July 9, 2010

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Entertainment, Cable & Media / Consumer

Warner Music Group Corp. (WMG) – Buy

WMG: FY 3Q10 Preview-Lowering EPS Estimates

WMG is expected to report FY3Q10 (ended June 30) earnings in late July/early August. We are maintaining our revenue estimate but we are lowering our EPS estimate for FY3Q10, FY4Q10 and for FY10.

Lowering FY3Q10 EPS. We maintain our revenue estimate. Our new FY3Q10 EPS estimate is a loss of $0.50 (versus our previous estimate of a loss of $0.12). Our new FY10 EPS estimate is a loss of $0.86 (versus our previous estimate of a loss of $0.43).

- We are lowering our 3Q10 OIBDA estimates for Music Publishing by 44% to $25M, and our OIBDA estimate by 28% to $52M to reflect weaker than previously estimated results in synchronization revenue and higher costs.
- Additionally, we raise our D & A projections to more accurately reflect the trends of YTD FY10, which results in lowering our EPS estimate to a loss for FY3Q10 of $0.50 (from our previous estimate of a loss of $0.12 and the current consensus of a loss of $0.19).

FY4Q10. We expect the weaker trends in FY3Q10 to continue into FY4Q10 and we lower our revenue estimate by 2% to $2.986B, and our EPS estimate to a loss of $0.86 (versus our previous estimate of a loss of $0.43).

We reiterate our BUY rating and $8/share 12-month target price, but we caution that music is a hit-driven, talent-dependent business that isn't easy to project or control the timing of album releases.

EPS Change

Market Data	
Price (07/08/10)	$4.42
12-Month Price Target	$8.50
52-Week range	$8.01-3.90
Shares Out. (MM)	154.6
Market cap (MM)	$683.3
Avg. daily volume (000)	414.6
Financial Data	
Total Debt/Cap.	106.4%
Price/LTM Rev.	0.2x
Tangible BVPS	($16.71)
Net Cash Per Share	($10.37)

	FY 09/30/09 A	FY 09/30/10 E		FY 09/30/11 E	
		Old	New	Old	New
Rev. (MM)	$3,188.0	$3,045.9	$2,985.6	$3,076.6	$2,852.1
Growth	*(8.7%)*	*(4.5%)*	*(6.3%)*	*1.0%*	*(4.5%)*
Op. Mar.	*4.2%*		*3.7%*		*4.4%*
EPS: 1Q	(0.09)	(0.11)	(0.11)A		
EPS: 2Q	(0.23)	(0.17)	(0.17)A		
EPS: 3Q	(0.13)	(0.12)	(0.50)		
EPS: 4Q	(0.12)	(0.03)	(0.07)		
EPS: Year	(0.57)	(0.43)	(0.86)	(0.49)	(0.80)
Growth	*(140.8%)*	*(23.8%)*	*(50.5%)*	*12.6%*	*6.8%*
P/E Ratio	nm	nm	nm	nm	nm

Note: Pro forma earnings estimates displayed above do not include one-time items or any stock compensation expenses.

Disclosures applicable to this security: B.
Disclosure explanation on the inside back cover of this report.

WHAT'S NEW?

LOWERING EPS ESTIMATES

Figure A includes our current and prior quarterly estimates, and compares them to consensus estimates.

Figure A

FYE 9/30:	3Q10E	4Q10E	2010E
Rev Cur ($mm)	**$650**	**$756**	**$2,986**
Previous ($mm)	$650	$816	$3,046
Consensus	$729	$824	$3,130
EPS Operations	**($0.50)**	**($0.07)**	**($0.86)**
Previous	($0.12)	($0.03)	($0.43)
Consensus	($0.19)	$0.02	($0.50)
P/E			NMF
Sources: Needham & Co. est, Yahoo Fin.			

SUMMARY OF FY3Q10 ESTIMATE REVISIONS

Revenue & OIBDA. We estimate FY3Q10 revenue of $650M (down 17% y/y and no change from our prior estimates). We estimate an FY3Q10 EPS loss of $0.50 ($0.38 lower than our prior estimate and $0.31 below consensus). Our FY3Q10 estimates are broken out as follows:

- **Recorded Music** revenue is estimated to be $525M (down 17% y/y and no change from our prior estimates). OIBDA for this segment is estimated to be $50M (down 42% y/y and no change from our prior estimates). We expect weakness in the quarter owing to a lack of major releases in 3Q10 other than the soundtrack from the *Twilight Saga: Eclipse*, as well as continued deterioration of physical sales.

- **Music Publishing** revenue is estimated to be $132M (down 10% y/y and no change from our prior estimates). Costs are higher in this segment than we previously expected and the mix of revenue tilted away from more profitable synchronization revenue in FY3Q10. As a result, we are lowering our estimate for OIBDA for this segment by 44% to $25M (down 7% y/y).

FY3Q10 Segment OIBDA (after Corp) is estimated to be $52M (down 42% y/y and 28% below our estimates).

