music Group (WMG) Industry Continues to Contract and Buying Revenue Growth Cannot Hide Underlying Problems; SELL

Why would we continue to short WMG?

- **Revenues Declining Excluding Acquisitions.** While management refuses to break out the specific benefit of acquisitions on revenue growth, their response to our question on the conference call implies that organic revenue growth (with constant currencies) was down low-mid single digits.
- **Lowered the performance bar,** in order to compensate senior management (in our minds, it's like repricing options). From WMG's recently filed proxy: "in 2007, the Compensation Committee considered and approved adjustments to increase the aggregate bonus pool amounts that would have resulted from reference to the metrics [revenue growth and EBITDA growth] to reflect unanticipated pressures on the recorded music industry, particularly the industry-wide decline in physical music sales, which was larger than expected."
- **Net Debt is rising as EBITDA falls.** At the end of fiscal (Dec) Q1, WMG's net debt stood at \$2.1 bn, up from \$1.9 bn with EBITDA in the quarter down 8% year-over-year.
- **CD Sales Collapsing Once Again.** While some investors were excited by an improvement in CD sales (smaller declines) in the first two weeks of 2008, unit sales have rapidly dropped off, with year-over-year declines now back over 20% on a weekly basis. As floor space at retail continues to contract and consumers begin to forget what a CD is, we expect physical CD unit sales declines to accelerate. In addition, digital unit sales are up only 30% so far this quarter, about half of the growth experienced last year at this point in the quarter.
- **Market Share Gains Likely Unsustainable.** Warner Music has grown market share through acquisitions and A&R success, which has helped the company outperform the industry. Yet during yesterday's conference call, management indicated that market share may be difficult to grow in 2008 given the

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WMG: SELL

Price \$6.94

Target Price: \$5.00

52 Week Range: WMG	\$4.57 - \$21.51
Market Cap. (mm):	\$1,015
Avg. Daily Volume (100 day):	1,050,000
4-Yr. Est. EBITDA Grwt Rate:	-12%

Fiscal Sept (WMG)	2007A	2008E	2009E
Q1	\$0.12	(\$0.11)A	N/A
Q2	(\$0.19)	(\$0.09)E	N/A
Q3	(\$0.12)	(\$0.09)E	N/A
Q4	\$0.03	\$0.11E	N/A
FY	(\$0.14)A	(\$0.18)E	(\$0.32)E
P/E	NM	NM	NM
Prior EPS	NM	(\$0.12)E	(\$0.30)E
Consensus	NM	(\$0.18)E	(\$0.13)E
Revenues	\$3,385	\$3,309	\$3,198
EBITDA	\$461	\$398	\$338
EV/EBITDA	NM	7.4x	8.7x

Source: Pali Research Estimates and Company Documents
Note: EBITDA and EPS are before non-recurring items

Please Read: Important disclosures and analyst's certification appear in Appendix

increasingly difficult comparisons it faces. If that proves accurate, WMG's revenue and EBITDA performance will be even more challenged in FY2008.

- **Mobile revenues (ringtones) are declining** with US revenues down and international sales about flat.
- **Dividend Likely Unsustainable.** Given the continued decline in EBITDA, we believe the company will be hard pressed to maintain its \$0.13 quarterly dividend. WMG management even went out of their way on the conference call to highlight that they will now be addressing the dividend issue quarterly and will provide an update on their thinking on each conference call going forward. We take that to mean that dividend payments are likely to end at some point during fiscal 2008.
- **Nobody was "fired" for Bulldog mistake.** The Bulldog acquisition was never disclosed, as Warner Music's investors relations informed us that it was deemed immaterial at the time. Yet, within only eight months of making an immaterial acquisition, WMG disclosed an \$18 mm impairment charge. In addition, we believe Bulldog sustained substantial losses implying the total cash impact was closer to \$30 mm. How can a company with declining revenues and declining EBITDA, make an acquisition of that size, and nobody gets fired for the mistake and everyone in senior management is still paid millions of dollars each in total annual compensation?

APPENDIX**IMPORTANT DISCLOSURES AND ANALYSTS' CERTIFICATIONS****Analyst Certification**

I, Richard S. Greenfield, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject companies and their securities. I also certify that I have not been, and will not be, receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report.

I, Mark D. Smaldon, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject companies and their securities. I also certify that I have not been, and will not be, receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report.

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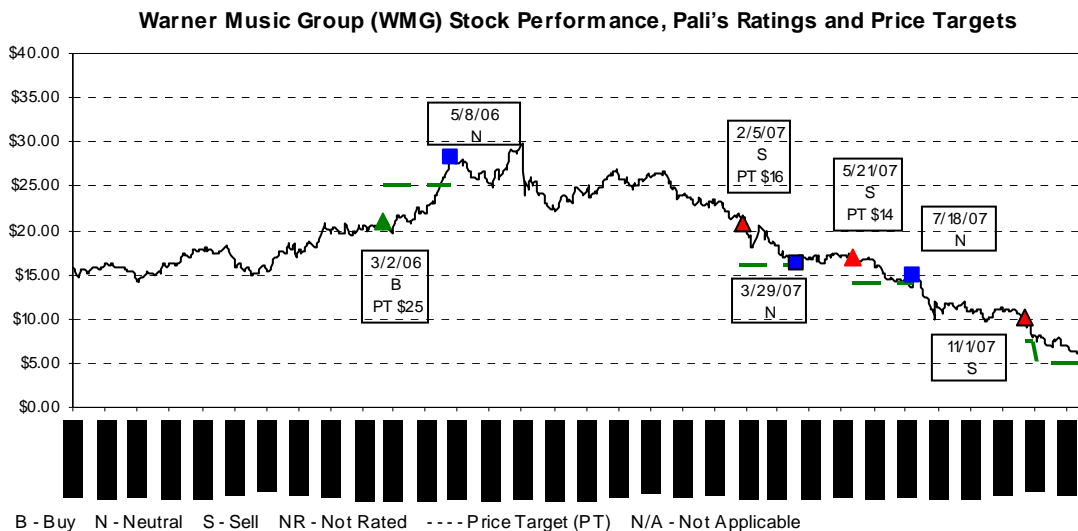
Unless otherwise noted, all prices are as of the close on February 6, 2008.

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Disclosure Chart for WMG



Source: Thomson.

Valuation Methodology

- We believe WMG's current valuation of 7.4x our FY '08E EBITDA estimate and 10.6x '08E FCF is expensive given the deteriorating industry fundamentals.
 - Our \$5.00 target price is based on 6.7x '08E EBITDA and 7.6x '08E FCF, which due to rapidly declining earnings equates to 7.9x '09E EBITDA and 8.6x '09E FCF.

Risks to our Valuation and Price Target

- Significant Market Share Growth at WMG. While the driver of our SELL rating is a weakened industry outlook, if WMG can dramatically outperform the industry, our estimates for 2008 and 2009 could be exceeded.
- Rapid Shift to DRM Free Music. We believe the industry needs to rapidly shift to DRM-free music to end interoperability issues that are pressuring digital music growth. While we do not expect the industry to widely embrace DRM-free music (beyond tests and trials) until mid-2008 and more likely 2009, a rapid shift to removing DRM could improve WMG's prospects.
- Significant improvement in industry performance. We had a buy rating on WMG in early 2006, as industry results were stronger than we expected. To the extent that the dramatic fall-off in CD sales abates and the overall industry can grow based on the year-over-year increases in digital tracks sales, WMG could exceed our expectations.

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