

July 2007

**As liquidity ebbs and flows, the media sectors evolve**

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In light of the recent equity markets gyrations reflecting concerns over deteriorating debt market liquidity, with the S&P 500 Index falling by approximately 5% during the week of July 23, the theme of a “Deal Side” column would either be to predict further gloom or to depict current events as a temporary overreaction. Given the abundance of punditry that will have preceded this newsletter, we instead limit ourselves to a set of historical observations, particularly in relation to our coverage sectors in media and communications, underscoring historical patterns that we believe to be noteworthy. Our conclusion, as will be shown, is that regardless of capital markets directions, the media and communications industry can only continue on one course.

Observations:**The ebbs**

... the corporate debt markets had in fact been showing strong indications of weakness even as the DJIA was cruising towards its peak of 14,000...

Near Earth’s market indices (see front page of this newsletter and supporting metrics in Market Comparables analysis on page 14), illustrate that the media sectors we track had already been on the decline for at least two months, and have underperformed the broader market for at least the past year. Our Media Index, which peaked in May – having finally caught up to the broader market on a comparable index basis (using August 2006 as the starting point of our tracking benchmark) – was off by more than 2.7% in June, and fell by an additional 5.9% in the current month. This performance remains well below that of the broader market even after the latter had precipitously fallen in the past week. Fundamental concerns triggered by a challenging advertising environment (particularly for traditional media such as newspapers and radio), have contributed to market caution and served as a valuation suppressant distinct from capital markets liquidity factors currently in play. Regardless of how the markets behave in coming weeks and months, these fundamental issues are likely to linger.

**The flows**

Despite the attention currently paid to headline-grabbing corporate credit market setbacks (e.g., Chrysler, Alliance Boots, Cadbury), which seem to have contributed the most towards fears of a liquidity crunch, the corporate debt markets had in fact been showing strong indications of weakness for some time. According to a list compiled by the Wall Street Journal on July 26, there were no fewer than 27 credit issuance setbacks reported since the third week in June (i.e., offerings that had been pulled or delayed), and 16 (more than half) of these were being reported even as the Dow Jones Industrial Average was cruising towards its peak of 14,000 on July 19. The equity markets had apparently turned a blind eye to trouble that was clearly brewing, highlighting the extent to which



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excess liquidity can underpin valuations even under adverse circumstances...

But not forever! As of July 27, with the Dow having fallen more than 500 points in two days, we see that liquidity support can be a frail foundation at best, which notion wasn't lost on highly liquid long-distance phone companies of old, that have successfully transformed themselves and are now battling for wireless and video market share, and is not lost on the current media vanguard. See below:

### **The evolution**

In parallel with the dynamic depicted above – of downward valuation pressure from fundamental risks in “old” media on one hand, and support from excess market liquidity (that may now, or if not now at any time later, erode) on the other – a number of noteworthy M&A and other strategic transactions have been announced. These include:

- AOL's acquisition of Tacoda Inc., a marketing firm that specializes in tracking Web user habits to deliver targeted online ads;
- Microsoft's acquisition of AdECN, a network linking buyers and sellers of Internet ad space;
- R.H. Donnelley's acquisition of Business.com, which operates a business search engine, directory, and pay-per-click advertising network;
- Katz Media Group's acquisition of Net Radio Sales, which sells streaming audio advertising and other Web advertising across online radio channels; and
- Sprint Nextel's 20-year deal with Clearwire to jointly build out a WiMax network nationwide, followed by a deal with Google to provide a mobile-Internet portal for Sprint's WiMax service.

A common feature of all the listed deals is the continuing advancement of “new” media. Whether a traditional media rep firm expands its Internet radio ad sales capabilities, a major printer/publisher acquires a business-oriented Web presence, a former long-distance phone company lays the groundwork for mobile Web access, or leading “new” media pioneers such as Microsoft and AOL seek to become even “newer”, the media migration is continuing undeterred by financial market fluctuations. (It may also be worth noting that Google and Amazon share prices stood their ground as the broader market fell last week.)

### Conclusion:

It seems that as an industry, in the aggregate, media and communications is on an irreversible course of evolution that may not even be slowed, let alone reversed, by capital markets obstacles. New technologies and the new possibilities these enable, combined with new habits and expectations instilled in new generations of consumers, (worldwide), have set a clear direction for both content and distribution.

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Individually, however, there will be successful and less successful enterprises, some that will actively seek a part in the migration, and others that will fall behind and risk extinction.

Availability of capital will, as always, be a limiting or a driving force... but history has shown that, when fundamentals are sound, the capital never resists for long. The New York Times in a July 27 article reminds us that a 6% S&P 500 correction caused in the 1980's by a sudden slow-down in lending, was recovered within 12 weeks. On the other hand, we all remember how capital irreversibly dries up when, like around 2000 to 2002, the fundamentals become questionable.

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