FY3Q10 Operating Income We have raised our estimates for D & A to more accurately reflect the trends of 1H10 and the expected trends for 2H10. As a result, our estimate for Net Operating Income is a loss of $75M (worse than the loss of $27M in 3Q09 and lower than our previous estimate of a loss of $18M).

EPS. Reported EPS is estimated to be a loss of $0.50, versus a loss of $0.25 in 3Q09 and lower than our previous estimate of a loss of $0.12.

DETAILED FY3Q10 ANALYSIS

Table 1 is our estimates for WMG's fiscal 3Q10 estimates, current and prior, vs FY3Q09 results.

Table 1
Warner Music Group: 3Q09 vs. New 3Q10E vs. Prior 3Q10E
$ and shares in millions, except per share data

Revenue	3Q09A	New 3Q10E	Yr/Yr Growth	Prior 3Q10E	New/Old
Recorded Music	$629	$525	-17%	$525	0%
Music Publishing	$147	$132	-10%	$132	0%
Eliminations	($7)	($8)	-14%	($8)	0%
Total Revenue	**$769**	**$650**	**-17%**	**$650**	0%
Segment OIBDA					
Recorded Music	$86	$50	-42%	$50	0%
Music Publishing	$27	$25	-7%	$45	-44%
Segment OIBDA	$113	$75	-34%	$95	-21%
Corporate Exp & Elims	($23)	($23)	0%	($23)	0%
OIBDA (after corp)	**$90**	**$52**	**-42%**	**$72**	-28%
EBIT (Op Income)	**$25**	**($11)**	**-144%**	**$39**	**NM**
Interest Expense, net	($61)	($50)	19%	($50)	0%
Net Inv. Rel-Losses	$0	$0		$0	
Impairment Cost	$0	$0		$0	
Other Expense, net	$4	($5)		$0	
Minority Interest Expense	($1)	$0		$0	
Income Before Tax	($33)	($65)	-50%	($11)	NM
Income Taxes	($4)	($10)	-150%	($8)	-33%
Net Income-Operating	($37)	($75)	NM	($18)	NM
EPS Operating	**($0.13)**	**($0.50)**	**NM**	**($0.12)**	NM
Net Income-Reported	**($19)**	**($75)**	-297%	**($18)**	NM
EPS Reported	**($0.25)**	**($0.50)**	-104%	**($0.12)**	NM
Avg Diluted Shs Out	150	150	0%	150	0%

Sources: Company Reports, Needham & Company estimates.

FY4Q10 Estimate Revisions

We expect that weakness in 3Q10 will continue into 4Q10, resulting in lower revenue and profitability. We are lowering our 4Q10 revenue estimate by 7.3% to $756M and EPS loss to $0.07, from our previous estimate of a loss of $0.03.

TARGET PRICE

Our target price of $8.50 is based on a DCF valuation. We use a WACC of 11% for WMG and a long-term nominal GDP growth rate of 2%. The standard DCF is widely used on Wall Street because it is a rigorous bottom-up valuation of the enterprise based on discounting its long-term cash flows and removing the impact of non-cash accounting conventions. Positives and negatives of this valuation methodology are highlighted beside the calculation in Table 5. Our $8.50 target price embeds a 10-year OIBDA growth rate of negative 1.8% annually beginning in 2011 and represents a 8x multiple of forward year (2012E) OIBDA.

VALUATION

Our BUY rating is based on several forms of valuation, summarized in Table 2:

Table 2: WMG: Valuation Summary & Conclusions					
2011E Valuation Multiples				Embedded Expectations Metrics	
1	EV/Sales	0.8	7	**Breakeven DCF** (Calculated as the	
2	EV/OIBDA	6.1		10-Yr EBITDA CAGR required	
3	P/E	(5.8)		to justify current share price)	-6.3%
4	FCF/Share	$1.09			
5	EV/FCF	13.5			
6	FCF Yield	24%			
Source: Needham & Company estimates.					

1. The **"Breakeven DCF"** valuation methodology uses the current share price to calculate the market's growth expectations for the enterprise, including capital efficiency trends. This valuation methodology concludes that WMG must achieve a 10-year OIBDA compound annual growth rate of ***negative 6.3%*** to justify its current share price. (Please see Table 6.)

2. In Table 7, we summarize several **valuation multiples** for Sales, OIBDA and P/E. WMG's EV/OIBDA trading multiple is approximately 6.1 x 2011E.

3. In Table 8, we present **Free Cash Flow** valuation metrics. Our Free Cash Flow analysis shows that WMG is currently valued at about 13.5x 2011E Free Cash flow and has a 24% free cash flow yield.

4. In Table 9, we present our Comparative Industry valuation metrics which shows WMG compared with other media companies on several valuation metrics.

