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TAG Media Mosaic

ADVERTISING ERUPTION COLLIDES WITH ENERGY PRICE SPIKE

IN THIS REPORT

> The advertising scatter market has erupted over the past six months.

> Spiking commodity prices are likely to have spill-over effects that might temporarily slow or cool the ad market.

> We are not calling for an end to the recovery or a downturn of the cycle, but we believe spiking energy prices could cause more attractive entry points.

> We are not downgrading the sector, however, we would recommend taking some money off the table in overweight positions. On the other hand, pullbacks should be viewed as buying opportunities.

> The best defensive plays in a sector sell-off are likely to be higher-quality companies and those that have under-performed during the rally of the past six months including DirecTV, Discovery Communications and Walt Disney.

> The worst performers are likely to be the high beta and turnaround names including CBS Corp and Viacom.

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> **Advertising price eruption collides with the energy price spike** – Within the context of an ongoing ad recovery, we believe that spiking commodity prices would probably have spill-over effects. We think the odds are favorable that the ad market cools temporarily – which could create more attractive entry points for our preferred recommendations.

> We are introducing our **"Household Cash Flow Model,"** our **"Blueprint for Navigating the Stages of the Cycle,"** and our **"Inflation Cycle Mental Model."** These illustrate how energy price spikes could siphon consumer purchasing power, and flow through to advertising spending.

> **The logical sequence of events includes**: a) commodity prices siphon purchasing power of personal incomes; b) growth slows for non-commodity personal consumption expenditures; c) companies react to the sluggish consumer by slowing the growth of inventory, new hires, advertising and other overhead; and d) advertising purchasing managers stop chasing pricing, and the hot/tight ad market cools.

> **Warning of bullish sentiment within the media sector** – We are voicing our concern for the near-term performance of the sector. Over the past quarter, the media sector sentiment and outlook have improved meaningfully – as the advertising scatter market has erupted. As a result, the sector has gotten "hot" from an investment perspective (i.e. a real lack of fear or caution). Note that we are not calling for the end of the recovery or a down-turn of the cycle. However, we believe spiking energy prices could create more attractive entry points.

> **This near-term warning does not conflict with our fundamental outlook** – We believe that investment markets run on fear and greed, and these mood swings resemble the movement of a pendulum (cycling between despondency and panicked enthusiasm). As a result, we tend to be more constructive (within the context of a cyclical recovery) when market participants are depressed; and we tend to get defensive when sentiment and conventional wisdom have shifted to outright bullishness. On balance, we believe an energy price spike would likely re-introduce fear and caution into the market environment.

> **What are we recommending** – We are not downgrading the sector given our belief that: a) we are mid-cycle; b) our EPS and EBITDA estimates don't reflect the most-bullish scenarios or whisper numbers; and c) relative valuation premiums are reasonable within the group. However, we would consider taking some money off the table particularly in the case of overweight positions. And, be poised for a buying opportunity. The best performers in a sector sell-off are likely to be higher-quality companies and those that have under-performed during the rally of the past six months including DirecTV, Discovery Communications and Walt Disney. The worst performers are likely to be the high beta and turnaround names including CBS Corp and Viacom.

"Stay dispassionate and be patient is Buffett's message. You're dealing with a lot of silly people in the marketplace; it's like a great big casino and everyone else is boozing. If you can stick with Pepsi, you should be okay. First the crowd is boozy on optimism and buying every new issue in sight. The next moment it is boozy on pessimism, buying gold bars and predicting another Great Depression."

Warren Buffett interview in Forbes – November 1974

ADVERTISING ERUPTION COLLIDES WITH ENERGY PRICE SPIKE *(CONT'D)*

> **Fragile consumer spending is susceptible to inflation** – Growth of consumer spending hovered at an annualized rate of +2.3% during 2H10 (see below: Real PCE yr-yr % chg). Given that gas station retail spending accounts for 9.8% of retail sales, the 10.3% price hike over the past two weeks (and 76.9% rise over the past year) will likely erode U.S. consumer purchasing power. Note that our analysis excludes other impacts from higher energy and other commodities including rising prices for nearly all petroleum related products. As mentioned above, the likely chain of events includes: a) commodity prices siphon purchasing power of personal incomes; b) growth slows for personal consumption expenditures (ex energy and other commodity-related purchases); c) companies react to the sluggish consumer by slowing the growth of inventory, new hires, advertising and other overhead; and d) advertising purchasing managers stop chasing pricing, and the hot/tight ad market cools.

