Our Outlook for Media & Telecom Stocks

Media and telecom offer some pockets of stability, but few signs of an economic rebound.

By Michael Hodel, CFA, Associate Director of Equity Analysis

Although portions of the media and telecom sector continue to offer stability, it has shown few concrete signs of economic recovery. Cable companies saw a rebound in growth during the first quarter, but both Comcast CMCSA and Time Warner Cable TWC, which collectively reach nearly two thirds of U.S. households, reported that March and the first weeks of the second quarter looked more like the end of 2008, when consumers were effectively "frozen." Networking and telecom equipment companies indicated that customers have been more willing to discuss the possibility of buying new equipment, and they have even budgeted for projects. Reported sales and management forecasts still point to double-digit percentage declines year over year in sales, showing that customers have yet to commit to new spending. Even more clear-cut growth areas, such as online advertising and wireless data services, have taken a hit. We believe these results reflect the theme we've seen for several quarters now: The downturn has accelerated or exacerbated certain trends across media and telecom that will allow firms positioned well to emerge stronger while forcing many of those less fortunate by the wayside.

The highest concentration of the less fortunate remains in "old" media. Consumers' steady shift online, the cyclical downturn in advertising spending, and excessive leverage claimed another victim during the past quarter, with directory publisher R.H. Donnelley RHDC filing for bankruptcy protection. Thawing debt and equity markets have given a boost to many old media stocks, but these firms continue to put up abysmal numbers. According to TNS Media Intelligence, newspaper and radio advertising each fell more than 25% in first quarter, while overall television advertising fell 10%. We've previously discussed our negative views on these industries and we continue to believe the equities of the majority of the newspaper, radio, and broadcast television firms we cover are worthless. New York Times NYT is an exception, although we did lower our moat rating on the firm to none from narrow after its top line was again pounded during the first quarter and it slipped into the red. We don't see a way out of a brutal Catch-22 for the Times: The firm needs to cut costs to remain profitable, but cutting costs threatens the premium content that formed the basis for its moat in the past. If the advertising market picks up in the near term—we've seen no evidence of this yet—the Times could enjoy a reprieve from its current situation, but we believe this would be brief as advertisers continue to spread spending across more platforms.

Online advertising hasn't escaped the downturn unscathed. Google's GOOG first-quarter search revenue advanced only 9% year over year, the first time growth has failed to reach double digits. Display advertising was hit even harder, with many large online publishers posting double-digit declines in display revenue, including Yahoo YHOO (negative 13%), Time Warner's TWX AOL segment (negative 17%), and IAC IACI (negative 37%). Although we think both areas of online advertising will eventually rebound, we continue to think that the search advertising industry, dominated by Google, has better long-term prospects. Microsoft's MSFT Bing search engine has garnered a lot of attention recently, but we believe Microsoft needs more than initial buzz and a few added features to close the enormous gap between it and Google (market share of 65% versus 8%, according to ComScore).

Despite the gloomy comments from the cable companies, these businesses continue to hold up well. A lot of noise has been made recently about the rising threat that online video poses to the pay television business model, but we believe this remains a longer-term concern. The cable, satellite, and phone companies we follow added nearly 25% more net new television customers during the first quarter than the same period a year ago. While the initial February deadline for local broadcasters to go all-digital likely pushed some over-the-air viewers to pay television, the weak economy has also slowed household formation and cut into demand at the margin. The stability of the business in the current environment is a testament to the value pay television delivers to the typical consumer, in our view. In addition, the cable companies continue to deploy new technology that will allow Internet access service speeds far faster than what the competition offers in most areas, without sharply increasing capital budgets. Comcast and Time Warner Cable, our favorites in the industry, posted record free cash flow during the first quarter and continue to expand their share of consumer telecom spending in the markets they serve.

