

Viacom Inc. CL B (VIAB) – Buy

VIAB: FY4Q10 ROIC Trends

This report tracks VIAB's capital allocation decisions and capital efficiency trends for its major business segments through the September 30, 2010 quarter.

- There is typically an 80-90% statistical correlation between forward-year ROICs and share prices in the media space. Recently it hit 83%.
- New ROIC Issues.** Several positive ROIC trends reversed themselves in the Sept. 30, 2010 quarter, which we will monitor closely in the quarters ahead:
 - VIAB's total assets were up 1.4% to \$22.1B.
 - Cash from Ops fell 36% y/y to \$364M.
- Positive ROIC Datapoints in FY4Q10.**
 - Net debt continued to decline (shrinking the asset base), down 3% q/q and down 10% y/y to \$5.9B at 9/30/10.
 - EBITDA was up 19% y/y and up 17.5% q/q.
 - ROA was 18.6%, up approximately 240 basis points y/y and up 260 basis points q/q.
- FY11E.** We estimate that VIAB will spend \$175M of total CapX to drive an incremental \$150M of EBITDA (above FY10's level), representing a marginal return on invested capital of 86%. We estimate that VIAB's ROIC will grow by about 230 basis points in FY11 (from 12.8% to 15.1%), implying its share price will rise in FY11. VIAB's current valuation is a bit above the valuation line, which may mute the full impact of its ROIC improvement in FY11. VIAB's rising ROICs will be driven in part by shrinking its asset base through share repurchases and debt repayment.

We maintain our BUY rating and \$43 target price.

	FY 09/30/10 A		FY 09/30/11 E		FY	
	Old	New	Old	New	Old	New
Rev. (MM)	\$13,515.0	\$14,240.8	\$14,240.8			
Growth	(1.8%)	5.4%	5.4%		0.0%	0.0%
Op. Mar.	24.8%		24.6%			
EPS: 1Q	1.14					
EPS: 2Q	0.42					
EPS: 3Q	0.71					
EPS: 4Q	0.75					
EPS: Year	3.02	3.22	3.22			
Growth	25.8%	6.4%	6.4%		0.0%	0.0%
P/E Ratio	10.5x	12.0x	12.0x		nm	0.0x

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

Company Update

Market Data	
Price (12/17/10)	\$38.61
12-Month Price Target	\$43.00
52-Week range	\$40.05-27.92
Shares Out. (MM)	607.0
Market cap (MM)	\$23,436.4
Avg. daily volume (000)	3,935.0
Financial Data	
Total Debt/Cap.	42.2%
Price/LTM Rev.	1.7x
Tangible BVPS	(\$3.63)
Net Cash Per Share	(\$9.68)

Viacom, consists of BET Networks, MTV Networks and Paramount Pictures, and is one of the world's leading entertainment content company. Viacom's global reach includes approximately 170 channels and 400 online properties in more than 160 countries and territories.



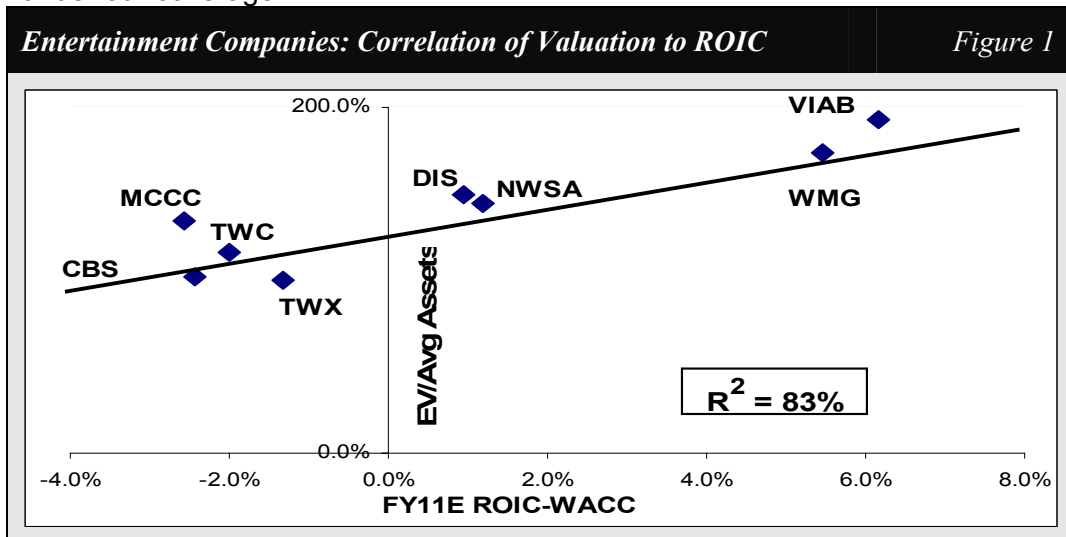
Disclosures applicable to this security: B.
Disclosure explanation on the inside back cover of this report.

Why ROIC Matters in Media

Returns on invested capital (ROIC) in the media space are closely related to share price performance. In fact, there is typically more an 80-90% statistical correlation between U.S. entertainment company valuations and their year-forward estimated ROICs. Recently, the correlation hit 83%. This high correlation implies that shifts in ROIC are predictive of changes in total valuation and share prices. An important valuation implication of this high correlation is that a company is likely to stay on the line (ie, valuations should move up or down) as its ROIC outlook changes.

We estimate that VIAB's ROIC will grow by about 230 basis points in FY11 (from 12.8% to 15.1%). VIAB's WACC will remain at about 9.0%, according to our estimates. VIAB's valuation is above the valuation line, which may mute the full impact of its ROIC improvement in FY11

Importantly, the slope of the entertainment regression line is typically very steep. Therefore, it is important to accurately assess ROIC trends for entertainment companies. Making mistakes is expensive for investors in cases where an entertainment company under-delivers expected ROICs and a boon to investors who accurately predict ROIC improvements. Figure 1 includes a recent statistical correlation between of FY11 forward-year returns on invested capital compared with valuations for the media stocks under our coverage.



What is ROIC?

