

Time Warner Inc. (TWX) – Hold

TWX: TV Everywhere Drives Upside for Content Companies

Revenue of the US television ecosystem in 2012 will total approximately \$165B, made up of approximately \$85B of subscription and license fees paid to cable, satellite and telephone companies plus approximately \$80B of TV advertising, according to PWC. We estimate that the roll-out of TV Everywhere over the next 3-5 years could add approximately \$12B of revenue annually to the US television ecosystem. These dollars dwarf any near-term revenue streams from digital platforms (Hulu, YouTube, etc). Additionally, these are low risk dollars as adding services to the TV bundle suggests additional revenue rather than economic cannibalization.

We calculate the value creation from TV Everywhere as follows:

- **Content Owners.** We calculate that TV Everywhere could add approximately \$10B/year of advertising revenue (12% of total) to the largest public content companies. Time Warner (TWX, Hold) and Disney (DIS, Hold) should be the biggest beneficiaries because they are the furthest ahead at rolling out TV Everywhere.
- **TV Distributors.** In addition, TV Everywhere could add approximately \$1.7B per year of revenue (an extra 2% annually) to the cable, satellite and telco distributors owing to incremental pricing power driven by new services. Comcast (CMCSA, NR) and Time Warner Cable (TWC, Buy) are key beneficiaries as they lead the industry in TV Everywhere adoption.

Valuation Implications: The EV/sales multiple for the content companies in our coverage is typically 2-4x, depending on business mix. By implication, TV Everywhere could add \$24-\$48B of value creation to the US TV ecosystem over the next 5 years. We estimate that the public market capitalization of the TV ecosystem today is approximately \$330B.

Company Update

Market Data	
Price (01/18/12)	\$37.39
12-Month Price Target	N/A
52-Week range	\$38.20-27.74
Shares Out. (MM)	1,181.2
Market cap (MM)	\$44,165.1
Avg. daily volume (000)	7,616.1
Financial Data	
Total Debt/Cap.	33.3%
Price/LTM Rev.	1.6x
Tangible BVPS	(\$6.03)
Net Cash Per Share	(\$10.64)

	FY	FY		FY	
	12/31/10 A	Old	New	Old	New
Rev. (MM)	\$26,888.0	\$29,027.5	\$28,942.1	\$29,646.3	\$29,646.4
Growth	5.9%	8.0%	7.6%	2.1%	2.4%
Op. Mar.	23.5%		20.1%		20.8%
EPS: 1Q	0.61	0.59	0.59A		
EPS: 2Q	0.50	0.59	0.59A		
EPS: 3Q	0.62	0.78	0.78A		
EPS: 4Q	0.68	0.87	0.87		
EPS: Year	2.42	2.81	2.81	3.15	3.15
Growth	38.9%	16.3%	16.1%	12.1%	12.0%
P/E Ratio	12.7x	12.2x	12.2x	11.9x	11.9x

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.

BACKGROUND & OVERVIEW

TV Everywhere is the ability of a consumer to enter an authentication code to gain access to most TV content, on-demand, on any screen in the home or outside the home. It is a cloud-based service offered by the incumbent TV distributors. TV Everywhere is also called “Authentication” and “TV Plus.” We believe that TV Everywhere is good for both consumers and for the US TV ecosystem.

Revenue of the US television ecosystem in 2012 will total approximately \$165B, made up of approximately \$85B of subscription and license fees paid to cable, satellite and telephone companies plus approximately \$80B of TV advertising, according to PriceWaterhouseCoopers (PWC). We believe that TV Everywhere will be one of the primary drivers of valuation growth for today’s TV ecosystem over the next five years.

ANALYSIS OF ECONOMICS

We estimate that the economic implications of TV Everywhere include:

1. **Pricing Power.** The current pay-TV distributors raise prices to consumers approximately 3-5% annually. We believe that the ability to access your favorite TV shows when and where you want, in or out of the home, will add 1-3% (100-300 basis points) to pricing power across the entire TV ecosystem for each of the next five years.