INVESTMENT POSITIVES

Near term growth drivers include:

1. **New YouTube Deal**. In September 2009, WMG signed a new deal with YouTube which allows WMG to control the ad inventory next to its music videos. This represents premium ad inventory. In addition, there are now links directly to WMG's artist's websites which facilitates higher fan interaction and individual artists' audience targeting by advertisers. Over time, we expect music videos shown on YouTube to have links to purchase albums, merchandise, etc.

2. **360 Deals.** Since 2006 with Paramore, WMG's first 360 degree deal, WMG now only signs 360 degree deals with new artists. In 360 degree deals, WMG gets a percent of ALL revenue that an artist generates, much like an employee relationship in other

industries, but unprecedented in the music industry. Under these expanded rights deals, WMG participates in the artist's ancillary revenue streams such as live performances, merchandising and sponsorships. Artists with 360 degree deals now represent >50% of total artists under contract and <10% of revenue (by our estimate). The importance of 360 degree deals is that they expand the music biz model. We expect ROICs to rise vs deals where WMG only shares the revenue from recorded music.

3. **iTunes Variable Pricing.** In April 2009, iTunes began tiered pricing for singles ($0.69, $0.99 and $1.29/song). This price differentiation has proven positive for WMG's revenue and absolute gross profit dollars, but margins are similar among the three price points owing to a variable payout structure to Apple.

4. **Performance Rights Act.** The US is one of only five countries in the world that does not have a royalty paid to recording artists for songs played on terrestrial radio. A bill addressing this issue has passed both the House and Senate and is now in committee and we expect a final vote in 1H10. The MPAA is supportive, but the NAB is against it. Our calculation of the economic upside is based on our observation that the music industry generates about $500B of music publishing royalties from radio stations. If this legislation created a similar magnitude of fees, then WMG would garner $50mm annually (calculated as $500mm minus 50% to the artist times WMG's market share of about 20%). We estimate that margins on this incremental revenue would be about 90%, implying $45mm of annual incremental EBITDA if this bill becomes law.

5. **Release Slate Strong.** WMG's US and International release slate was solid in 1H10 (ended 3/31/10) and were lead by the New Moon soundtrack and Michael Buble, Enya and Muse, in addition to carry-over from 4Q09's strong release schedule. WMG expects a strong 2H10 release schedule.

6. **Mobile** Growth Potential:

- **Access model.** TDC (a Danish telephone operator) was one of the first to bundle music into its handset in Denmark. Its research shows that this bundle reduced churn. Nokia's "Nokia comes with music" product is now in 8 markets globally, including the UK, Mexico, Brazil, Australia, Singapore and other parts of Asia. Nokia has deals whereby each individual music company supplies unlimited (all you can eat) music to its phones handsets for which Nokia pays a one-time fee per handset. It's viewed as a retention tool because if a consumer changes phones to a different handset maker, they lose their music and must begin all over. Assuming 3 billion handsets globally x 5% of them paying $2.00 to WMG once every 5 years (replacement cycle), implies incremental revenue of $60mm/year. At a 80% profit margin this would add $48mm/year to EBITDA for the foreseeable future.

- **Streaming services strategy**. WMG will only agree to stream its music to mobile devises that are part of a subscription plan and little desire to stream to advertising-supported business models because they have typically been unsuccessful.

Longer-term investment positives that should drive WMG's valuation higher include:

1. **Digital Growth.** Because physical sales are falling at 15-20% y/y, this is rapidly becoming a less important component of total revenue. When the digital line crosses the physical line, we believe WMG will be revalued upwards as growth returns.

2. **IP Protections.** Around the globe, countries are moving to protect intellectual property on digital platforms. In France, there has been talk since 2008 about a "graduated response" rule whereby any consumer violating copyright is warned, then suspended then banned from the internet for a year if they steal IP over the internet. The UK recently published a paper entitled "Digital Britain" which underscored the need to protect intellectual property in the digital age. Also, Chinese businessmen have recently stated that, without protections, China will never become a global content producer.

3. **FCF & ROIC Growth**. To drive FCF and ROICs, WMG significantly cut capital spending and investments in FY09. WMG reported CapX of only $27m in FY09, down 15% y/y vs the FY08 level of $32mm. In addition, in FY09 WMG spent only $16mm acquiring businesses compared with the $132mm it spent in FY08. Finally, in FY09, WMG sold assets for $133mm compared with only $25mm in FY08.

4. **Balance sheet--** Cash balances were $383M at 3/31/10 and Net debt at 3/31/10 was $1.55B, near its lowest level since the company went public. In May 2009, WMG raised $1.1 billion at 9.50% in the high yield debt market which it used (along with $380mm of cash) to repay its senior secured bank debt. As a result, WMG's nearest maturity is in 2014 and WMG has NO maintenance covenants, only incurrence tests. With its FCF, we believe WMG could purchase some of its public bonds below par, which would further lower leverage.

5. **Tax Advantages.** WMG has a $100mm/year tax shield in the US for the next 10 years owing to the structure of its acquisition of Warner Music as a purchase of assets from Time Warner (TWX, NR) which allows WMG to deduct the value of intangible assets (most music assets are intangible). We estimate that WMG's taxes will be payable from offshore earnings and that their blended rate will be in the 20-25% range (about $50mm/year) for the foreseeable future.