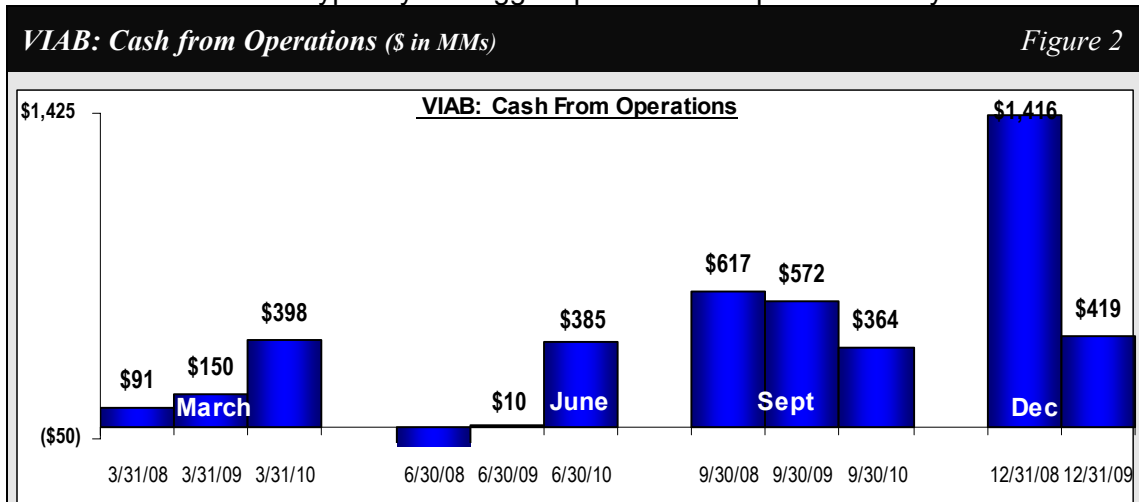
Return on invested capital or ROIC is a measure of how efficiently a company uses capital to generate profits. There are three primary sources of capital: net income after taxes from running the businesses; equity capital (public sale of shares); and debt capital (public bond issuances and/or bank loans). Improving asset efficiency typically drives accelerating free cash flow that can be used for debt repayment, share repurchases, dividend increases and/or acquisitions (ie, acquiring new cash flow streams). ROIC analysis focuses attention on the balance sheet and cash flow statement, which are often predictive of income statement metrics.

VIAB: ROIC Summary & Conclusions

The clearest signposts of improving ROICs are rising FCF and deleveraging.

Cash From Operations Analysis:

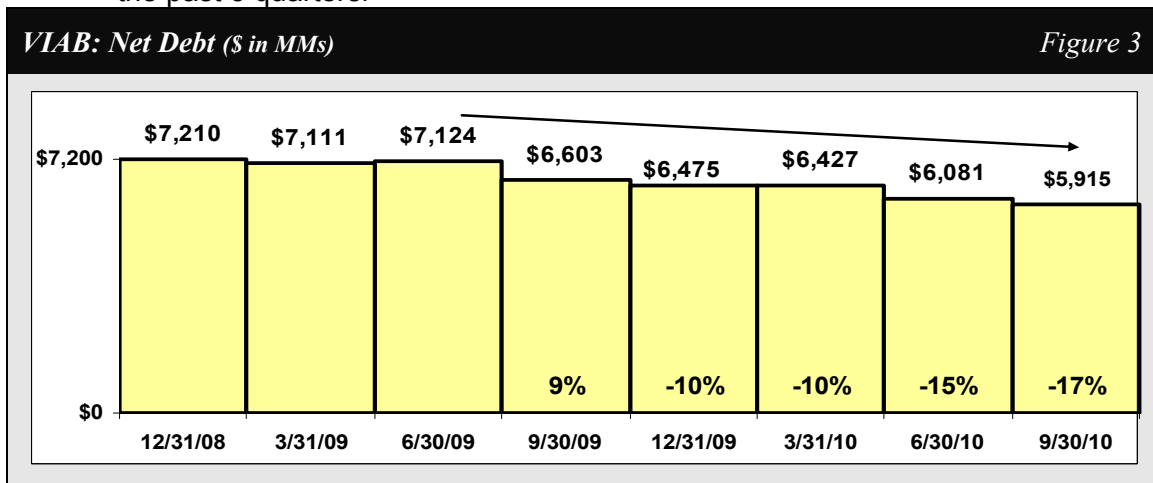
- **9/30/10:** VIAB's Cash from Operations was down 36% in the September quarter. This reverses a positive trend from the prior two quarters.
- **LT Trends.** VIAB'S Cash from Operations has been positive in 10 of the past 11 quarters, despite the worst advertising recession in 30 years.
- **Seasonality:** Seasonal with June the weakest FCF quarter of the year and December the typically the biggest positive FCF quarter of the year.



Source: Company reports, Needham & Company, LLC. research.

Net Debt Analysis:

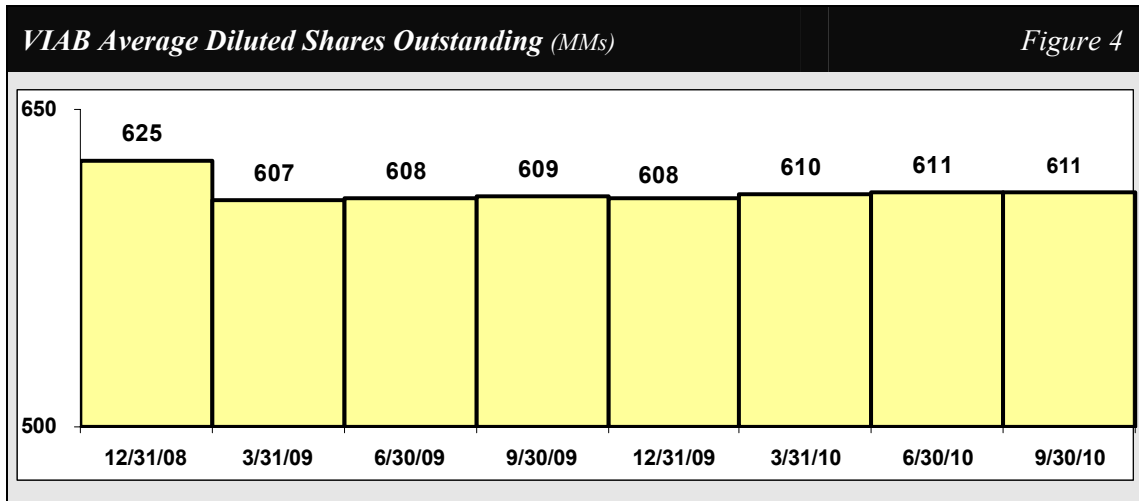
- **9/30/10:** Strong ROIC trends. Debt fell \$166M in the 3 months ended 9/30/10.
- **LT Trends:** Debt declining steadily. VIAB's net debt has fallen by \$688M in the past 12 months. This consistent deleveraging implies stronger equity returns and higher ROICs.
- **Seasonality:** Debt repayment has NOT been seasonal. Analysis shows that VIAB has had lower net debt (ie, shrinking the asset base) in every quarter for the past 5 quarters.



Source: Company reports, Needham & Company, LLC. research.