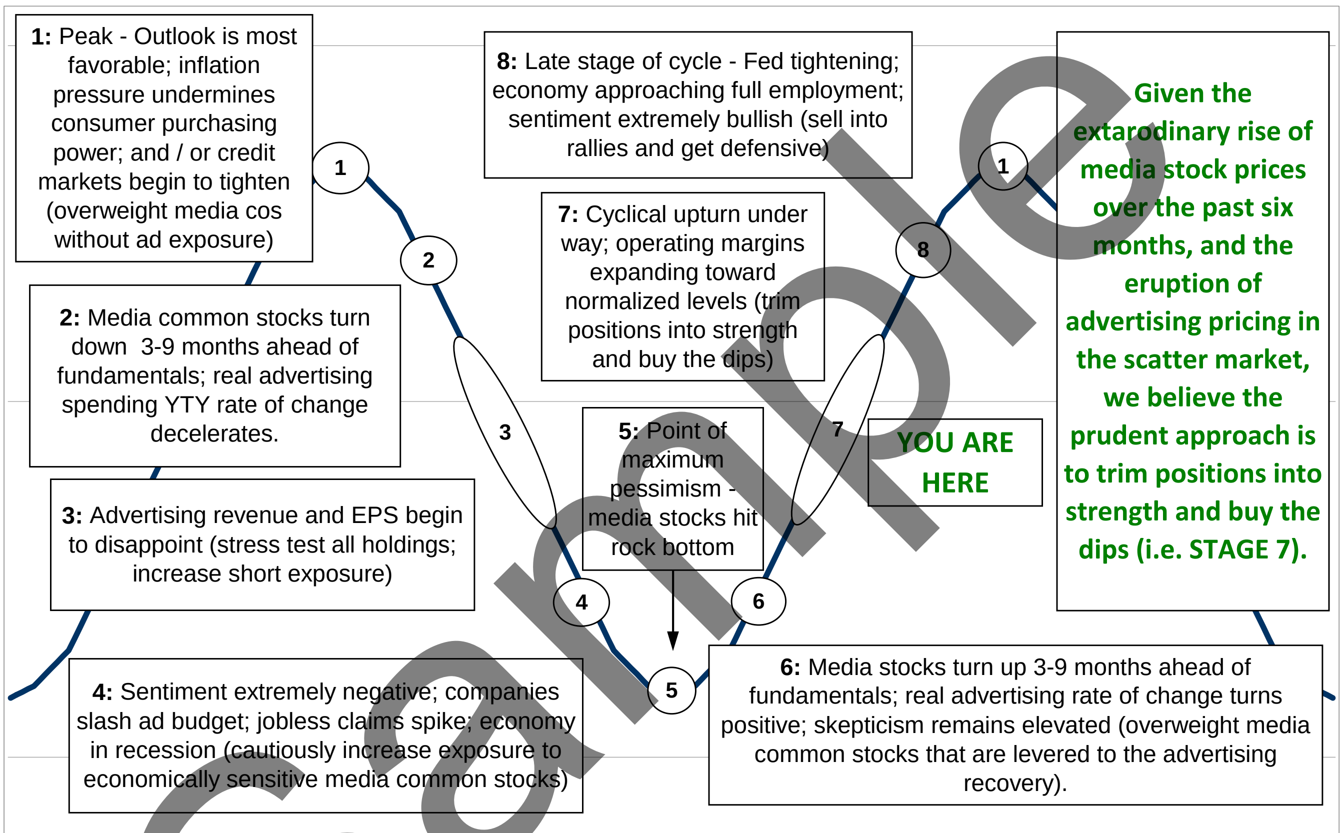
HOUSEHOLD CASH FLOW MODEL

($B; SAAR)	2008	2009	1Q10	2Q10	3Q10	Oct-10	Nov-10	Dec-10	2010	Jan-11
Personal income	12,391	12,175	12,350	12,517	12,596	12,675	12,708	12,764	12,545	12,897
YTY % chg	4.0%	-1.7%	3.2%	2.1%	2.6%	3.5%	3.8%	3.8%	3.0%	4.6%
Real personal income % chg	0.7%	-1.9%	0.8%	0.2%	1.2%	2.3%	2.8%	2.6%	1.8%	NA
Civilian employment (MM)	143.3	138.0	139.0	139.1	139.4	139.1	138.9	138.2	138.2	139.3
YTY % chg	-2.0%	-3.7%	-1.3%	-0.6%	0.4%	0.5%	0.2%	0.9%	0.9%	0.6%
Average hourly earnings	18.39	18.85	18.93	19.05	19.14	19.23	19.24	19.23	19.23	19.33
YTY % chg	3.9%	2.5%	2.2%	2.5%	2.2%	2.5%	2.3%	2.0%	2.0%	2.2%
Personal current taxes	1,438	1,140	1,135	1,149	1,178	1,201	1,205	1,213	1,167	1,268
Rate of taxation %	11.6%	9.4%	2.1%	2.6%	3.5%	9.5%	9.5%	9.5%	9.3%	9.8%
Disposable personal income	**10,953**	**11,035**	**11,216**	**11,368**	**11,417**	**11,474**	**11,503**	**11,551**	**11,378**	**11,629**
YTY % chg	5.1%	0.7%	3.1%	2.5%	3.4%	4.1%	3.8%	3.8%	3.1%	4.6%
Real DPI YTY % chg	**1.8%**	**0.6%**	**0.7%**	**0.6%**	**2.0%**	**2.9%**	**2.8%**	**2.6%**	**1.9%**	**NA**
Personal outlays	**10,505**	**10,380**	**10,604**	**10,664**	**10,736**	**10,844**	**10,876**	**10,930**	**10,722**	**10,952**
