

October 2005**ALTERNATIVE RADIO:
SATELLITE VS. INTERNET RADIO...LET THE COMPETITION BEGIN**

After 70 years, terrestrial radio finally has some real competition from multiple angles. On one side, two Satellite Radio providers, at \$12.95 a month, have garnered almost 8 million subscribers in four years. As the hardware prices are dropping and more cars are being manufactured with the product factory installed, few see growth slowing in the near term. On the other end of the spectrum, hundreds of Internet radio companies had collectively garnered at least as many subscribers to their free service. Some are now accessible on 2.5G telephones, making them truly mobile. In the middle, portable devices such as Apple's IPOD, as well as MP3 enabled cell phones and iTunes downloads to laptops, provide users the ability to program their own music and listen on the go. The playing field has clearly changed. Who will be the winners, who will be the losers, and why?

The Case for Satellite Radio

Satellite is clearly the high-end product. Due to the combination of satellites and terrestrial repeaters, the coverage is virtually ubiquitous from Canada to Northern Mexico. Aside from infrastructure, Sirius and XM have invested almost two billion in high-end content. In addition to Sirius's well know \$500 million 5-year deal with Howard Stern, the satellite companies have bought exclusive rights to the NFL, Major League Baseball, and a host of other proprietary programming. In addition, both have spared little expense in hiring top talent to "DJ" their channels and creating live performances and interviews from their studios.

But this comes at a cost. Approximately \$1.5 billion invested to-date by each company for satellites and repeaters must be replaced every 10-15 years, adding about \$150 million to the annual cost of the service. Finally, the content is mostly commercial free. Therefore, the elimination of advertising on the music channels means customers must pay (currently \$12.95 per month) to make the business model viable. Although subscriber growth has been strong so far, it is not clear how many consumers are willing to pay for radio, which, for most of the last century has been free. Of course, we could have said the same thing about cable television in its infancy (and we did). Now over 90% of US consumers are paying for television that is otherwise available "free" off the air. We expect, over the next 5 years, total Satellite Radio demand could reach 20-30 million subscribers.

The Case for Internet Radio

On the surface, it seems that Internet Radio overcomes the cost issues of Satellite Radio – as a result of much less capital intensive infrastructure and lower transmission costs – while still achieving relative ubiquity via 2.5G phones. Additionally, there are no effective spectrum limitations and, since most consumers now use personal computers and/or cell phones, no additional hardware charges to the end-user other than the need for a broadband connection.



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Despite these advantages, most of the start-up Internet Radio companies so far have failed, primarily due to insufficient advertising revenue. We believe there are three reasons for this general characteristic. First, radio is primarily listened to in the car. 2.5G phones have only been available in quantity for a short period of time and most still do not have the ability to offer music listening over the Internet. Consumers, moreover, have not become accustomed to listening to music on their cell phones in this way. This should become less of an issue in the future. Second, Internet Radio companies have not made the investment that Satellite or Terrestrial Radio have made in content and programming, and it is therefore more difficult for Internet Radio to gain listener loyalty other than indirectly through a host portal. Third, Internet Radio has a “chicken and egg” problem as it is difficult to sell national advertising until a critical mass of listeners is achieved and hard to fund programming to attract such levels of listeners without a growing revenue source. Consequently, none have the kind of name recognition that Sirius, XM or Clear Channel have achieved. Fourth, the satellite radio companies have exclusive deals with automakers that keep out their competition, while Internet Radio has no practical way to lock out competitors.

Subscriber Model vs. Advertising Model

Another major difference between Satellite and Internet Radio is that the former is largely a subscription model, whereas the latter is advertising-based. Which is better? Terrestrial Radio has functioned well on an advertising model, but it is hard to argue with Satellite Radio’s recent success. It makes sense that people who spend hundreds of dollars for equipment might be more easily disposed to paying for a monthly service, but this could be a market segmentation difference created by the need to pay for the equipment. Another possibility is that most Internet Radio companies have been so under-capitalized that they could not afford the fixed-cost associated with the high-end content to justify charging a fee. Also, the Internet Radio field is so fragmented that any fee charging would likely result in a quick price war. Now that the Internet Radio shakeout seems to have ended, we would not be surprised to see some players aim for the best of both worlds by adding fee-based “premium tiers”. Nor would it surprise us to see Satellite Radio try to generate additional growth by offering a few free channels.

The Verdict Is....

The first generation of Internet Radio has underachieved while Satellite Radio has been a strong success. However, given advances in technology and the critical mass that some Internet Radio players have realized (especially those associated with major portals such as [Radio@AOL](#), MSN Radio and Yahoo’s LAUNCHcast), we expect to see the future become far more competitive than the past. For investors and entrepreneurs, this will pose risks that thoughtful industry analysis and diligence should soon convert to unique opportunities.

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