VIAB Average Shares Outstanding:

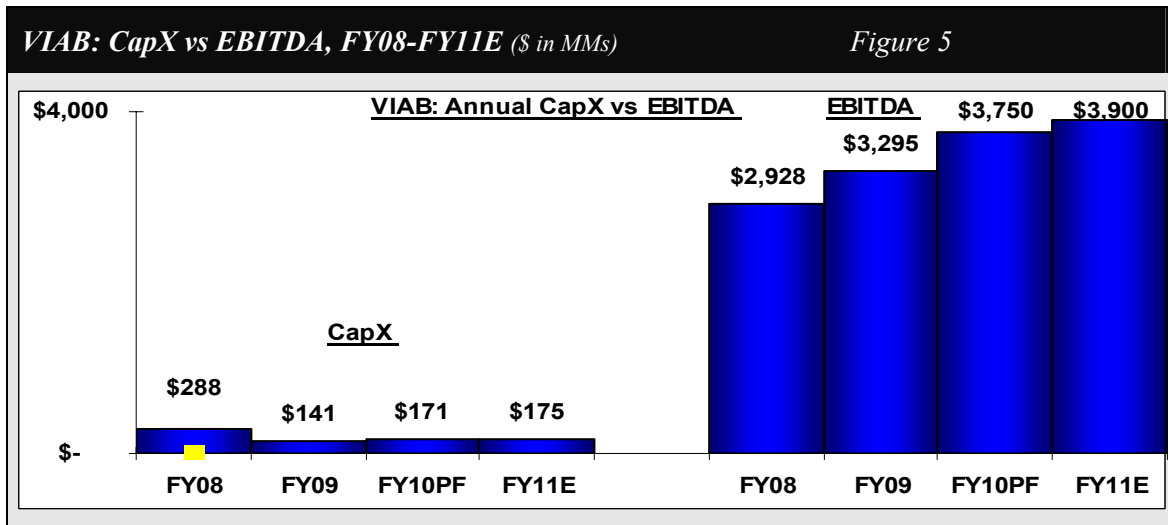
VIAB’s diluted share count had been relatively stable over the past 7 quarters, with most quarters reporting 607-611M average diluted shares outstanding. VIAB authorized a \$4 billion share repurchase program in June 2010 and began repurchasing shares under the program in October 2010. At the time of VIAB’s September 2010 earnings release, 4.3M shares had been repurchased for \$163M. We expect VIAB to accelerate its repurchase of shares and so we expect the number of shares outstanding to fall steadily going forward, which is another way of shrinking the asset base and driving higher ROICs.



Source: Company reports, Needham & Company, LLC research.

CapX vs EBITDA Trends:

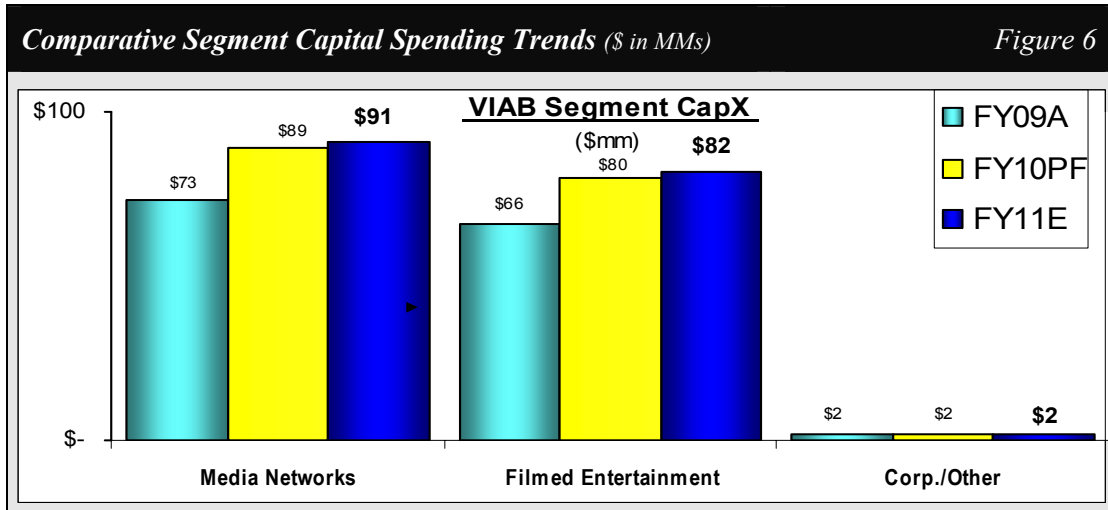
VIAB has a strong FCF profile. In FY10PF, EBITDA rose by about \$455M while CapX rose by only \$30M, implying accelerating ROAs. In fact, if VIAB spends only \$175M in total CapX and EBITDA grows by \$150M in FY11E, this represents a marginal return on incremental invested capital of 86%.



Source: Company reports, Needham & Company, LLC research.

Segment Capital Spending Trends:

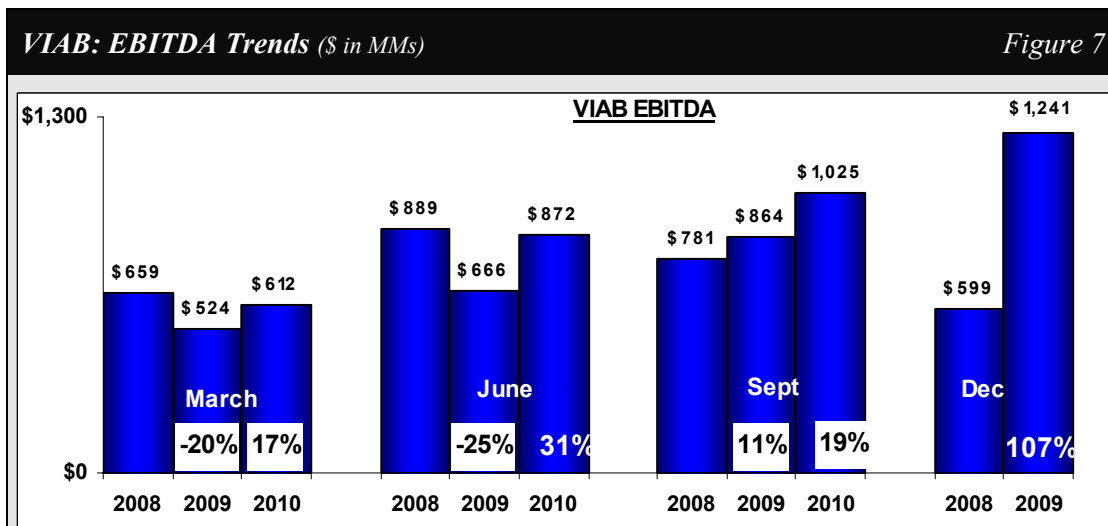
- **FY11E:** We estimate that in FY 2011E VIAB will spend approximately \$175M of CapX, which is in line with FY10PF levels of \$171M. Given our estimate for strongly higher EBITDA, this implies accelerating ROICs in FY11E.
- **LT Trends.** Capital spending has risen in both of the past 2 fiscal years, although it remains low compared to EBITDA growth. There is no segment that is a large capital user any more. We do not expect this trend to reverse itself in FY11.



