

# PALI RESEARCH

August 5, 2008

## Warner Music Group (WGM) Sony BMG Consolidated at Only 4.5x EBITDA; Negative for WGM Valuation

Sony announced the acquisition of the remaining 50% of its Sony BMG music joint venture (Bertlesman's share). While Sony's direct cash outlay to Bertelsmann was only \$600 mm, the true, economic cost of the transaction was about \$900 mm (accounting for the movement of cash within the JV).

We believe Sony's acquisition price has negative implications for music industry valuations, specifically Warner Music.

- Bertelsmann's 2007 annual report states that their 50% share of Sony BMG EBITDA was €139 mm, implying that 100% of the JV's US\$ EBITDA was around \$380 mm (using avg. exchange rates).
- While Sony BMG's revenues are down in 2008, we believe cost cutting (including the removal of expensive management layers) has mitigated EBITDA declines. In addition, the ability to consolidate Sony Music Japan should lead to cost savings with Sony BMG's Japan label, yielding pro forma EBITDA of at least \$400 mm.
- Based on the economic cost to Sony of \$900 mm for 50% (\$1.8 bn valuation on entire JV) with EBITDA of \$400 mm, we estimate the acquisition occurred at 4.5x 2008E EBITDA.

*Note: Sony BMG is a recorded music company (not a diversified recorded music/music publishing company like the other major music companies, such as WGM/EMI/Universal); in addition, Sony was the only logical buyer of Bertlesman's stake.*

**Implications for WGM.** We estimate that WGM is trading at 7.0x 2008E EBITDA, however, that includes its music publishing business. Assuming WGM could sell its music publishing biz for 14x EBITDA (12x after-tax), which is likely aggressive in today's music landscape and credit markets (especially given the size of Warner's music publishing biz), we estimate, WGM's '08 recorded music business is effectively trading at 4.6x EBITDA.

PALI CAPITAL, INC.

**Richard Greenfield**  
(212) 259-5176  
[rgreenfield@palicapital.com](mailto:rgreenfield@palicapital.com)

**Ari Danes**  
(212) 259-2037  
[adan@palicapital.com](mailto:adan@palicapital.com)

**WGM: Neutral**  
**Price \$7.77 <Intraday>**  
**Target Price: N/A**

52 Week Range: WGM \$4.57 - \$12.25  
Market Cap. (mm): \$1,123  
Avg. Daily Volume (100 day): 639,600  
5-Yr. Est. EBITDA Grwth Rate: -7%

Fiscal (WGM)	Sept	2007A	2008E	2009E
Q1		\$0.12	(\$0.11)A	N/A
Q2		(\$0.19)	(\$0.23)A	N/A
Q3		(\$0.12)	(\$0.20)E	N/A
Q4		\$0.03	(\$0.06)E	N/A
FY		(\$0.14)A	(\$0.59)E	(\$0.62)E
P/E		NM	NM	NM
Consensus		NM	(\$0.48)E	(\$0.27)E
Revenues		\$3,385	\$3,475	\$3,399
EBITDA		\$461	\$441	\$403
EV/EBITDA		NM	7.0x	7.5x

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**

Given that there is only one clear buyer for WMG's recorded music business (meaning EMI) and probably no buyers in the current credit market environment, it's hard to see much upside to WMG's valuation at current levels.

- While music industry fundamentals are not nearly as bad as we expected them to be in 2008 (owing to a strong release schedule, especially at WMG and a weaker economy that favors cheap forms of entertainment), we continue to believe the industry will struggle over the next couple of years.

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## Exhibit A: What WMG's Recorded Music Biz Would be Trading at if Publishing were Sold

WMG	<b>Current Price</b>			
Current WMG Stock Price	\$	7.75		
WMG Shares Out		148		
WMG Revs	\$	3,475		
WMG Net Debt	\$	(1,943)		<u>Current WMG Multiples</u>
WMG EBITDA	\$	441	12.7%	EBITDA 7.0x
WMG FCF	\$	(97)		FCF (11.8x)
<b><u>Sale of Warner Chappell</u></b>				
WMG Music Publishing EBITDA (a)	\$	141		(a) includes 20% of overhead
EBITDA Multiple Paid		14.0x		
Value of WMG Publishing	\$	1,968		
Estimated Tax Basis	\$	500		
After-tax Value	\$	1,704		
Tax-Effectuated Multiple		12.1x		
WMG EBITDA	\$	300	8.6%	
WMG Net Debt	\$	(239)		EBITDA 4.6x
WMG FCF		(100)		FCF (11.5x)
EBITDA/Share	\$	2.03		
Leverage		0.8x		

Source: Pali Research estimates.

**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.

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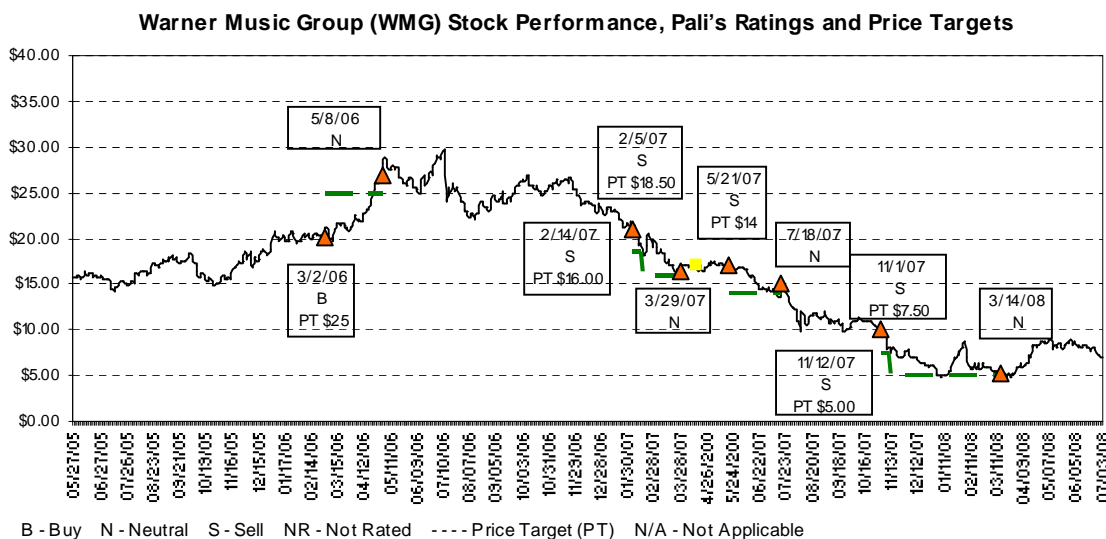
Unless otherwise noted, all prices are as of the close on August 4, 2008.

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**Disclosure Chart for WMG**



Source: Thomson.

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