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Entertainment/Cable/Media
Hulu: Killer App or TV Killer?

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Laura Martin, CFA
917-373-3066
laura.martin@media-metrics.com

Sales and Research
1-800-447-4318

Trading
1-800-569-2407
www.soleilgroup.com

Sector Coverage

Ticker	Price	Rating
CBS	$13.24	Buy
LAMR	$29.53	Buy
MCCC	$5.13	Buy
NWS	$14.71	Buy
TWC	$42.45	Buy
TWX	$31.25	Buy
WMG	$6.27	Buy
CMCSA	$15.11	Hold
DIS	$29.23	Hold
VIA/B	$28.51	Hold
CCO	$8.29	Sell

Action

The worst advertising recession in 30 years appears behind us and the height of the "V" at the top of this recovery will depend on the economic risks of TV & film content moving to the web for many media companies, in our view.

The stakes are enormous. In the US, TV advertising revenue is $65 billion/year plus video subscription revenue of $120 billion/year. The mkt cap of the value chain at risk is $330B.

This report analyses Hulu as a strategic response. We estimate that:

- Direct costs of Hulu are $75mm in 2009E. At an average 8x multiple of its owners, this represents value transfer of about $600mm to Hulu from owners GE, NWS and DIS.
- The indirect costs of Hulu that are quantifiable are potentially as much as $168B.
- The hidden costs of Hulu that are non-quantifiable may be the largest of all.

Bottom Line. We believe that the Internet distribution platform should be viewed as part of the entire distribution ecosystem of a piece of content. That is, no one distribution platform should have much more price/value to the consumer. Content creators should have an NPV for each consumer and pricing on each platform should be additive, not NPV negative. The price should be raised so that customers can chose among a price/value continuum involving when and where and for how much content is viewed. *No one distribution platform should trump all others or it destroys the monetary value of the others*. The content owners should protect their primary monetization engine (the TV) most harshly because it aggregates audiences and pays for the hit programming that can then be monetized on all other platforms. *Today, Hulu has too much value vis-à-vis other distribution platforms which could destroy other distribution windows' economics.*

Important disclosure information is contained on page 14 of this report. The recipient of this report is directed to read these disclosures.

Hulu: Killer App or TV Killer?
Hulu.com (Hulu) has become shorthand for: "What's the future of video in the digital world?" The answer appears to depend on whether your perspective is consumer demand or economics. Consumers love it: They just aren't paying for it.

Value Added or Destructive?
Wall Street's incessant refrain is: "Show me the money!" The best valuation question is: How much of Hulu.com's viewing is additive vs substitutive? If Hulu viewers are additive to the TV network schedule, this suggests incremental revenue and potential long-term profit upside. Any substitutive viewing is value destructive instantly.

Substitution of TV for PC destroys $920 per thousand viewers, implying Hulu is on track to destroy $425mm of value in 2009

Back-of-the Envelope Answer. At the simplest level, we estimate that Hulu airs 4 advertisements per hour of programming at a $50 CPM compared with 32 30-second spots in an hour of that same programming on TV at a $35 CPM. This huge ad-load difference suggests value destruction of $920 per thousand viewers that view network programming on Hulu rather than the TV. These economics suggest that ***Hulu's owners must be at least 5x as confident*** *($200 of revenue on the PC vs $1,120 revenue on the TV)* ***that viewing is not substitutive to be comfortable that value is not being destroyed*** by putting their product on Hulu.

Worst case, if 100% of Hulu's 38mm viewers in August were substitutive (not additive), then Hulu destroyed about $35mm of value in August (38.5mm unique viewers divided by 1,000 times $920), equating to $425mm/year.

Hidden costs of Hulu are higher than its direct costs

In fact, the economic trade-offs of moving content from the TV to Hulu are worse than this for Hulu's network owners (Fox, ABC, NBC) because sell-outs are lower on Hulu than the TV, and Hulu has its own cost structure which is losing money and requires continual investment to fund. In fact, ***we calculate that Hulu's hidden costs are greater than its direct costs*** (see Table 4), although both are meaningful today.

More Details about Hulu's Revenue
Hulu's revenue numbers are pretty easy, although approximate because Hulu is a private company and won't confirm its precise economics. Hulu is free to users today and therefore generates no subscription or pay-per-play revenue.