Source: Company reports, Needham & Company, LLC research.

VIAB's EBITDA Trends

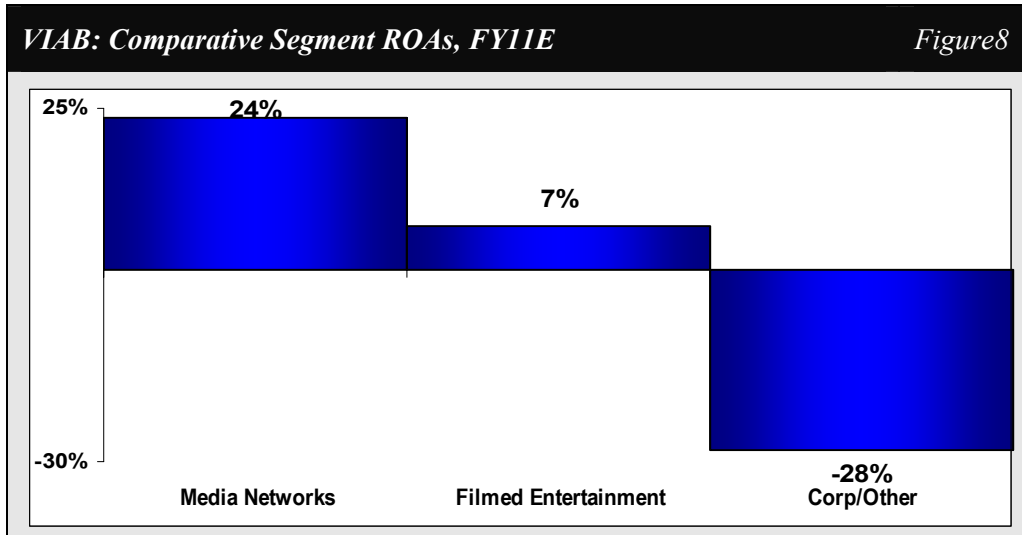
Figure 7 includes Viacom's recent trends in EBITDA. The most recent quarter reported continued strong growth in EBITDA, up 19% y/y and up 18% q/q. All of this EBITDA growth is coming from the Media Networks segment, as Paramount is down both y/y and q/q. A robust advertising environment plus strong affiliate fee increases are driving Media Networks EBITDA up by strong double digits.



Source: Company reports, Needham & Company, LLC research.

Segment ROA Analysis:

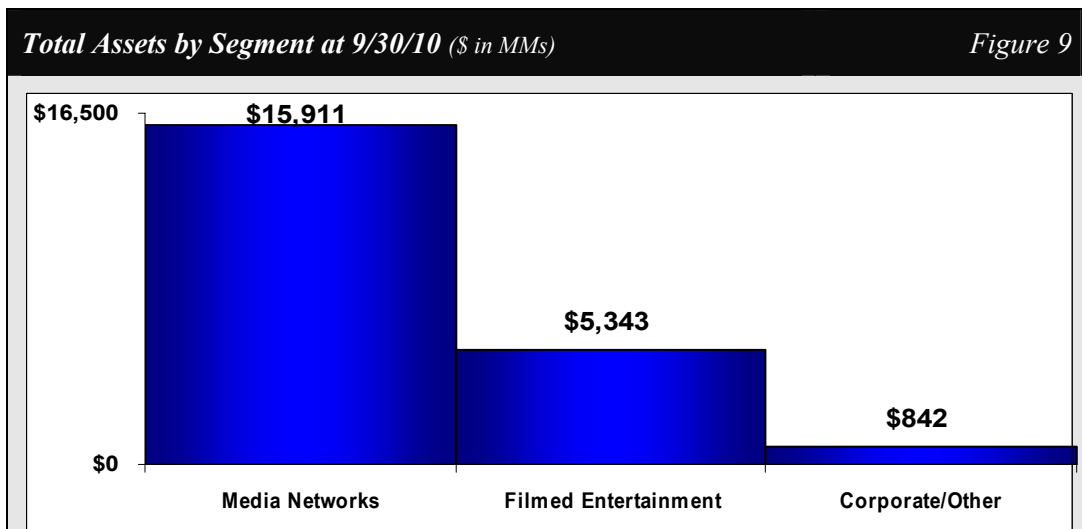
For FY11E, we estimate that VIAB's two operating segments will have ROAs of 24% for Media Networks and 7% for Filmed Entertainment. Media Networks is composed of MTV (which includes a video game business that includes Rock Band), VH1, CMT, Nickelodeon, Comedy Central, and other programming channels. Filmed Entertainment segment is composed of Paramount Pictures, DreamWorks and other film studios. The "Corporate" segment includes corporate overhead expense and cash.



Source: Company reports, Needham & Company, LLC research.

Segment Assets Analysis:

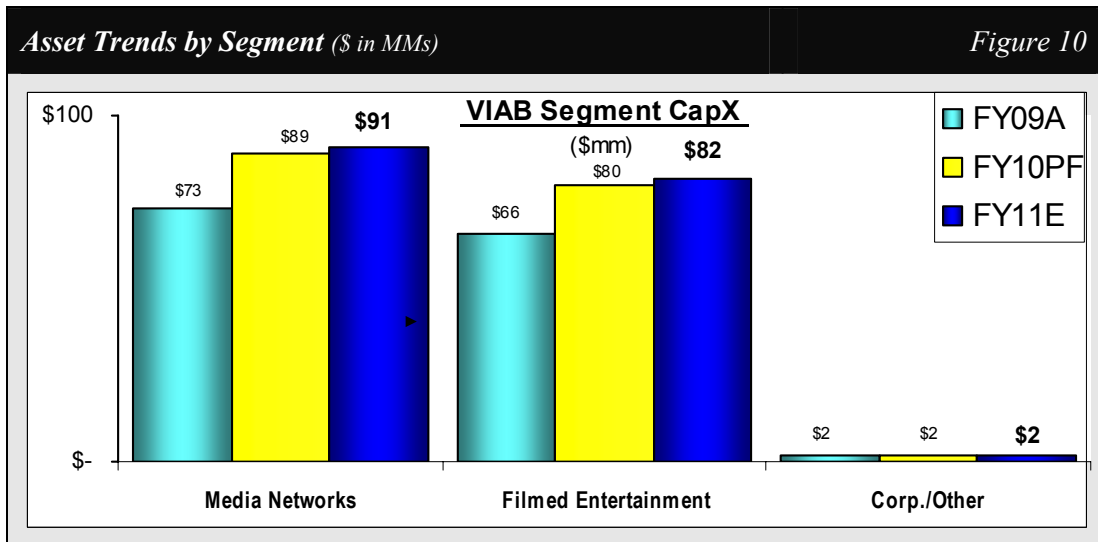
Media Networks is the largest asset base of VIAB's two operating divisions at \$15.9B, followed by Filmed Entertainment at \$5.34B. There is a big step down to Corporate at \$842M of assets.