6. **Execution Excellence:**

   - **Market Share Gains.** Music is a hit-driven business. WMG's management team has a long track record of being one of the best A&R (artists & repertoire) teams in the world. We estimate that WMG's share of the worldwide recorded music business has grown from about 13% in 2004 when this management team took over, to 16% in FY09. In the US, WMG now has a 21% market share. This strong track record implies accelerating growth.

   - **Margin Expansion.** Since buying WMG, current management has expanded margins from 10% to 13%, has grown recorded music market share in 16 of the last 19 quarters and is at its highest market share since the 1980s. Additionally, WMG has moved up from being the #4 music company to being the #3 music company.

7. **Equity Sponsors.** WMG, originally a subsidiary of Time Warner, was purchased by Thomas H Lee, Bain and Providence and subsequently taken public in 2Q05 at $17/share.This strong private equity sponsorship limits the risk of financial distress and maximizes share price maximization focus.

8. **Industry Structure Protects Profits.**

- Music industry barriers to entry on a global scale are enormous, including the expertise in identifying and grooming talent, distribution and marketing expertise, economies of scale, etc.

- The record business is the only entertainment business with strong underlying economics with talent. Aggregate failure costs are low despite 10 releases required to generate 1 hit. The low talent cost structure in music drives value creation.

- The music industry is a disciplined oligopoly with few players sharing a global revenue base and steady consolidation. The 3 majors (excluding EMI) represent approximately 80% of recorded music sales and 65% of music publishing revenue. Market share shifts are relatively slow.

- **Digital Margins Higher.** We estimate that the profit margin for online digital revenue is about 47% compared with 40% for physical music sales. The difference stem from lower manufacturing and distribution expenses, inventory costs and returns handling. Therefore, the shift toward digital revenue implies margin expansion and that the profit crossover point will come faster than the revenue cross over point.

RISKS TO OUR TARGET PRICE

1. **Acquisitions.** EMI is a troubled music company and WMG and EMI have been in a long-term courtship. If WMG bought EMI, we believe the market would penalize WMG's share price. EMI is a strong strategic fit with WMG because EMI has only 8% market share in the US (of which 80% is from catalog sales) which is where WMG is dominant.

2. **Physical Declines.** The bad news that everyone knows is that the migration from physical CDs to digital platforms is putting secular downward pressures on all music companies. This secular trend, coupled with the current severe consumer recession, is putting downward revenue and margin pressure on WMG. WMG's physical CD unit declines hit 19% in fiscal 2009, and was worse (down 23%) in FY4Q09.

3. **Piracy** and theft continue to be important leaks to music industry economics.

4. **Unit Pressure.** New hit albums are selling fewer copies than in the past.

5. **Mobile** sales in the US have disappointed and continue to be anemic, slowing the growth trajectory of digital revenue.

6. **Music Publishing.** WMG's Music Publishing includes a great library but we estimate that only 20% of WMG's music publishing revenue relates to WMG's recorded music artists. WMG's publishing segment has been growing 100-200 basis points slower than the market for the past several years, and we expect this to continue because competition for music publishing rights has driven prices up and growth comes from purchasing catalog rights.

7. **Hits.** Music is a hit-driven business which implies unpredictability and volatility of financial results.

COMPANY DESCRIPTION

WMG is the world's third largest record company and includes the Atlantic and Warner Bros. records labels. In addition, it is the second largest music publisher under the name Warner/Chappell. WMG operates throughout the world and over 50% of its revenue is generated from abroad. Artists under its various labels include The Eagles, Fleetwood Mac, Linkin Park, Green Day, Josh Groban and Madonna. Its music publishing copyrights include "Star Wars Theme", "Happy Birthday", "Frosty the Snowman" as well as many more.