Hulu's Advertising Revenue

- **Commercial Load**: Instead of the eight minutes (which equates to sixteen 30-second ads) commercial loads in the same half-hour of programming on the TV, Hulu inserts only two ad slots typically at the beginning and end of a 22-minute program. A Hulu program typically carries ads from just one sponsor (sometimes the identical ad).
- **Viewers.** ComScore's September 2009 report stated that in August 2009, Hulu ranked as the 6th highest visited online video site, with 38.5mm unique viewers and ranked as the fifth highest online video site ranked by videos, with 488 mm videos viewed, making up 1.9% of all videos viewed online in August. The average Hulu viewer watched 12.7 videos in August, totaling 1

hour and 17 minutes of videos per viewer compared with the average duration for online video across the web of 3.7 minutes.

- **Sell-Out Ratio**. By looking at the site, we estimate that about 30% of Hulu's ad inventory is sold to paying advertisers, with the rest going to public service announcements or empty. In addition, many viewers may not watch the second commercial. We note that only 40% of video Web users watch any video stream to the end.
- **CPM.** We believe that Hulu gets a significant premium to a TV network CPM at $50 CPM (meaning Hulu gets $50 for every 1,000 viewers) vs a network CPM of about $35. In May of 2009, Hulu's CEO stated that Hulu had sold ads to 200 different advertisers. *As an aside, at a 30% sell out ratio, Hulu's $50/CPM isn't a clearing price – ie, not comparable to TV. If Hulu had to sell out 90% of its ad inventory (like TV does), Hulu's price might have to be a $10/CPM.*

Hulu's Revenue Calculation. We estimate that Hulu will generate only advertising revenue and only in the US in 2009. Table 1 includes our estimates of Hulu's 2009E revenue.

Hulu's revenue is rapidly approaching YouTube's

Table 1
Hulu Revenue Calculation, 2009E

Advertising Revenue:	
August Monthly Unique Visitors-mm (comscore)	38.5
x Monthly Videos per Unique	12
x Months in 2009	12
Total Est Hulu Videos Seen in 2009E (mm)	5,544
x 2 ads/video	2
Total Commercials Available in 2009E	11,088
x Sell-out ratio	30%
Total Commercials Sold in 2009E	3,326
divided by one thousand to get to CPM	1000
x cost per thousand paid by advertisers	$50
Hulu Advtg Revenue ($mm)- 2009E	**$166**
Subscription Revenue	$0
Pay-Per-Play Revenue	$0
Hulu Total Revenue ($mm)- 2009E	**$166**

Sources: comScore, Media Metrics estimates.

Hulu's Cost Structure

Content Costs. Hulu's cost of goods sold (its payments to content) are accounted for as a contra-account to revenue because its deals are structured as revenue sharing arrangements (we believe) with its biggest program suppliers and owners Fox, NBC and ABC. We estimate that Hulu pays out 75% of revenue to its content providers, and keeps 25% for itself. *Note: The 25% kept by Hulu is revenue that the networks would have kept on their own individual online sites if they didn't have to fund the Hulu cost structure.*

Other Costs. Hulu incurs other costs including bandwidth, marketing, SG&A, R&D, and overhead costs. Bandwidth costs are variable and escalate rapidly as consumer demand for online videos grow. Marketing and overhead costs are more controllable by management. Hulu's TV commercials starring celebrities, such as Alec Baldwin, are a puzzle because they spend dollars to move viewers from the TV to the PC (which is value destructive), and they add to the losses of Hulu by spending money on TV advertising.

We estimate that Hulu's other costs run about 45% of gross revenue based on our 2009E estimates for Google (GOOG, Hold) and Yahoo (YHOO, Buy) for these expenses as a percent of gross revenue. We may be understating these costs because Hulu doesn't yet have the scale of YHOO and GOOG. Table 2 includes our estimates of Hulu's 2009E costs.

Table 2
Hulu Costs, 2009E

	$mm	% of Hulu 2009E Gross Rev	YHOO* 2009E	GOOG* 2009E
Other Costs				
Research & Devt	$20	12%	19%	12%
Sales & Mkting	$23	14%	20%	9%
Genr'l & Admin	$15	9%	9%	8%
Other	$17	10%	1%	13%
Total Other Costs	**$75**	**45%**	**49%**	**42%**
Content Costs	$125	75%		
Total Costs	**$200**			

* Our estimates of YHOO & GOOG's expense items/gross revenue in 2009E.
Source: Media Metrics estimates.

Hulu's direct costs exceed its revenue, despite the fact that its cost of goods are subsidized by its owners.

The Direct Costs of Hulu. We believe Hulu will lose money in 2009E, requiring its owners (Fox, NBC, ABC) to put up $33mm to subsidize Hulu's losses. Table 3 calculates our P&L estimates for Hulu in 2009E.