Source: Company reports, Needham & Company, LLC research.

Total Assets Trends:

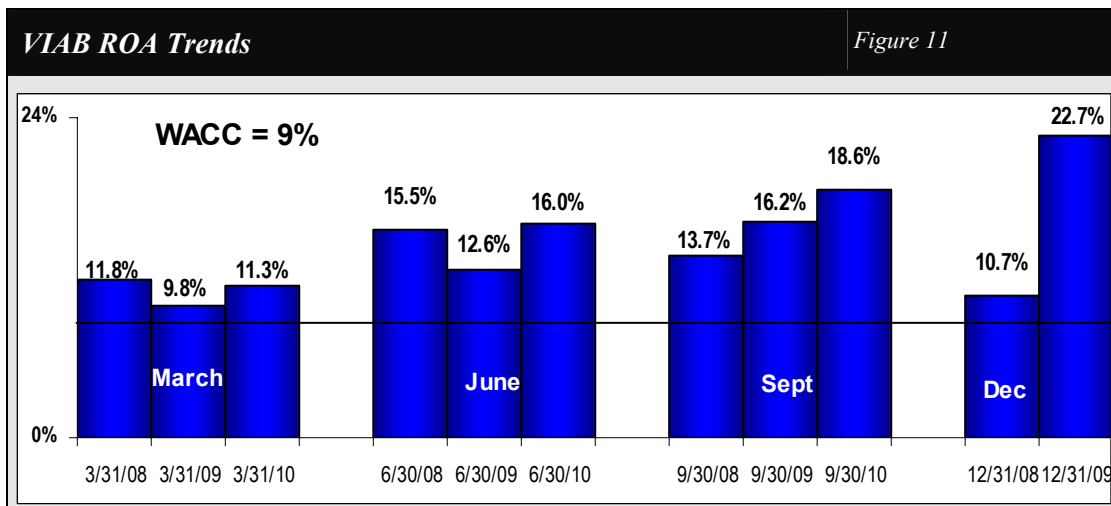
On a same-store basis, we estimate that in FY11E assets at VIAB's Media Networks will only grow by 0.6% (up \$89M), while assets at Filmed Entertainment will increase by 1.1% (\$57M). This represents an excellent trend for improving ROICs.



Source: Company reports, Needham & Company, LLC research.

VIAB ROA Trends:

VIAB's ROA's (defined as EBITDA/Assets) have been up 5 quarters in a row. ROAs have been above VIAB's WACC for the past 11 quarters, ranging from a low of 9.8% to a high of 22.7%. VIAB's WACC is approximately 9.0%. We note that share prices tie closely to trends in ROIC, not the actual level of ROICs.

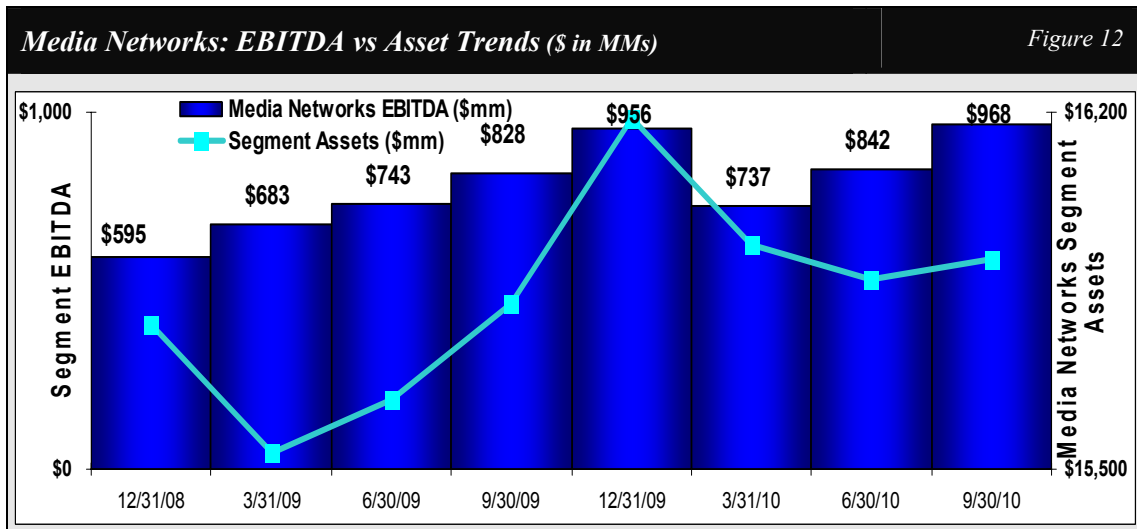


Source: Company reports, Needham & Company, LLC research.

Segment Capital Efficiency Trends

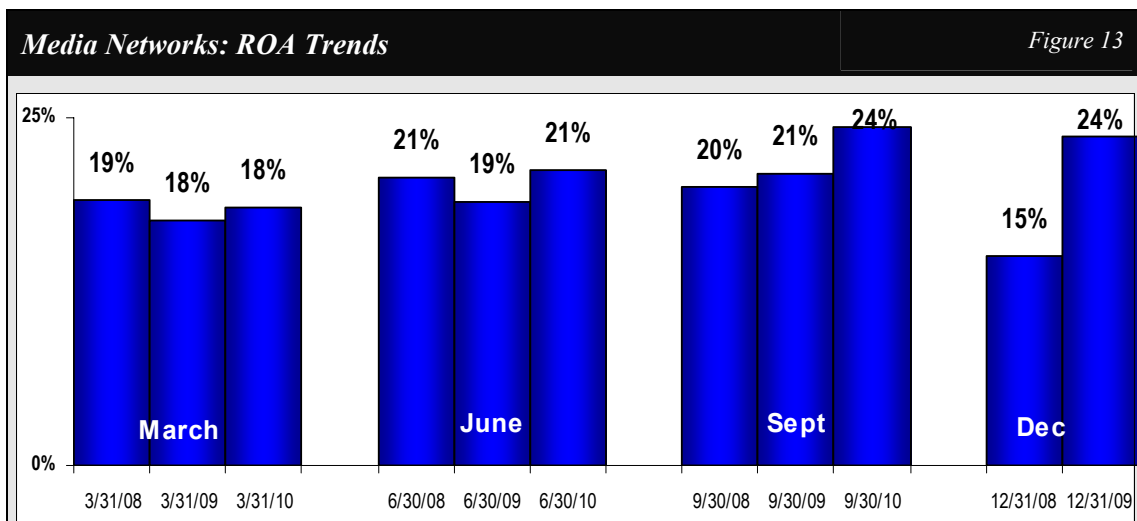
Media Networks ROA Analysis:

- **Assets.** This segment has the largest asset base in the VIAB empire. Media Networks segment assets increased 0.2% in the most recent quarter after declining during the prior two quarters. We expect assets in this division to remain relatively constant for FY11E.
- **EBITDA.** VIAB weathered the negative impact of the advertising recession of 2009 due in large part to affiliate fee payments and films. The four most recent quarters show a strong y/y increase and we expect this to improve in the quarter ending 12/31/10.



