

## Media Industry Update - Focus on Retransmission Consent

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Happy New Year everyone! Most of us are relieved to put 2009 behind us and I personally expect a much more active 2010. Like most years, 2009 ended with news of several TV retransmission consent negotiations between TV station owners and cable MSOs going right down to the wire. While most Americans were celebrating the New Year, executives at News Corp. and Time Warner Cable negotiated through the night and well into the next day. News Corp. was reported to be asking \$1 per subscriber for its owned and operated Fox affiliates, while Time Warner Cable was reported to be offering \$0.25-\$0.30 per sub. Terms of the agreement have not been disclosed, but most analysts estimate that a compromise was reached in the \$0.50-\$0.60 per sub range. Besides News Corp/Time Warner, Sinclair continued to negotiate with Mediacom (since resolved), while Cablevision refused to continue to carry Scripps Network's Food Network and HGTV at the 300% price increases that Scripps was asking.

### To Stay a Broadcast Network or Become a Cable Network?

During the last couple of years as a broadcast analyst at Bear Stearns, the single most asked question I received from investors concerning the TV industry was why the broadcast networks didn't drop their affiliates and become cable-only delivered networks. At first, the question seemed preposterous given that networks such as CBS and Fox owned the maximum number of stations allowed under FCC ownership rules (39% coverage of TV households). After all, the CBS, Fox, NBC and ABC networks are the 1<sup>st</sup>, 3<sup>rd</sup>, 4<sup>th</sup> and 6<sup>th</sup> largest owned and operated TV station groups. Why would these companies kill off their own TV station groups in order to become cable only networks?

What started as a question by hedge and mutual fund investors a few years ago seemed to reach a crescendo in the press in 2009. The prevailing wisdom is that the broadcast television network business model is broken, since broadcast networks had only a single revenue stream (ad revenues) and were at a disadvantage to cable networks which have a dual revenue stream (retrans/subscriber fees and ad revenues). While I agree with this premise, it ignores the fact that 1) many broadcasters have been getting paid by cable MSOs since 2005, and 2) in the 1990s, broadcast networks got "paid" for their broadcast signals by launching cable channels of their own. For example, CBS was paid retrans fees in the 1990s when it owned The Nashville Network (now Spike TV) and Country Music Television (now CMT). CBS was stripped of these assets when it split off from Viacom in 2006.

In my opinion, the two main differences between a cable network and a broadcast network are 1) content and 2) retransmission consent fees.

As it pertains to content, the primary difference is that cable content free from decency restrictions that allow cable programming to be more "real world", racy and "cutting edge". Content restrictions hardly seem reason enough to dump affiliates and convert to a cable network, particularly when the highest rated shows on television are predominantly broadcast programming.

Therefore, from a financial standpoint, the question for broadcast networks becomes whether the incremental money they can make from retrans fees to the 60%+ of the country that they aren't allowed to distribute to more than offsets the cash flow generated from their O&O stations. In other words, would a broadcast network stand to make more money by reaching 100% of the country by sending programming directly to cable MSOs or satellite companies, or would they make more money by reaching 30%-40% of the country through their O&Os, and perhaps negotiating for a piece of retrans fees from their affiliates for the remaining 60%-70% of the country. As broadcast networks extract retrans fees directly from cable and satellite companies, their business model begins to more closely replicate the cable network model's dual revenue stream. You would think that as broadcast networks begin to adopt a more cable-like business model, it would alleviate the need to explore becoming a cable-only delivered network.

#### The Comcast-NBCUniversal Joint Venture: The Fly in the Ointment?

While pundits in the press debated the logic of converting broadcast networks to cable, along comes Comcast's deal to acquire NBCUniversal. In some respects, this seems like having the fox oversee the chicken coup. Just when broadcasters are finally getting paid by cable MSOs, the biggest cable MSO in the country acquires one of the largest broadcast networks and straddles both sides of the negotiating table.

In the future what kind of retrans fees can NBC expect to receive from Comcast, knowing full well that, once fully consolidated, Comcast would simply report retrans fees as an intercompany elimination? This very question was asked by an analyst on Comcast's investor conference call, and management deftly ignored the question. Comcast management can be forgiven for their non-answer once you realize that NBCUniversal's broadcast business accounted for just 10% of the company's 2009E EBITDA, and just 8% of the new joint venture's EBITDA. Even more surprising is that the cash flow generated from NBC's broadcast business will contribute less than 1% of Comcast's pro forma business going forward.

If it once seemed inconceivable that a broadcast network would convert to a cable-only network, it would seem the circumstances are now in place for a broadcast network to convert to a cable-only network without incurring significant financial repercussions.

While remote, nothing would concern me more than to see a broadcast network switch to becoming a cable-only network. When the NBC network took away the NBC affiliation from Young Broadcasting's KRON-TV in 2002, it was not only bad for Young (*disastrous* would be a better word), but it was terrible for the entire San Francisco TV market. As an independent station, KRON's sales force had to sell 16 minutes of ad time locally rather than 4 minutes as an NBC affiliate. The substantial increase in the number of local units available for sale in the San Francisco market was detrimental to all stations in the market. Now imagine if one station in every market in the country lost its affiliation. Talk about survival of the fittest.

It almost seems too much of a coincidence that Comcast is acquiring NBC, the same network that seemed determined to ruin its owned and operated stations (while saving a few bucks at the network) by programming the Jay Leno Show at 10pm, killing the lead-in for the biggest revenue generator of most NBC affiliates: late evening newscasts.

Fortunately, converting from a broadcast network to a cable network is far more complicated in practice than in theory. First of all there would be a considerable political backlash if nearly one-quarter of this country's free over-the-air television shows became available only on a pay basis. Second, with network-

affiliate agreements coming up for renewal at different times, it would be very challenging for a broadcast network to convert to cable unless all affiliate agreements were due to expire at the same time.

Also reassuring is that Comcast is saying all the right things. At Citi's media conference, CEO Brian Roberts stated that he is committed to maintaining the network-affiliate model in perpetuity. In our opinion, Comcast management will continue to say all the right things until the deal has passed regulatory scrutiny. Another positive sign is that NBC announced it is reprogramming its late night schedule.

### What To Do Now?

Over time, I believe the cable MSOs will pay retransmission or subscribers fees to broadcast or cable channels based on the audiences they deliver to the MSO. It will likely take another 10-20 years for broadcast networks and affiliates to be appropriately compensated for the large audiences that they bring to cable MSOs. Broadcast networks should be encouraged to extract as much retransmission consent fees as possible in order to reinvest those dollars into better programming to retain their ratings leadership. Local affiliates should invest increasing retrans fees into more locally produced programming (where economically feasible) in an effort to distinguish their channels as locally focused (something cable channels can't do). Slowly but surely broadcasters could develop dual revenue stream business models to more effectively compete with cable. Finally, local TV stations must develop a mobile TV offering or risk having the government reallocate spectrum that is not being adequately utilized.

### The Sun Begins to Shine

We are encouraged by what we are hearing as we talk to local media companies. As expected, it would appear that business is picking up and we believe many media companies are poised to post revenue growth in 1Q 2009, the first time in many quarters. The public equity markets appear to be anticipating these trends, with outdoor companies currently trading at 11.7x 2009E EBITDA, TV companies at 10.9x and radio companies at 11.7x. Several local media companies, such as CBS, Lamar, Belo, Sinclair and Salem have been able to tap the credit markets to improve their balance sheets. As credit markets thaw and fundamentals improve, we expect capital and M&A markets to respond constructively. Our view that 2010 will mark a new beginning for growth and change in the industry appears to be taking shape.

Sincerely,

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