The downturn has left a mark on the wireless industry, though this business too has held up well. AT&T T reported a big slowdown in wireless data revenue growth, citing increasing customer frugality and a pullback in company-sponsored wireless service. The more dramatic impact of the downturn on wireless can be seen in the rising popularity of prepaid calling plans, especially those that offer unlimited minutes of use for a fixed, low price. Prepaid accounted for nearly three quarters of the net new customers added during the first quarter, up from about 40% a year ago. Prepaid specialists Leap Wireless LEAP and MetroPCS PCS have benefited from this trend, but we continue to believe these firms operate at a disadvantage relative to the industry's giants. Sprint Nextel S, for example, dramatically reduced its customer losses during the first quarter by introducing a prepaid plan that mimics Leap and Metro's. If demand continues to grow for this type of plan, we'd expect AT&T and Verizon Wireless VZ VOD—and their marketing muscle—to follow suit sooner or later.

We expect that wireless data services will grow rapidly over the next several years as phone makers continue develop compelling new devices, such as the recently launched Pre from Palm PALM and, of course, Apple's AAPL iPhone product line. New devices from Apple and Research in Motion RIMM are still flying off the shelves, and while a subsidized handset is not a tremendously big-ticket item, the fact that customers are committing to contracts that can add up to a couple of thousand dollars over two years supports our belief that demand for these devices and their related services will continue to grow. We suspect AT&T's data growth issues appear more company-specific and likely don't reflect directly on the volume of traffic on its networks. One area that stands to benefit from data growth—but doesn't get a lot of attention—is the wireless tower industry. As data traffic increases, so does the burden on wireless networks, prompting carriers to add tower sites to expand capacity. The tower companies we follow— American Tower AMT, Crown Castle CCI, and SBA Communications SBAC—reported strong results for the first quarter and raised expectations for the balance of 2009 across the board. These companies have tremendous visibility into future results because more than 95% of full-year revenue is already under contract and the typical contract runs 10 to 25 years in length. Thawing debt markets also directly benefit these firm, as each carries a substantial debt load.

Valuations by Industry

Valuations are less attractive today than three months ago across every portion of the media and telecom sector. The number of 5-star rated firms among the roughly 200 media and telecom stocks we cover has fallen to about 12 from around 40 since mid-March. The numbers in the accompanying table exclude companies with a $0 fair value estimate, which makes the publishing and entertainment industries, in particular, look more attractive. Regardless of industry, we believe media and telecom tends to face relatively high uncertainty as consumer demand and technology evolves. As a result, we prefer firms with strong balance sheets and cash flow that afford the flexibility to respond or, at least, the ability to provide some value to shareholders rather than creditors.

Media & Telecom Industry Valuations

Segment	Average Star Rating	Price/Fair Value*	P/FV Three Months Prior	Change (%)	Uncertainty** (%)
Advertising & Marketing Services	3.04	0.88	0.55	60	47.7
Communication Equipment	2.98	0.98	0.74	32.4	52.3
Communication Services	3.48	0.81	0.65	24.6	46.6
Entertainment	4.47	0.78	0.51	52.9	3.4
Internet Information Providers	2.94	0.88	0.66	33.3	68.2
Internet Software & Services	3.01	0.96	0.73	31.5	42
CATV Systems	3.76	0.93	0.49	89.8	87.5
Networking and Communications Devices	4.73	1.06	0.67	58.2	23.9
Publishing	2.92	1.02	0.82	24.4	37.5

Data as of 06-12-09.
*Market-Weighted Harmonic Mean
**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Cable stands out as an area that we believe offers a lot of value, both among system operators and network programmers. We expect cable companies, such as Comcast, will extend their lead versus the phone companies in most parts of the country and remain competitive with the satellite providers' television offerings as several network upgrade initiatives reach completion over the next few quarters. Cable programmers, like Viacom VIA.B, should continue to steal share from the broadcast networks and narrow the pricing gap versus these rivals with advertisers thanks to the stability their subscription-based revenues afford.