Source: Company reports, Needham & Company, LLC research.

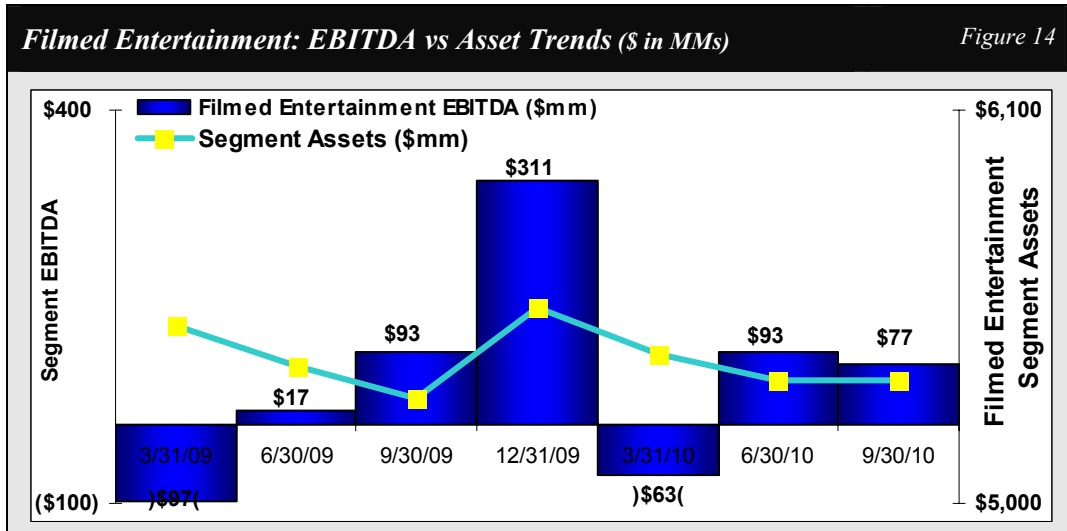
Media Networks has had solid ROAs for the past 11 quarters, ranging from a low of 15% to a high of 24%, including the most recent quarter ended 9/30/10. These returns do not appear to be seasonal, and they have been steadily improving since Sept of 2009. All are well above VIAB's WACC of 9.0%.



Source: Company reports, Needham & Company, LLC research.

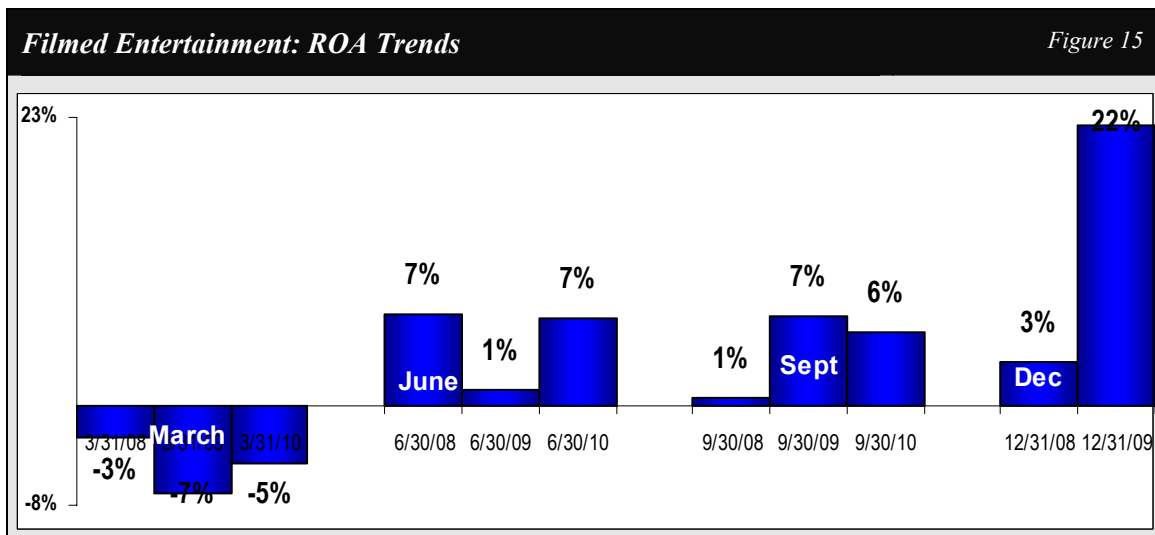
Filmed Entertainment ROA Analysis:

- **Assets:** This segment has the second largest asset base of VIAB's two operating divisions. Film assets have been declining steadily over the past three quarters, down 3.7% y/y to \$5.34B at 9/30/10.
- **EBITDA** in this segment is very volatile, depending on the box office performance of the films released in the quarter. Marketing expenses often dampen the P&L of this segment in the quarter before films are released.



Source: Company reports, Needham & Company, LLC research.

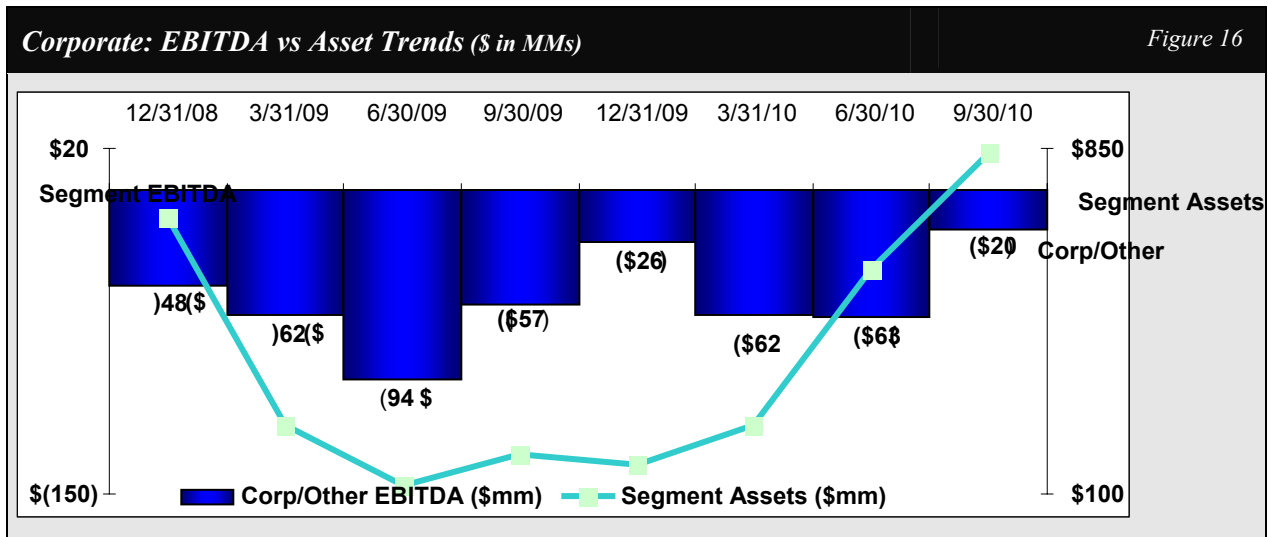
Seasonally, Film segment ROAs in the June and December quarters are typically the highest and March are the lowest. This is related to the Paramount box office and DVD release schedule each year. The hit-driven nature of the film business can be seen in how much higher Dec 2009 ROA results were than Dec 2008. Generally, this division does not meet VIAB's cost of capital of 9.0%