YTY % chg	2.9%	-1.2%	3.0%	3.6%	3.0%	4.1%	3.8%	3.8%	3.3%	4.6%
Personal savings	**447.9**	**655.3**	**611.8**	**704.3**	**681**	**630.2**	**626.8**	**620.9**	**655.7**	**677.1**
Personal savings rate %	**4.1%**	**5.9%**	**5.5%**	**6.2%**	**6.0%**	**5.5%**	**5.4%**	**5.4%**	**5.8%**	**5.8%**
PCE Deflator (inflation hurdle)	**3.3%**	**0.2%**	**2.4%**	**1.9%**	**1.4%**	**1.2%**	**1.1%**	**1.2%**	**1.2%**	**NA**
Personal consumption expend (PCE)	**10,105**	**10,001**	**10,231**	**10,285**	**10,366**	**10,478**	**10,512**	**10,569**	**10,351**	**10,593**
YTY % chg	3.0%	-1.0%	3.2%	3.7%	3.2%	3.8%	3.8%	3.9%	3.5%	4.0%
Real PCE yr-yr % chg	-0.3%	-1.2%	0.8%	1.8%	1.9%	2.5%	2.7%	2.8%	2.3%	NA

Source: Telsey Advisory Group estimates

> **Navigating the stages of the classical advertising cycle** – Common stocks that are levered to the ad cycle are best purchased when the world appears to be coming to an end, and fear is high. To succeed in timing the cycle, we believe the prudent way is to act as a contrarian: a) put money to work during the bear market, and take advantage of others' fear and panic to pick up bargains; b) let optimism abate as prices rise; and c) take on a more defensive posture as the ad cycle approaches peak conditions.