Our Top Media & Telecom Picks

Top Media & Telecom Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Price/ Fair Value
Walt Disney Co.	★★★★★	34.00	Wide	Low	0.7
American Tower Corp.	★★★★	41.00	Narrow	Medium	0.73
Comcast Corp.	★★★★★	25.00	Wide	Medium	0.56
Cisco Systems, Inc.	★★★★★	31.00	Wide	Medium	0.62
NII Holdings, Inc.	★★★★★	43.00	Narrow	High	0.47

Data as of 06-19-09.

Last quarter, we added Google to our top media and telecom picks, but the shares have run about 20% since then and are now rated 3 stars. While we still love the firm's competitive position, we've swapped the firm out for American Tower, our favorite of the wireless tower companies. The stock is trading just above our Consider Buying price. Unlike much of the market, the tower companies' shares have been flat to down over the past quarter, which we think is odd given their sensitivity to the debt markets. If any renewed turbulence in the capital markets tipped American Tower into 5-star territory, we'd take a keen interest in the shares.

Walt Disney DIS

Although Disney is exposed to the slowdown in consumer spending, we like the long-term prospects of this wide-moat firm. About half of overall operating profit comes from its cable networks, which garner a majority of their sales from affiliate fees. We expect both ESPN and Disney Channel to maintain a dominant position in cable television over the next decade. While its theme parks and studio entertainment results have taken a hit during this recession, we don't think Disney's brand power is any less valuable today than it was a year ago. The strength of these brands allows the company to exploit its characters and franchises through box office and home video sales, theme park attendance, and merchandising. As evidence, the firm held attendance at its theme parks roughly flat year over year during the first quarter. While increased promotions drove this result and pulled revenue lower, Disney is faring far better than other theme park operators, including recently bankrupt Six Flags.

American Tower AMT

American Tower is the only wireless tower firm we believe has an economic moat because of the quality of its asset base. The firm generates the highest revenue per tower in the group, which is critical because operating leverage in this business is extremely high—more than 80% of incremental revenue falls to the bottom line. American Tower posted solid first-quarter results and U.S. carrier leasing demand has remained strong, which bodes very well for the second half of 2009. Another dynamic that differentiates American Tower from its competitors is diversification. In addition to its strong domestic footprint, the firm is now active in Mexico, Brazil, and India. The firm is also the least levered company in the industry.

Comcast **CMCSA**
With Time Warner Cable taking on debt to pay a huge special dividend during the first quarter, Comcast is now the clear standout among the cable companies thanks to its unrivaled financial strength. The firm has been very aggressive with its rollout of DOCSIS 3.0, a technology that will allow it to offer Internet access speeds far faster than those commonly available today. We think this upgrade, along with the firm's effort to reclaim network capacity currently used for analog service, will give Comcast the capabilities needed to retain and win customers well into the future.

Cisco **CSCO**
We expect Cisco to maintain its dominance in routing, switching, and a handful of adjacent markets, and we believe that network convergence, data center consolidation, and increased global communications needs will continue to drive demand for the firm's equipment. However, we're already seeing some strong signals that Hewlett-Packard HPQ and IBM IBM (both major players in the server market and frequent Cisco partners) are pre-emptively retaliating against Cisco's nascent foray into the server market by strengthening their relationships with Cisco competitors. While we don't think that Cisco is at any risk of losing its dominant spot in the networking world anytime soon, we will be concerned if we see the firm starting to trade low-margin server revenue for high-margin networking revenue.

NII Holdings **NIHD**
Volatility in NII's operating currencies, especially the Mexican pesos and Brazilian reais, has distracted investors from the company's operations over the past couple of quarters. While subscriber and revenue growth remained solid in local currencies through the first three months of the year, most of the gain was erased when translated back to U.S. dollars, the firm's reporting currency. We still believe the firm has strong growth opportunities in Latin America and should generate nice returns as it continues to sign up new subscribers.

Michael Hodel, CFA, does not own shares in any of the securities mentioned