Economic estimates:

- There is no talk currently of only charging homes extra if they want TV Everywhere. The idea is that TV Everywhere will be rolled out across the entire US pay-TV footprint of 97mm homes. This should drive more rapid consumer adoption. We believe this is better for consumers as it maximizes every household’s choices equally, not based on income level through premium service pricing.
- For every 1% (100 basis points) of extra pricing power that TV Everywhere enables, this suggests that an additional \$850mm (\$85B x 1%) is added to the US TV ecosystem. We believe that the value of TV Everywhere will support a 2% (200 basis points) per year average price increase, adding about \$1.7B of revenue each year to the current TV ecosystem.
- We assume that the incumbent cable, satellite and telco distributors will be allowed to keep 100% of these incremental revenues.

2. **Better Consumer Value.** Digital devices are individual while a TV bundle is sold per household. There were 2.6 people per household in 2010 (Commerce Dept data) and, logically, the TV bundle has a different value to each member of the household. Young people find linear channels the least valuable. They prefer to watch premium content on-demand over their personal screens such as laptops and smartphones. Since 18-34 year olds are the most valuable demographic for advertisers, securing this age-group to the TV bundle maximizes long-term revenue upside. Advertising revenue near term is maximized by elongating viewing by this demographic today. Longer term, household formation by this group must include adoption of the TV bundle or ecosystem revenue will fall.

Economic estimates:

- According to the US Census, 23% of the total population is between the ages of 18 and 34. According to Nielsen, this group represented 24% of total time spent watching TV in 2010, not under-weighted as commonly assumed.
- Because this is the most valuable demographic to advertisers, we estimate that this audience segment represents approximately 35% of total ad dollars or \$28B in 2012E (\$80B x 35%). This implies a multiplier of 1.5 (35% of ad dollars vs 24% of viewing).
- 18-34 year olds watched an average of 136 minutes per day of TV in 2010, according to the US Bureau of Labor Statistics. For every 10% more (13.6 minutes) per day that TV Everywhere increases viewing by 18-34 year olds, this suggests a 15% increase in ad revenue over and above the \$28B of annual revenue they account for, or \$4.2B/year (\$28B x 15%), by our estimates.
- All of this incremental ad revenue is kept by the programmer/content owner so long as they keep the same ad load and Nielsen codes intact from the live TV viewing stream for the first 3 days of the C+3 window. The distributor shares none of this.
- We believe making TV content available on-demand has promotional value because it makes finding and trying new shows easier. However, this promotional value of TV Everywhere is difficult to quantify.

3. Improved Monetization. The emerging business model for TV Everywhere and VOD is favorable to content companies. The best idea is to keep the original ad loads from the live TV feed with the built-in Nielsen measurement codes for the first three days. This way, Nielsen simply adds the viewers on all platforms to the C+3 current industry-standard ratings and the content owner/channel gets paid for all those extra M's in the CPM (cost per thousands) calculation by advertisers under the exiting business model. This solution adds incremental viewers and advertising revenue and also makes many consumers happier by meeting their demands. We also like this solution because it does not train consumers that premium content viewed online should have fewer commercials.

Economic estimates:

- According to Leichtman Research Group in a study dated October 2011, about 44% of American TV households now have at least one digital video recorder and 62% of digital cable subscribers now use video-on-demand at least monthly but, even so, about 90% of all TV viewing is still viewed live.
- Since 50% of commercials are skipped when watching programming via a DVR compared with only 15% for VOD and TV Everywhere, this implies content owners can monetize time-shifted viewing better with TV Everywhere.
- We expect all of the 10% of viewing done on DVRs to shift to TV Everywhere over time, since a consumer doesn't have to plan ahead with TV Everywhere. If commercials skipped decline from 50% to 15% on 10% of total viewing, this implies an incremental \$5.6B of advertising revenue to the content owners each year. We calculate this as follows:
 - 10% of total TV viewing is time-shifted viewing;
 - This equates to about \$8B of advertising revenue annually (10%).
 - However, 50% of commercials during DVR viewing are skipped so this \$8B could be higher if there was NO commercial skipping.
 - If no commercials were skipped during DVR viewing, ad revenue should be \$16B (\$8B x 2 to get to 100%) each year.
 - Fast forwarding of commercials is typically disabled for TV Everywhere and VOD so only the final 15% of commercials (after the show is over)

are typically skipped, suggesting total revenue should be \$13.6B in a world where VOD and TV Everywhere replace DVR viewing.

