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## After Years of Circulation Decline, Have Newspapers' Values Finally Followed?

Much has been made about the decline of newspapers over the past decade. The industry has been called a dinosaur, irrelevant, and even proclaimed to be dead. Sure, circulation volume has been on the decline since the 1950s. Competition for advertising dollars has intensified. And everyone knows that younger people just don't read newspapers anymore. All old news, if you pardon the pun. But chances are you still get your daily news fix from newspapers, 53% of Americans still do.

Esteemed investor Warren Buffett once referred to newspapers as the "ultimate bullet-proof franchise." He put his money where his mouth is and bought his first newspaper stock in 1973 and even bought the *Buffalo Evening News* in 1977. This sense of invincibility and the fact that all these dire warnings have yet to come true created a certain complacency for newspaper managers, but we think the real problems for newspapers are just beginning. The true assault on newspapers is finally here and the enemy is well armed.

**Traditional barriers to entry are now obstacles to compete effectively.** Large numbers of journalists, multiple foreign bureaus, massive printing plants, extensive distribution facilities, delivery trucks, and an army of drivers are all needed to design, write and deliver the paper to your doorstep before 7AM. This infrastructure is effective at keeping other newspapers out of your territory, but not at keeping a blogger from stealing your readers. Investments in this infrastructure will limit investments in new media.

**Brand equity has faded.** Newspapers historically have had strong local brands. Members of the community trusted newspaper reporters. Media kept others honest. Interestingly today, a bias has crept into newspapers and other media. Whether real or perceived, *The New York Times* and Fox News need to contend with this change. Now it seems the bloggers keep the traditional media honest by providing transparency that was once impossible (think of the bloggers breaking the story on CBS' fake National Guard memo). Even worse, print editions are getting 'scooped' not by their cross-town print competitor but from cable news, RSS feeds and the blogosphere.

**Natural monopolies are being cracked open to competition.** There are few natural monopolies in the business world, but classified advertising was one of them. Advertisers seeking buyers, buyers seeking advertisers created a virtuous cycle, driving operating cash flow margins in classified over 70%. The Internet is making real headway here and the pain will be felt at newspapers across the country.

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**The erosion of the classified business will cut off the oxygen to the newspapers.** Classified advertising is critical to newspapers because it represents roughly 30% of revenues at a typical newspaper, but probably 60% of total operating profits.

- Auto classified has already moved to the Internet never to return (prospective car buyers today show up with a printout from the internet not a copy of their local newspaper).
- A slowing economy and online competition will conspire to sap the growth from help wanted. Recruitment classified is just now rolling over, down five months in a row after being up 10% in 2005 and 12% in 2004. If trends continue 2006 will be down between 3-5%. While 2000 represented the high water mark for help wanted volume, 2006 will likely represent the last year of positive revenue growth for the recruitment category - ever.
- And lastly, the outlook is not much better for real estate classified. Fueled by the housing boom for the past decade, this category will now follow the slowdown of the real estate market.

**Downsizing, selling assets and buying back stock will not solve the newspaper industry's problems.** With the rapid deterioration of fundamentals looming, it is no wonder newspaper companies have roughly \$5B of newspaper assets on the block. However, tax leakage and tepid buyers will keep asset sales from moving the stocks higher. And buying back stock won't help either. Repurchasing shares of a negative growth business at 8.5 times EBITDA won't increase shareholder value. Expect to see more downsizing at newspapers, or what should be called "rightsizing," as newspapers cut costs to limit losses.

**Multiples still need to compress.** Despite the truly gloomy news, newspaper stocks are still trading at 8.5 times forward EBITDA. This is smack in the middle of the historical range of 7-10 times EBITDA, despite EBITDA growth rates declining from 6-8% in the 1990s to negative 4% today for pure play newspapers. I guess old habits die hard.

**Some newspapers are registering success in new media investments.** Not all the news is gloomy. Some companies have had success investing in new media efforts. Scripps' has invested in online shopping service Shopzilla.com. Dow Jones purchased Marketwatch.com, while The New York Times Company bought About.com. A number of newspapers are collaborating to build online classified businesses from scratch; notable examples include CareerBuilder.com, Cars.com and Apartments.com. Interesting initiatives like the *Washington Times*' recent effort to make audio feeds available for all of their stories is interesting. Thinking longer term, The American Press Institute has undertaken an interesting initiative it dubs "Newspaper Next" to research and test viable new business models for newspapers on the web. While some might criticize these efforts as too little, too late, some newspapers recognize the threats facing the industry

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and are taking action to protect their franchises. The time to act is now, before newspapers lack the currency to buy new media businesses without suffering dilution. And managers need to get a stomach for more aggressive investment in new media before their classified franchise evaporates.

**Others have reinvested cash flow from newspapers into high growth business, diversifying their businesses.** A few newspaper companies have actively invested outside their core newspaper business, helping to diversify their cash flow and achieve higher growth rates. Scripps' effort in the cable network and new media areas is not able, as is Washington Post's move into education services (Kaplan). These efforts have helped the companies generate the highest operating cash flow growth rates in their peer group.

Warren Buffett frequently advises investors "if business does well, the stock eventually follows." If newspapers don't start to remake their business with some urgency, we wonder why Mr. Buffet won't follow his own advice and sell them.

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