Table 3
Hulu Income Statement, 2009E
(dollars in millions)

Hulu Total Revenue ($mm)- 2009E	$166
Total Costs	$200
Hulu Gross Profit, 2009E	**($33)**

Source: Media Metrics estimates.

Hulu's Potential Hidden Costs are Higher than its Direct Costs
In addition to its direct costs, Hulu has other potential hidden costs – both quantifiable and qualitative.

Hulu's potential hidden costs are about $168 Billion, by our estimate

Table 4
Hulu's Potential Hidden Costs - Quantifiable

	$mm	Basis of Calculation
1 Content Costs 2009E	$42	2009E Hulu revenue x 25%
2 Substitutive Viewing	$425	Annual Hulu viewers x $920/thousand
3 Network Brand Value Destruction	$3,000	CBS's brand value today
4 Unbundling Risks	$165,000	50% of Market Cap of TV-Related Companies at 10/20/09*
	$168,467	

* We note that >80% of the market cap of newspaper and music industry value chains have been destroyed in the transition to digital platforms.
Sources: Media Metrics research & estimates.

1. **Content Costs.** If we're right about total Hulu revenue in 2009E of $166mm, then one of the direct costs of Hulu is that the 25% of the revenue that Hulu kept that the content companies would have gotten from their own websites. In 2009 this aggregates about $40mm, by our estimates.
2. **Substitution Costs.** We mentioned that each thousand viewers that substitute the PC for the TV costs Hulu's owners $920. If *all* viewing (unlikely) is substitutive, this implies that Hulu is on track to destroy $425mm of value (at current user rates) over the next 12 months.
3. **Brand Value.** What happens to the Fox (or NBC or ABC) brand when its best content becomes available on another platform? The shows on Hulu *are* the brands. The Fox, NBC and ABC logos do not appear on the front page of Hulu.com and even when you hold the curser on page 1 over a show to get more information, nowhere does it mention the network where the show airs. Using CBS as a guide (because it's the only *public* broadcaster), CBS's intangible "brand value" today is about 20% of its total enterprise value ($15.9B EV- $12.8B book value), **implying that about $3B of brand value is at risk** for each of Fox, ABC and NBC brands as the best shows become available on Hulu.

Hulu's potential hidden costs are much higher than its direct costs

4. **Unbundling:** In pay-TV bundles, consumers pay for >300 channels and they, on average, watch about 8-12 channels. Hulu unbundles programming and lets consumers watch only the shows they want to. As proven by iTunes and the music industry, when the consumer is allowed to buy only the content they want, they are willing to pay a slight premium for it, but they buy only 10-20% of the total prior content in the bundle, which destroys aggregate revenue. ***The Economic Risk of Unbundling:*** There is a $120 billion/year subscription model that pays programmers for their programming in the US. Cable network programmers typically generate about 50% of their total revenue and broadcast stations get retransmission consent payments from satellite, cable or telcos (pay-TV companies) payments every month. If the same content becomes available over the Internet for free, there is no reason to expect consumers (or pay-TV companies) to continue to pay for it. ***About 45% of total viewing is of the 4 broadcast networks,*** of which 3 have posted their content for free on Hulu. The more content that appears on Hulu, the more likely it becomes that a consumer stops paying his/her average $60/month pay-TV fee. Four broadcasters plus about 10 important cable channels would probably topple the

current $330B TV value chain. Three of the Broadcasters are currently on Hulu. *Much of the TV value chain's $330B market capitalization could be at risk if viewership moves from the TV to a Hulu's free model on the Internet.* (Please see Appendix A.) We note that more than 80% of the market capitalization of the newspaper and music industry value chains has been destroyed as those industries have transitioned to digital platforms. Finally, we believe that the more aggressively the content creators try to disintermediate the pay-TV companies, the more aggressively the pay-TV companies will increase modem speeds (moving their profit margins from TV to PC), encouraging viewers to steal TV content on the PC. Bottom line: The TV ecosystem's economics rise and fall together. United they stand- divided they fall.

Non-Quantifiable Potential Hidden Costs

There are important potential costs of Hulu that are not easily quantifiable

1. **Retraining the Consumer.** The consumer is being retrained by Hulu to view the TV as a lower price/value equation vs the web (even though the TV drives 5x the revenue for content creators). Also, watching the same broadcast TV series on the PC on demand is a more convenient way for consumers to view it vs watching it on a specific day each week on the TV - this convenience should be paid for. Finally, the PC is easier to navigate than the TV - another valuable service consumers should pay for.