Table 3

Warner Music Group Corp.: Quarterly Income Statement Projections, 2010E

$ and shares in millions, except per share data

	12/31/09A	3/31/10A	6/30/10E	9/30/10E	2010E	Year/Year Change Q1	Q2	Q3	Q4	2010E
Revenue										
Recorded Music	$783	$534	$525	$631	$2,473	3%	-1%	-17%	-11%	-6%
Music Publishing	$141	$134	$132	$136	$543	4%	-1%	-10%	-16%	-6%
Eliminations	($6)	($6)	($8)	($11)	($31)	20%	50%	14%	10%	19%
Total Revenue	**$918**	**$662**	**$650**	**$756**	**$2,986**	**3%**	**-17%**	**-16%**	**-12%**	**-6%**
Segment OIBDA										
Recorded Music	$113	$49	$50	$82	$294	6%	9%	-42%	-15%	-12%
Music Publishing	$22	$61	$25	$55	$163	-1%	11%	-7%	-7%	0%
Segment OIBDA	$135	$110	$75	$137	$457	4%	10%	-34%	-12%	-8%
Corporate Exp & Eliminations	($22)	($23)	($23)	($26)	($94)	2%	15%	0%	-26%	-6%
OIBDA (after corp)	**$112**	**$87**	**$52**	**$111**	**$363**	**5%**	**9%**	**-42%**	**-7%**	**-9%**
Segment Op Income										
Recorded Music	$68	$6	$7	$39	$120	15%	200%	-83%	-22%	-21%
Music Publishing	$4	$43	$7	$37	$91	-37%	16%	-29%	-12%	-4%
Corporate Exp & Eliminations	($24)	($25)	($25)	($25)	($102)	2%	4%	0%	-34%	-8%
Operating Income	**$47**	**$24**	**($11)**	**$51**	**$112**	**16%**	**60%**	**-144%**	**-5%**	
Interest Expense, net	($51)	($46)	($50)	($50)	($197)	16%	12%	-19%	2%	1%
Other Income (Expense), net	$1	($4)	($5)	($2)	($10)					
Minority Interest Expense	$0	$0	$0	$0	$0					
Income Before Tax	**($3)**	**($26)**	**($65)**	**($1)**	**($95)**	NM	NM	NM	NM	90%
Income Taxes (Expense)	($13)	($2)	($10)	($10)	($35)	-19%	-80%	150%	-50%	-30%
Net Income-Operating	**($16)**	**($28)**	**($75)**	**($11)**	**($130)**	NM	NM	NM	NM	30%
Non-Controlling Interests	**($1)**	**$3**	**$0**	**$0**	**$2**					
Net Income-Reported	**($17)**	**($25)**	**($75)**	**($11)**	**($128)**					
EPS (Operating)	**($0.11)**	**($0.19)**	**($0.50)**	**($0.07)**	**($0.88)**	**NM**	**NM**	**NM**	**NM**	**31%**
EPS (Reported)	**($0.11)**	**($0.17)**	**($0.50)**	**($0.07)**	**($0.86)**	**28%**	**-29%**	**297%**	**-40%**	**50%**
Avg Shs Out	150	150	150	150	150					

Sources: Company Reports, Needham & Company estimates.

Table 4

WMG: Annual Income Statement Projections, 2007A-2011E

$ and shares in mm, except per share data

FYE 9/30:	2007A	2008A	2009A	2010E	2011E	07-11E CAGR
Revenue						
Recorded Music	$2,837	$2,895	$2,634	$2,473	$2,350	-4.6%
Music Publishing	$570	$623	$580	$543	$533	-1.7%
Eliminations	($24)	($28)	($26)	($31)	($30)	5.7%
Total Revenue	**$3,383**	**$3,491**	**$3,188**	**$2,986**	**$2,852**	**-4.2%**
Segment OIBDA						
Recorded Music	$422	$416	$334	$294	$305	-7.8%
Music Publishing	$160	$162	$163	$163	$150	-1.6%
Segment OIBDA	$582	$578	$497	$457	$456	-5.9%
Corporate Expenses	($108)	($103)	($100)	($94)	($91)	-4.2%
OIBDA (After Corp)	**$474**	**$475**	**$397**	**$363**	**$365**	**-6.3%**
Tot. D&A	($246)	($268)	($245)	($240)	($240)	-0.6%
EBIT (Operating Income)	**$228**	**$207**	**$135**	**$112**	**$125**	**-14.0%**
Interest Expense, net	($182)	($180)	($195)	($197)	($195)	1.7%
Income Before Tax	$41	$14	($50)	($95)	($70)	
Income Taxes	($49)	($49)	($50)	($35)	($50)	0.5%
Reported Net Income	($8)	($35)	($85)	($130)	($120)	
Net Income-Operating	($8)	($56)	($100)	($128)	($120)	
EPS -Operating	**($0.06)**	**($0.38)**	**($0.57)**	**($0.86)**	**($0.80)**	
EPS-Reported	**($0.06)**	**($0.24)**	**($0.67)**	**($0.88)**	**($0.80)**	
PF Diluted Shares Out	146	148	150	150	151	0.8%

[1] Includes $1.02 billion for impairment of goodwill and other intangible assets.

Note: WMG changed its fiscal year from November to September.

Sources: Company Reports, Needham & Company estimates.