Source: Company reports, Needham & Company, LLC research.

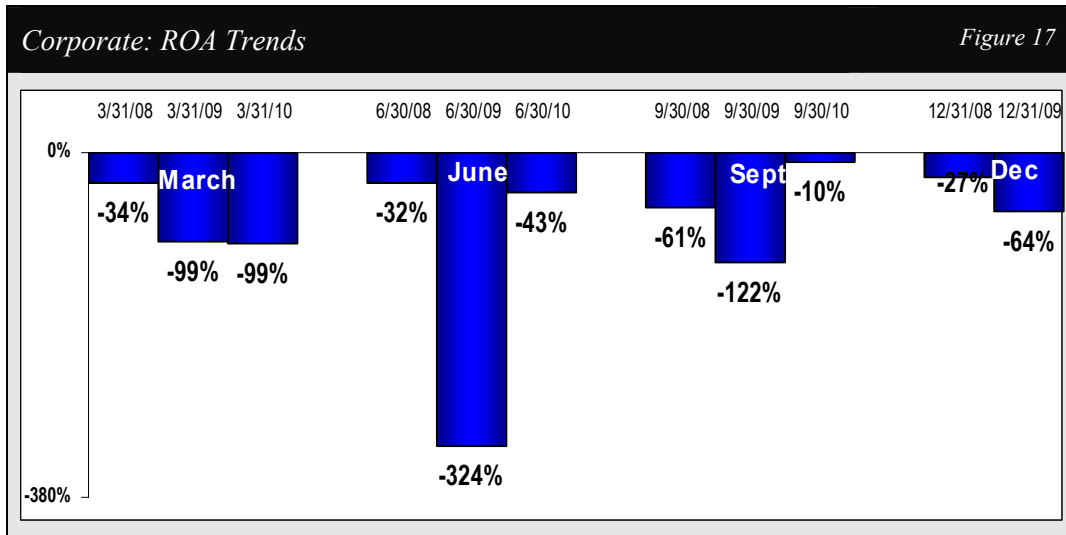
Corporate ROA Analysis:

- **Assets:** Corporate segment assets (NYC HQ, etc) are very low at less than \$850M, but we note that they have increased 5-fold in the past 9 months. This surprises us. Assets in this segment are relatively small so changes have minimal impact on overall VIAB ROAs, although this is a trend we will watch closely.
- **EBITDA** in this segment are always negative because corporate is a cost center. We do believe that income on cash balances is included in this segment's EBITDA, which partly masks the true cost of the corporate center. The volatility of the EBITDA surprises us, with negative \$94M in June 2009 falling to negative \$26M in Dec 2009 and improving to negative \$20M in the quarter ended 9/30/10.



Source: Company reports, Needham & Company, LLC research.

Corporate results are always negative. We note that the Sept 30, 2010 quarterly performance by this segment is the best of the past 11 quarters. We expect this to continue in the Dec quarter, the strongest quarter of the year seasonally.



Source: Company reports, Needham & Company, LLC research.

TARGET PRICE & RISKS

Our target price of \$43 is based on a DCF valuation. We use a WACC of 9% 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. Our \$43 target price embeds a 10-year OIBDA growth rate of about 1.7% annually beginning in 2011 and represents a 7.7x multiple of forward year (2012E) OIBDA.

Risks to our target price include a weakening economy, advertising weakness, and piracy of content online. In addition, films are a hit-driven business and tentpole films often cost \$100mm to make plus >\$50mm to market. Finally ownership by Sumner Redstone through an A/B voting structure gives him absolute control of Viacom.

VALUATION

Our BUY rating is based on several forms of valuation, summarized in Table 1:

<i>VIAB: Valuation Summary & Conclusions</i>			<i>Table 1</i>
2011E Valuation Multiples		Embedded Expectations Metrics	
1	EV/Sales	2.1	7 Breakeven DCF (Calculated as the 10-Yr EBITDA CAGR required to justify current share price) 0.8%
2	EV/OIBDA	7.5	
3	P/E	12.0	
4	FCF/Share	\$2.91	
5	EV/FCF	17.0	
6	FCF Yield	8%	
Source: Needham & Company estimates.			

Source: Needham & Company, LLC research.

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 VIAB must achieve a 10-year OIBDA compound annual growth rate of approximately 0.8% to justify its current share price.
2. VIAB’s EV/OIBDA trading multiple is approximately 7.5x 2011E.
3. Our Free Cash Flow analysis shows that VIAB is currently valued at about 17x 2011E Free Cash flow and has an 8% free cash flow yield, making it one of the least expensive companies we cover.