2. **ROIC Risk Rises.** Content creation is hit driven and therefore risky. TV programmers have historically created a mechanism for advance payments before they create new programming so they can afford to produce ten shows in order to create the one hit. For the broadcast networks, $8-10B of revenue is committed by the largest advertisers in the upfront market in June of the prior year. For cable network programmers, affiliate fees paid by MSOs typically represent 40-60% of total revenue and guarantee funding over 5 year contract terms. ***When content is moved to the Internet, risk moves to the content company because the consumer only watches the hit programs AFTER they are produced, and doesn't fund any non-hits.***

3. **A-Product Drives Economics.** *Only a mass platform can create a hit that is monetizable across other platforms*, including the Internet. Owing to the highly fragmented audiences on the web, the Internet will probably not be a place to create monetizable hits that move to other platforms for ancillary revenue over the next decade.

4. **The Device Determines Consumer Behavior.** We belive that the PC platform is structurally inferior to the TV platform from a monetization point of view. We believe that the advertising potential for an hour of programming on the PC will be structurally lower than the TV forever because not only is there a culture of free on the web, but also because the PC has hundreds of choices that are just a click of the mouse away when a commercial appears. We believe that, long term, Internet audiences will never put up with as many commercials as there are on TV. Worse yet, we expect the TV and PC devices to converge over the next two years which will hasten the adoption of the PC as a substitute viewing devise for premium content, risking value destruction faster if better monetization models don't appear.

5. **Measurement Costs.** We estimate that each of the ***broadcast networks spends $2-3B/year to create high-quality programming for their networks***. AC Nielsen only measures TV viewing. Nielsen doesn't measure other screens so as content companies make their content available to consumers *off* the TV platform (ie, Hulu or wireless platforms), they lose ratings and undermine the advertiser's perception of TV reach and frequency (value). Video-on-demand, online and wireless *do NOT* get measured in live + 3 days ratings (C+3), whereas DVR usage does get measured by Nielsen.

Economic Questions Raised by Hulu:

Interesting and important economic questions are raised by Hulu's existence

1. **Substitutability.** The only programming quality that can cannibalize "The Office" is "the Office". *Why are the content creators charging consumers nothing for the only true substitute for their own product?* The newspapers were forced to move online because craigslist, monster.com, and other online classified listings are near-perfect substitutes to a classified newspaper listings. However, when ABC, NBC and Fox move their network programming from under the price umbrella of the TV onto the PC, there is NO perfect substitute threatening their value if they don't. User-generated content is NOT a close substitute to content that costs billions of dollars a year to make.
2. **Margins.** The Internet is a zero margin platform, replacing a 30-40% (bdcast affiliate and cable margins) platform. This margin pressure should disrupt content budgets long-term, so why speed this process?
3. **Time Savings.** There are virtually NO advertising interruptions on Hulu so the viewer saves 16 minutes/hour of viewing time. Why aren't content companies charging the consumer for that time savings (and offset part of the lost ad revenue from that 16 minutes)?
4. **Piracy Cost.** Is Hulu's balance between piracy and economics the right one? Giving away its premium content free to consumers guarantees low piracy, but if demand is inelastic (and we believe it is) a better strategy would be for Hulu to charge *all* consumers more and put up with some level of niche piracy.
5. **Why Risk $330B?** Why is professional content moving away from the protection of the TV platform's price umbrella onto the Internet platform where there is a culture of free? Game theory helps us frame an answer. In the classic prisoner's dilemma (analogous here), if all stand mute, all go free. If any one player rats out the others, the confessor goes free and all others go to jail. If more than one confesses, they all go to jail. Additional players make it more likely that players perceive that at least one will confess and this drives them to confess lest one goes free unfairly. In this case, if any one content channel puts their content on the PC and no one else does, it doesn't undermine the price/value relationship of the $60 bundle on the TV *and* the free channel garners extra advertising revenue on a new platform (the PC) because all other content on the PC is user-generated and therefore not a perfect substitute. However, this annoys the more-disciplined TV competitors, and they are incented to join on the "free" side of the wall and garner the extra ad revenue and viewers. Eventually, there is a tipping point where enough value is free on the web that consumers stop paying the $60/month price for channels on the TV. *Four broadcasters plus about 10 important cable channels would probably topple the current $330B TV value chain.* 3 of the Broadcasters are on Hulu.

Game theory is one way to explain Hulu's existence

Moving Content to the Web without Destroying Value:
Because the answers are unclear and the stakes enormous, experimentation is being done across the web. TV advertising is a $65 billion/year business in the U.S. plus video subscriptions represent another $120 billion/year.