Table 5

WMG: Traditional DCF Calculation, 2012E-2021E

$ and shares in millions, except per share data

Valuation Conclusions		% of Total
Sum of PV of Free Cash Flow [1]	$1,776	50%
PV of Terminal Value Discounted at WACC [1]	$1,083	31%
Value of Operations (WACC Method)	**$2,858**	**81%**
Plus: Cash at 9/30/11E	$580	
Plus: NOL Tax Value	$100	
Less: Minority Interest	$0	
Less: Unfunded Retirement Liabilities	$0	
Enterprise Value	**$3,538**	**100%**
Less: Debt at 9/30/11E	($2,000)	
Less: Lease Obligations	($200)	
Less: Preferred Stock Outstanding	$0	
Less: Value of Options & Restricted Sk, After-tax	($50)	
Common Equity Value	**$1,288**	**36%**
Fully Diluted Shares Out, 2011E	151	
DCF Value/Share	**$8.53**	
Current Share Price @ 7/7/10	$4.59	
Upside Potential (DCF-Current Price/Current Price)	**86%**	

Traditional Discounted Cash Flow (DCF) Valuation

Why We Calculate: DCF is a rigorous bottoms-up valuation of the enterprise focusing on cash flows (not accounting)

Strengths

1 Focuses on operations. Removes financing
2 Focuses on FCF. Removes non-cash accounting
3 Explicitly forecasts capital needs (WC & CapX)
3 Uses a levered beta (widely available)
4 Ent value focus captures entire business model

Weaknesses

1 Many assumptions. Valuation can be manipulated
2 Terminal value big & based on low visiblity projections
3 Model assumes constant debt/equity ratio
4 Complex to calculate
5 Calculates the enterprise value first, then equity value

[1] **Calculation of the Value of Operations (WACC Method)**

FYE 9/30:	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	CAGR '12-21E
OIBDA (after option expense & corp):	**$365**	**$357**	**$350**	**$343**	**$336**	**$326**	**$316**	**$307**	**$298**	**$289**	**$283**	**-2.6%**
- Depreciation	($240)	($260)	($260)	($260)	($260)	($260)	($260)	($260)	($260)	($260)	($260)	
+ Option Exercise Proceec	$0	$1	$1	$1	$1	$1	$1	$1	$1	$1	$1	
+ Int & Inv Income only	$6	$3	$3	$3	$3	$3	$3	$3	$3	$3	$3	
EBIT	$131	$101	$94	$87	$80	$70	$60	$51	$42	$33	$27	
Cash Taxes (at 20%)	($26)	($22)	($21)	($19)	($18)	($15)	($13)	($11)	($9)	($7)	($6)	
Plus: Depreciation	$240	$260	$260	$260	$260	$260	$260	$260	$260	$260	$260	
Plus: Sk Based Comp Exp	$0	$1	$1	$1	$1	$1	$1	$1	$1	$1	$1	
Working Capital Change	($10)	($10)	($10)	($10)	($10)	($10)	($10)	($10)	($10)	($10)	($10)	
Less: Capital Spending	($55)	($44)	($42)	($39)	($37)	($34)	($32)	($30)	($28)	($26)	($25)	
FCF from Operations	**$280**	**$285**	**$282**	**$280**	**$277**	**$272**	**$266**	**$261**	**$255**	**$250**	**$247**	**-1.6%**
PV Discounted at WACC [2]		$285	$255	$227	$203	$179	$158	$140	$123	$109	$97	
Sum of PV of Free Cash Flow											$1,776	
Terminal Value of 2021E FCF [3]											$2,761	
PV of Terminal Value at WACC [2]											$1,083	
Discount Period		0	1	2	3	4	5	6	7	8	9	

[2] **Calculation of WACC:**

10-Year Risk Free Rate ("RFR")	3.0%
Equity Risk Premium (Ibbotson-Arithmetic)	7.0%
Levered Beta (Bloomberg)	1.45
Target Equity/(Debt + Equity)	70%
Debt Rating	BB-
Debt Spread	6.0%
Marginal Tax Rate ("T")	35.0%
WACC	**11.0%**

(RFR+(Equity Risk Premium x Beta)) x % Equity/Total Capital + ((RFR + Debt Spread) x (1-T) x % Debt/Total Capital).

[3] **Calculation of Terminal Multiple (WACC Method)**

WACC	11.0%
Long-term Nominal GDP Growth	2.0%
WACC-GDP Growth	9.0%
FCF Terminal Multiple [1/(WACC-Growth Rate)]	**11.2**
EBITDA Terminal Mutiple	**9.8**

Sources: Company Reports, Needham & Company estimates.

Table 6

WMG: Breakeven Discounted Cash Flow (DCF) Valuation Calculation, 2012E - 2021E

$ and shares in millions, except per share data

Valuation Conclusions			% of Total
Sum of PV of Free Cash Flow [1]		$1,499	51%
PV of Terminal Value Discounted at WACC [1]		$766	26%
Value of Operations (WACC Method)		**$2,265**	**77%**
Plus: Cash at 9/30/11E		$580	
Plus: NOL Tax Value		$100	
Less: Minority Interest		$0	
Less: Unfunded Retirement Liabilities		$0	
Enterprise Value		**$2,945**	**100%**
Less: Debt at 9/30/11E		($2,000)	
Less: Lease Obligations		($200)	
Less: Preferred Stock Outstanding		$0	
Less: Value of Options & Restricted Sk, After-tax		($50)	
Common Equity Value		**$695**	**24%**
Fully Diluted Shares Out, 2011E		151	
Breakeven DCF Value/Share		**$4.60**	
Current Share Price @	7/7/10	$4.59	
Discount to DCF Value (DCF-Current Price/DCF)		0%	

Breakeven Discounted Cash Flow (DCF) Valuation

Why We Calculate: BE DCF uses the current share price to calculate the market's growth expectations for the enterprise.