- The upside from better monetization of time-shifted viewing alone is approximately \$5.6B (\$13.6B-\$8B) of advertising revenue each year.
 - All of this incremental ad revenue is kept by the programmer/content owner so long as they keep the same ad load and Nielsen codes intact from the live TV viewing stream for the first 3 days within the live + 3 day (C+3) measurement window. The distributor shares none of this incremental revenue from a shift from DVR viewing to TV Everywhere viewing.
- 4. Fast to Market.** Approximately 85% of the 115mm US TV households (Nielsen data) already pay a cable, satellite or telco provider a monthly subscription fee for their TV channels. At 2.6 people per household in 2010 (Commerce Dept data), this implies that approximately 250mm consumers have already adopted the pay TV bundle as their choice for accessing premium TV and film content. The demise of the music and newspaper industries are evidence of how dangerous ignoring consumer demand shifts can be. We expect TV Everywhere to be rolled out over the next 5 years, which will lead most consumers' demand for this type of product. TV Everywhere is a rapid response to giving consumers (often younger) what they want to watch when they want to watch it. The internet is building new business models from scratch which will take a long time to become meaningful. Adding new services to existing economics of the incumbent TV ecosystem maximizes near term earnings growth (ie, a higher NPV with lower risk).
- 5. Discourages Piracy.** We believe that TV Everywhere will dramatically slow piracy of TV shows and film. This helps every company in the TV ecosystem. By adding on-demand capabilities to premium content, this undermines the desire to go through the hassle of finding TV shows one at a time online, where viruses are prevalent.

INVESTMENT CONCLUSION, RATING, RISKS

TWX has been the most aggressive company at rolling out TV Everywhere. Today, HBO GO is available to 100% of the 97mm pay-TV households. In addition, the balance of TWX's cable networks (TBS, TNT, CNN, Cartoon Network, etc) are available in 80% of homes today, on their way to 100%. Because we believe in the economic upside of TV Everywhere, TWX is the best positioned to benefit because they have been the most aggressive at pursuing this path.

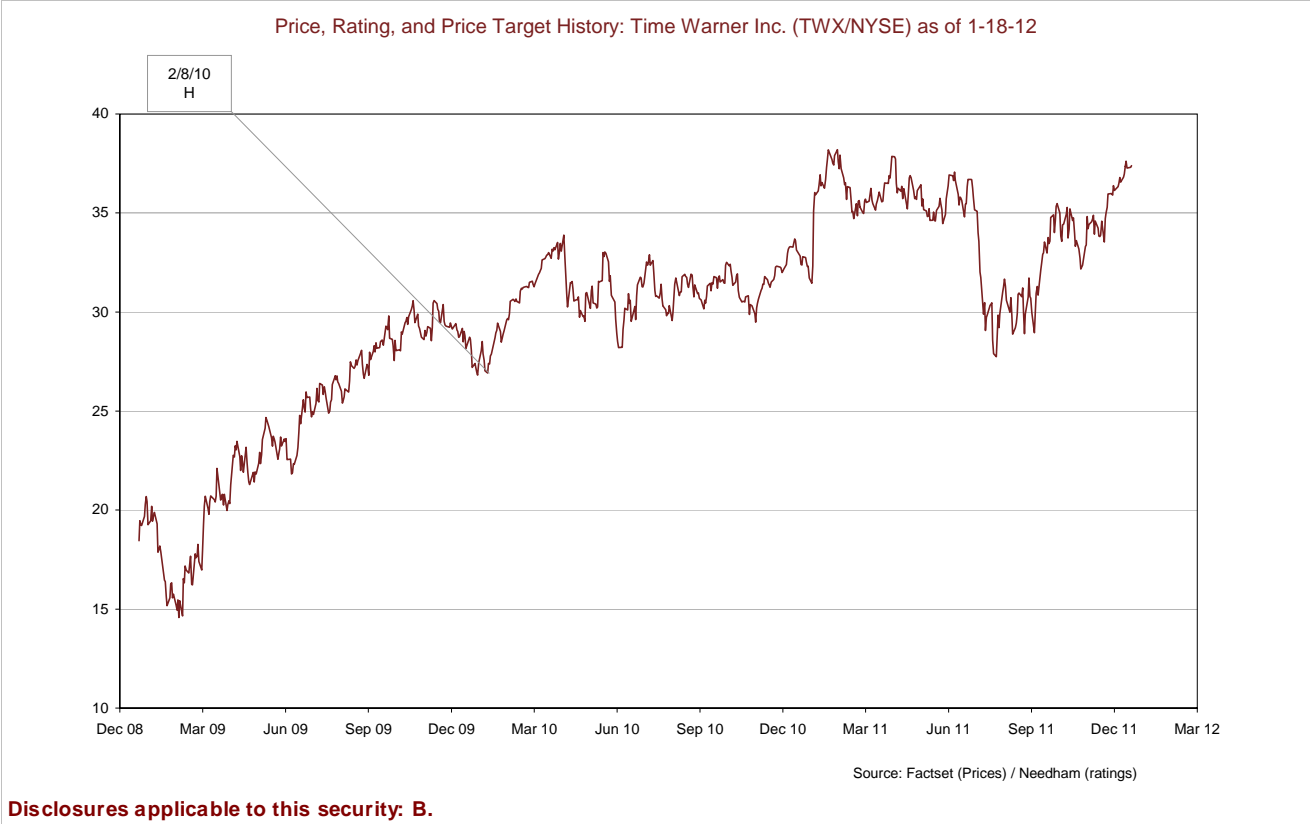
We retain our HOLD rating on TWX owing to near-term ROIC trends. We have no target price. Investment risks include a slowing economy, advertising weakness and ratings momentum at the Turner networks.