Table 2										
Viacom Quarterly Income Statement Projections, 2011E										
\$ and shares in thousands, except per share data						Year/Year Change				
	12/31/10E	3/31/11E	6/30/11E	9/30/11E	2011E	Q1	Q2	Q3	Q4	2011E
Revenue										
Advertising Sales	\$1,380	\$1,018	\$1,189	\$1,239	\$4,826	6%	6%	6%	6%	6%
Affiliate Fees	\$800	\$838	\$845	\$855	\$3,338	8%	7%	7%	7%	7%
Ancillary	\$218	\$146	\$134	\$120	\$618	-25%	-25%	-25%	-25%	-25%
Total Media Networks	\$2,398	\$2,002	\$2,169	\$2,214	\$8,783	3%	3%	4%	4%	3%
Entertainment	\$1,504	\$992	\$1,320	\$1,822	\$5,638	-16%	12%	6%	48%	9%
Eliminations	(\$45)	(\$45)	(\$45)	(\$45)	(\$180)	-73%	18%	29%	55%	41%
Total Revenue	\$3,857	\$2,949	\$3,444	\$3,991	\$14,241	-6%	6%	4%	20%	5%
Operating Income										
Media Networks	\$995	\$771	\$835	\$897	\$3,497	1%	8%	3%	3%	3%
Entertainment	\$75	(\$10)	\$13	\$184	\$262	-75%	-88%	-81%	254%	-23%
Segment Op Income	\$1,070	\$761	\$848	\$1,081	\$3,760	-17%	20%	-4%	17%	1%
Corp, Interseg. Elim.	(\$60)	(\$60)	(\$60)	(\$60)	(\$240)	15%	18%	33%	11%	19%
Op Inc (bef charges)	\$1,010	\$701	\$788	\$1,021	\$3,510	-16%	26%	-3%	22%	3%
Restructuring Charge	\$0	\$0	\$0	\$0	\$0					
Op Inc (after charges)	\$1,010	\$701	\$788	\$1,021	\$3,510	-11%	26%	-3%	22%	5%
Net Interest Expense	(\$100)	(\$100)	(\$100)	(\$100)	(\$400)	-5%	-12%	-4%	-3%	-6%
Other Income (Expenses)	\$0	\$0	\$0	\$0	\$0		-100%	-100%	-100%	-100%
Equity in Inc of Affiliates	(\$10)	(\$10)	(\$10)	(\$10)	(\$40)	50%	64%	58%	33%	-54%
Income Before Tax	\$900	\$591	\$678	\$911	\$3,080	-12%	47%	-1%		9%
Provision for Taxes	(\$337)	(\$222)	(\$255)	(\$341)	(\$1,154)	7%	61%	7%	46%	25%
Minority Interest	(\$5)	(\$5)	(\$5)	(\$5)	(\$20)					
Net Income-Operating	\$564	\$368	\$424	\$570	\$1,906	-15%	39%	-4%	202%	23%
Add Back	\$0	\$0	\$0	\$0	\$0	NMF	NMF	NMF	NMF	NMF
Net Income-Reported	\$569	\$363	\$419	\$565	\$1,906	-25%	36%	-5%	199%	16%
EPS Operating	\$0.94	\$0.61	\$0.71	\$0.97	\$3.22	-23%	40%	-2%	213%	20%
EPS-Reported	\$0.93	\$0.61	\$0.70	\$0.96	\$3.22	-24%	39%	-3%	210%	20%
Avg. Diluted Shares Out.	600	595	590	585	593					

Sources: Company Reports, Needham & Company estimates.

Table 3 Summary Comparative Financial & Valuation Information \$ and shares in millions, except per share data													
Laura Martin's Coverage				2011E Multiples					12/15/10			Conflicts Disclosure	
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		
Content Companies													
1	ACL, Inc	ACL	\$3	BUY	4.7	16.5	6.8	11.8%	-13.8%	\$35.00	\$25.28	38%	B
2	CBS	CBS	\$12	BUY	7.7	12.3	13.1	12.7%	0.1%	\$19.00	\$17.79	7%	B
3	Disney	DIS	\$70	HOLD	8.7	15.5	26.7	4.3%	5.3%	NA	\$36.95		B
4	NewsCorp	NWS	\$42	BUY	7.4	13.9	16.9	6.6%	0.2%	\$20.00	\$16.03	25%	B, G
5	Time Warner Inc	TWK	\$36	HOLD	7.4	12.3	19.8	7.0%	0.3%	NA	\$31.35		B
6	Viacom	VIA	\$23	BUY	7.5	12.0	17.0	7.5%	0.9%	\$43.00	\$38.57	11%	B
7	Warner Music	WMG	\$0.8	BUY	7.0	(6.5)	15.4	18.4%	-7.7%	\$8.50	\$5.49	55%	B
Industry Total/Average		\$186			7.2	10.8	16.5	9.8%	-2.1%	NA	\$24.49	NA	
Cable Companies													
8	Mediacom	MCCC	\$0.6	HOLD	7.6	N/A	N/A	N/A	0.6%	NA	\$8.45		B, G
9	Time Warner Cable	TWC	\$23	BUY	6.0	15.1	41.5	4.5%	1.3%	\$65.00	\$64.49	1%	B
Industry Total/Average		\$23			6.8	15.1	41.5	4.5%	0.9%	\$65.00	\$36.47	0.8%	
Total/Average from Above		\$209			7.0	13.0	29.0	7.2%	-0.6%			NM	
Sorted by Industry	WACC	Revenue 2011E	OEIDA 2011E	EPS 2011E	EV	Debt/Net Debt	Debt/OEIDA	Debt Rating	FCF	FCF/Share	Dividend/Share	Div. Yield	
\$ in millions, except per share data													
Content Companies													
1	ACL, Inc	10.5%	\$2,093	\$480	\$1.53	\$2,245	(\$1,000)	(2.1)	BBB	\$329	\$2.99	\$0.00	NA
2	CBS	9.0%	\$14,371	\$2,398	\$1.45	\$20,183	\$7,250	2.7	BBB-	\$1,537	\$2.26	\$0.20	1.1%
3	Disney	8.7%	\$40,511	\$9,314	\$2.39	\$80,697	\$10,250	1.1	A	\$3,019	\$1.59	\$0.35	0.9%
4	NewsCorp	8.8%	\$34,790	\$6,260	\$1.16	\$46,153	\$3,300	0.5	BBB+	\$2,730	\$1.05	\$0.15	0.9%
5	Time Warner Inc	9.1%	\$28,050	\$6,705	\$2.54	\$49,682	\$11,600	1.7	BBB	\$2,507	\$2.21	\$0.85	2.7%
6	Viacom	9.0%	\$14,241	\$3,680	\$3.22	\$29,353	\$5,400	1.4	BBB	\$1,725	\$2.91	\$0.60	1.6%
7	Warner Music	9.1%	\$2,782	\$336	(\$0.84)	\$2,349	\$1,420	4.2	BB-	\$153	\$1.01	\$0.00	NA
Cable Companies													
8	Mediacom	9.2%	\$1,515	\$570	\$0.63	\$4,305	\$3,680	6.5	B+	\$124	\$1.75	\$0.00	NA
9	Time Warner Cable	9.1%	\$19,491	\$7,051	\$4.27	\$42,491	\$20,500	2.9	BBB	\$1,025	\$2.93	\$1.60	2.5%

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

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ANALYST CERTIFICATION

I, Laura Martin, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company (ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

I, Dan Medina, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company (ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.



	% of companies under coverage with this rating	% for which investment banking services have been provided for in the past 12 months
Strong Buy	9	15
Buy	62	15
Hold	27	3
Under Perform	<1	0
Rating Suspended	1	25
Restricted	0	0
Under Review	0	0

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