Strengths

1. Makes no assumption about growth for first 10 years
2. Prevents over-optimism by working backwards
3. Data widely available and model well understood
4. Explicitly forecasts capital needs (WC & CapX)
5. Uses a levered beta (widely available)

Weaknesses

1. Terminal value big & based on low visiblity projections
2. Model assumes constant debt/equity ratio
3. Complex to calculate
4. Calculates the enterprise value first, then equity value

[1] Calculation of the Value of Operations (WACC Method)												Required LT
FYE 9/30:	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	Growth Rate
OIBDA (after option expense & corp):	**$365**	**$342**	**$320**	**$300**	**$281**	**$263**	**$247**	**$231**	**$217**	**$203**	**$190**	**-6.3%**
- Depreciation	($240)	($260)	($260)	($260)	($260)	($260)	($260)	($260)	($260)	($260)	($260)	
+ Option Exercise Proceec	$0	$1	$1	$1	$1	$1	$1	$1	$1	$1	$1	
+ Int & Inv Income only	$6	$3	$3	$3	$3	$3	$3	$3	$3	$3	$3	
EBIT	$131	$85	$64	$43	$25	$7	($9)	($25)	($39)	($53)	($66)	
Cash Taxes (at 20%)	($25)	($19)	($14)	($10)	($5)	($2)	$2	$5	$9	$12	$14	
Plus: Depreciation	$240	$260	$260	$260	$260	$260	$260	$260	$260	$260	$260	
Plus: Sk Based Comp Exp	$0	$1	$1	$1	$1	$1	$1	$1	$1	$1	$1	
Working Capital Change	($10)	($10)	($10)	($10)	($10)	($10)	($10)	($10)	($10)	($10)	($10)	
Less: Capital Spending	($55)	($44)	($42)	($39)	($37)	($34)	($32)	($30)	($28)	($26)	($25)	
FCF from Operations	**$281**	**$273**	**$259**	**$246**	**$234**	**$222**	**$212**	**$202**	**$192**	**$183**	**$175**	
PV Discounted at WACC [2]	-15%	$273	$233	$200	$171	$147	$126	$108	$93	$80	$69	
Sum of PV of Free Cash Flow											$1,499	
Terminal Value of 2021E FCF [3]											$1,953	
PV of Terminal Value at WACC [2]											$766	
Discount Period		0	1	2	3	4	5	6	7	8	9	

[2] Calculation of WACC:	
10-Year Risk Free Rate ("RFR")	3.0%
Equity Risk Premium (Ibbotson-Arithmetic)	7.0%
Levered Beta (Bloomberg)	1.5
Target Equity/(Debt + Equity)	70%
Debt Rating	BB-
Debt Spread	6%
Marginal Tax Rate ("T")	35.0%
WACC	**11.0%**

(RFR+(Equity Risk Premium x Beta)) x % Equity/Total Capital + ((RFR + Debt Spread) x (1-T) x % Debt/Total Capital).

[3] Calculation of Terminal Multiple (WACC Method)	
WACC	11.0%
Long-term Nominal GDP Growth	2.0%
WACC-GDP Growth	9.0%
FCF Terminal Multiple [1/(WACC-Growth Rate)]	**11.2**
EBITDA Terminal Mutiple	**10.3**

Sources: Company Reports, Needham & Company estimates.

Table 7 **WMG: Valuation Multiples (Sales, OIBDA, P/E)** $ and shares in millions, except per share data		
Valuation Conclusions		**2011E**
Market-Based Enterprise Value [1]		$2,213
2011E Sales (From Annual Projections)		$2,852
EV/Sales		**0.8**
Market-Based Enterprise Value [1]		$2,213
2011E OIBDA (From Annual Projections)		$365
EV/OIBDA		**6.1**
Target Price		$8.50
Target Price EV/2012E OIBDA		**8.0**
Current Price	7/7/10	$4.59
2011E EPS (From Annual Projections)		($0.80)
P/E Ratio		**(5.8)**
[1] **Calculation of Market-Based Enterprise Value**		
Year End 9/30:		2011E
Current Share Price	07/07/10	$4.59
Fully Diluted Shares Out		151
Market Capitalization		**$693**
Less: Excess Cash		($580)
Less: NOL Tax Value		($100)
Plus: Unfunded Retirement Liabilities		$0
Plus: Debt @ 9/30/11		$2,000
Plus: Lease Obligations		$200
Plus: Preferred Stock Outstanding		$0
Plus: Options & Warrants Outstanding		$50
Market-Based Enterprise Value		**$2,213**

Sources: Company Reports, Needham & Company estimates.