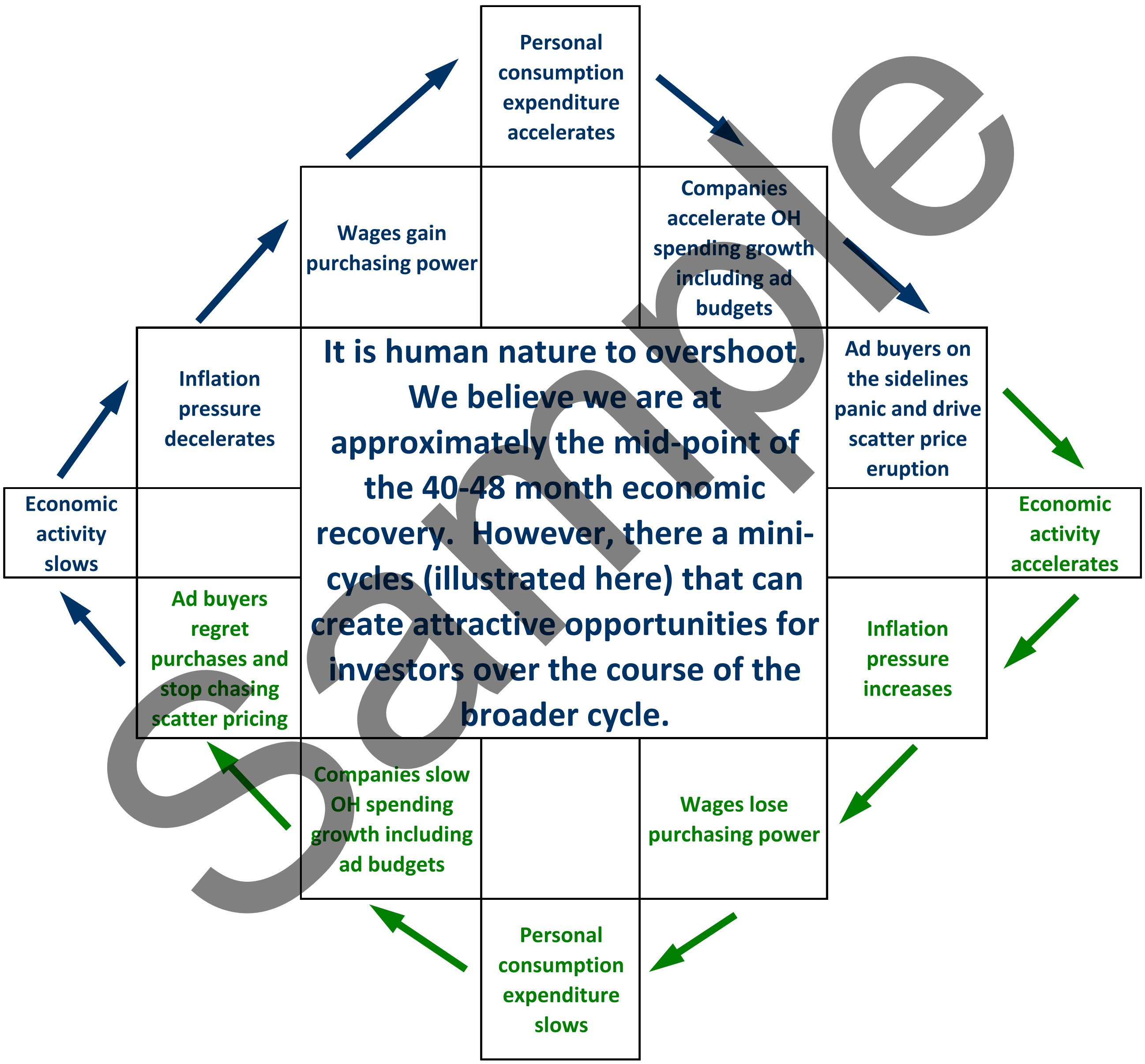
NAVIGATING THE STAGES OF THE CLASSICAL CYCLE CAN BE COUNTER-INTUITIVE



Source: Telsey Advisory Group estimates

> **The return of the inflation cycle** – We believe the inflation cycle has returned. As a result, we are assuming that the current business cycle experiences a stair-step recovery of pauses and accelerations (i.e. mini inflation booms and busts within the greater context of a 4-5 year business cycle recovery). The primary drivers include: a) rise of demand for commodities from China and other emerging economies; b) insufficient commodity production given the chronic under-investment during the 22 year commodity bear market (1980-2002); c) the easy money policies of Central Banks around the world; and d) unrest in the Middle East.

THE PURCHASING POWER OF INCOMES AND THE INFLATION CYCLE



Source: Telsey Advisory Group estimates

> **House-to-house search for value** – At present, the consensus argues that investors should be overweight the media sector given the extremely favorable outlook for the recovery of ad spending. However, we've found that the greatest portion of media common stock relative outperformance (especially those with leverage to the ad cycle) tends to commence three months ahead of the trough (when the outlook is the worst), and last through the first 24 months of the upturn (just as the expansion is gaining steam and becoming widely accepted in conventional wisdom). Further, during the commodity price spikes of the '04-'08 expansion, the broader media indices made little progress. Note that we are not downgrading the group, because we continue to believe many of our coverage companies can generate EBITDA and EPS growth rates well ahead of the broader market. However, we do think the best strategy is to: a) be patient and wait to buy the dips; and b) undertake a house-to-house search for value.

THE PURCHASING POWER OF INCOMES AND THE INFLATION CYCLE

Source: Telsey Advisory Group estimates

ADDENDUM

Important Disclosures:

Valuation Method for Target Price: Price-to-Earnings, price-to-EBITDA, P/E to growth, price to free cash flow, and discounted cash flow analysis.

Investment Risks: Slower consumer spending, rising interest rates, weaker consumer confidence, rising unemployment, supply chain disruptions, fashion misses, and excessive markdowns.

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To see price charts and TAG's historical price targets please click the following link: http://www.telseygroup.com/files/historicalprices.pdf

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None

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