Table 1				
TWX: Segment Annual Financial Information, 2010A-2012E				
\$ and shares in millions, except per share data				
Annual ¹				
FYE 12/31:	2010A	2011E	2012E	2012/2011
Revenue				
Filmed Entertainment	\$11,622	\$12,548	\$12,511	-0.3%
Networks	\$12,480	\$13,690	\$14,538	6.2%
Publishing	\$3,675	\$3,689	\$3,578	-3.0%
Intersegment Eliminations	(\$889)	(\$985)	(\$980)	-0.5%
Total Revenue	\$26,888	\$28,942	\$29,646	2.4%
Operating Income				
Filmed Entertainment	\$1,105	\$1,309	\$1,201	-8.3%
Networks	\$4,165	\$4,382	\$4,798	9.5%
Publishing	<u>\$526</u>	<u>\$546</u>	<u>\$587</u>	7.4%
Subtotal Segment Op Income	\$5,796	\$6,237	\$6,586	5.6%
Corp & Intersegment	(\$404)	(\$424)	(\$420)	-0.9%
Operating Income (after corp)	\$5,392	\$5,813	\$6,166	6.1%
Depreciation & Amortization	(\$938)	(\$938)	(\$950)	1.3%
Goodwill Impairment	\$0	\$0	\$0	
EBITDA calc	\$6,330	\$6,751	\$7,116	5.4%
Net Interest Expense	(\$1,178)	(\$1,212)	(\$1,256)	3.6%
Minority Interest (Expense)	(\$330)	\$0	\$0	
Other Income (expense), net	<u>\$0</u>	<u>(\$49)</u>	<u>\$0</u>	
Income Before Tax	\$3,919	\$4,534	\$4,910	8.3%
Income Taxes (proj at 37%)	(\$1,348)	(\$1,537)	(\$1,757)	14.3%
Discontinued Ops & Accting	\$186	\$22	\$0	
Net Income-Reported	\$2,571	\$3,023	\$3,154	4.3%
Net Income Bef. Disc Ops/Acct	\$2,578	\$3,020	\$3,154	4.4%
EPS-Reported	\$2.24	\$2.81	\$3.15	12.0%
EPS-Operations	\$2.42	\$2.83	\$3.15	11.3%
Avg Diluted Shares Out	1,145	1,068	1,003	-6.1%
(1) Adjusted to reflect the exclusion of TWC and AOL.				
Sources: Company Reports, Needham & Company estimates.				

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Price, Rating, and Price Target History: Time Warner Cable Inc. (TWC/NYSE) as of 1-18-12



Source: Factset (Prices) / Needham (ratings and target price)

Disclosures applicable to this security: B.

Price, Rating, and Price Target History: Disney (Walt) Co. (DIS/NYSE) as of 1-18-12



Source: Factset (Prices) / Needham (ratings)

Disclosures applicable to this security: B.

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Buy	61	16
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Under Perform	1	0
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Restricted	1	50
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