Table 8 **WMG: Free Cash Flow Valuation Metrics** $ and shares in millions, except per share data		
Valuation Conclusions		**2011E**
FCF/Share [2]		$1.09
Current Price	7/7/10	$4.59
FCF Yield		**24%**
FCF [2]		$165
2011E OIBDA (From Annual Projections)		$365
FCF Conversion Rate (FCF/OIBDA)		**45%**
Market-Based Enterprise Value [1]		$2,213
FCF [2]		$165
EV/FCF		**13.5**
Net Debt/OIBDA		3.9
Net Debt		$1,420
Net Debt/Market Cap		**204.9%**
[2] **Calculation of Free Cash Flow**		
Year End 9/30:		2011E
OIBDA		$365
Plus: Option Exercise Proceeds		$1
Less: Reported Interest Expense		($195)
Plus: Non Cash Interest Expense		$60
Minority Interest		$0
Less: Preferred Dividends		$0
Less: Cash Taxes		($14)
Less: Change in Working Capital		($10)
Less: Capital Spending		($42)
Free Cash Flow		**$165**
Shares Outstanding		151
FCF/Share		**$1.09**

Sources: Company Reports, Needham & Company estimates.

Table 9
Summary Comparative Financial & Valuation Information
$ and shares in millions, except per share data

Laura Martin's Coverage				2011E Multiples					7/7/10			
Sorted by Industry	Ticker	Market Cap ($B)	Rating	EV/ EBITDA	P/E	EV/ FCF	FCF Yield	Break-even DCF	Target Price	Current Price	Target/ Current	Conflicts Disclosure
Content Companies												
1 CBS	CBS	$9	BUY	6.8	11.3	15.4	11.6%	1.9%	$19.00	$13.33	43%	B
2 Disney	DIS	$62	HOLD	7.7	14.2	44.9	2.6%	8.3%	NA	$33.14		B
3 NewsCorp	NWS	$35	BUY	6.8	12.7	19.1	5.9%	1.5%	$20.00	$13.86	44%	B, G
4 Time Warner Inc	TWX	$33	HOLD	7.2	12.0	17.7	8.0%	0.7%	NA	$29.12		B
5 Viacom	VIAB	$19	BUY	5.7	10.1	18.0	6.8%	2.3%	$43.00	$30.77	40%	B
6 Warner Music	**WMG**	**$0.7**	**BUY**	**6.1**	**(5.8)**	**13.5**	**23.7%**	**-6.3%**	**$8.50**	**$4.59**	**85%**	**B**
Industry Total/Average		$159		6.7	9.1	21.4	9.8%	1.4%	NA	$20.80	NA	
Cable Companies												
7 Mediacom	MCCC	$0.5	HOLD	7.4	NMF	NMF	NMF	2.5%	NA	$6.79		B, G
8 Time Warner Cable	TWC	$20	BUY	5.3	13.0	20.5	9.6%	0.7%	$65.00	$54.69	19%	B
Industry Total/Average		$20		6.3	13.0	20.5	9.6%	1.6%	$65.00	$30.74	18.9%	
Total/Average from Above		**$179**		**6.5**	**11.1**	**20.9**	**9.7%**	**1.5%**			**NM**	

Sorted by Industry	Ticker	Revenue 2011E	OIBDA 2011E	EPS 2011E	EV	Net Debt	Debt/ OIBDA	Debt Rating	FCF	FCF/ Share	Dividend/ Share	Div. Yield
$ in millions, except per share data												
Content Companies												
1 CBS	CBS	$14,313	$2,414	$1.18	$16,305	$6,400	2.7	BBB-	$1,058	$1.54	$0.20	1.5%
2 Disney	DIS	$40,252	$9,407	$2.33	$72,538	$10,250	1.1	A	$1,615	$0.86	$0.35	1.1%
3 NewsCorp	NWS	$32,906	$5,848	$1.09	$39,876	$2,800	0.5	BBB+	$2,089	$0.82	$0.15	1.1%
4 Time Warner Inc	TWX	$27,237	$6,551	$2.43	$46,851	$10,500	1.6	BBB	$2,654	$2.34	$0.85	2.9%
5 Viacom	VIAB	$14,601	$4,040	$3.05	$22,999	$4,000	1.0	BBB	$1,279	$2.10	$0.60	1.9%
6 Warner Music	**WMG**	**$2,852**	**$365**	**($0.80)**	**$2,213**	**$1,420**	**3.9**	**BB-**	**$165**	**$1.09**	**$0.00**	**NA**
Cable Companies												
7 Mediacom	MCCC	$1,515	$570	$0.63	$4,187	$3,580	6.3	B+	$120	$1.69	$0.00	NA
8 Time Warner Cable	TWC	$19,444	$7,243	$4.21	$38,419	$19,500	2.7	BBB	$1,876	$5.23	$1.60	2.9%

Sources: Needham & Co, LLC estimates, Company documents, FirstCall, Yahoo Finance.

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Under Perform	<1	0
Rating Suspended	3	17
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