How we think about Hulu

Our answer is that the Internet distribution platform should be viewed as part of the *entire distribution ecosystem* of a piece of content. That is, *no one distribution platform should have much more price/value to the consumer.* Content companies should have an NPV for each viewer and pricing on each platform should be additive, not NPV negative. The price should be raised so that customers can chose among a price/value continuum involving when and how and for how much content is viewed. *No one distribution platform should trump all others or it destroys the monetary value of the others.* The content owners should protect their primary monetization engine (the TV) most harshly because it aggregates audiences and pays for their hit programming that can then be monetized on all other platforms. *Today, Hulu has too much value (because it's free) vis-à-vis other distribution platforms that consumers pay for - we see this as a recipe to destroy the other distribution windows/platforms economics.*

There are several solutions being tried in the marketplace that appear to have lower economic risks than Hulu:

Are there ways to move professional video content to the web that have lower hidden costs than Hulu?

1. **TV Everywhere.** "TV Everywhere" as named by Time Warner Inc- (TWX, Buy) is an authentication system whereby premium shows (TV, movies, etc.) are available online so long as the viewer can prove ("authenticate") that he/she is a pay-TV subscriber. That is, the password is free to consumers so long as they pay a monthly multichannel video subscription to any satellite, telco or cable company. Additionally, consumers could pay the content provider directly (ie, a Hulu subscription payment). If it works, this solution is great because: 1) it does NOT undermine the consumer's perception of the value of professional content; 2) it protects the price umbrella of content creators; and 3) it adds convenience to consumers for no *additional* fee.
2. **TV.com.** CBS puts its CBS TV video stream over its own portal TV.com. CBS's goal is to be revenue indifferent regardless of which platform it airs on (TV or web) because CBS wants to aggregate all its viewers and sell them to advertisers at the same network CPM of $35 regardless of where it was watched.
3. **Windowing.** Windowing has been used extensively in the film industry to maximize revenue. TV has a syndication window as well. The highest paying window typically gets an exclusive period of 30-180 days. Later windows pay less for the content because it's no longer new. The Internet is the lowest paying window, and therefore in theory would air programs after they had been aired on broadcast TV, the syndication window, etc. The Internet is a great idea for all catalog product as that is 100% incremental revenue.
4. **iTunes.** Apple is selling movies and TV programs for a fee in the iTunes store, just as it has done with music.

Killer App? The Advantages of Hulu

To Consumers:

Hulu's killer application appeal to consumers

- **Free,** legal, differentiated, high quality product, available on demand. Hulu is the only site that had legal access to the aggregated professional content of NBC, Fox, ABC and many others. Each of these broadcast networks also airs its programming on its own separate website.
- **User experience** at Hulu is simple and easy to use with a great search engine.
- **Clutter.** Hulu solves the problem of clutter on the Internet. Consumers will come to view the Hulu brand as THE online site for high-quality video on the Internet.
- **Gold.** Hulu "has set the gold standard," according to Will Richmond, president of Broadband Directions. "It has optimized… quality of video, navigation, controls."
- **Easy.** There is no additional player to download: A Hulu video plays instantly in a web browser.

To Advertisers:

Hulu's killer application appeal to advertisers

- **Engagement.** 1 hour 17 minutes spent at Hulu/month/viewer vs an average online video viewing period of 3.7 minutes.
- **Ad revenue per video** viewing stream is extraordinarily high at Hulu. This is largely owing to the excellent demographic audience (young and interactive), precise targeting, and measurability. Despite being a late entrant with a fraction of the unique visitors of GOOG/YouTube, Hulu's advertising revenue is approaching YouTube's by our estimate.
- **Recall.** Hulu carries ads from just one sponsor per program. According to CEO Jason Kilar in May 2009: "At Hulu, we're generating unusually high recall rates for advertisers' brands and unusually high recall rates for advertisers' messages. And we get paid by advertisers appropriately for that unusually high performance."

To Content Owners:

Hulu's killer application appeal to its content owners

- **Monetize.** Market-leading advertising revenue (per user per minute of content consumed).
- **Network Promotion.** Before each program airs, there is an ad for the TV Network it appears on and the time and date that the show on TV each week. This may drive viewers to the high revenue platform of the TV. Also, each video feed is watermarked with the name of the TV Network where it can be found.
- **Broaden Audience.** There may be incremental revenue from the ads related to the programs aired on Hulu that normally viewers would not have watched on TV.

- **Archives.** Hulu can deliver decades of archived TV media that has no revenue stream today, thereby adding to library value.
- **Demand.** Hulu's on-demand convenience should raise the overall consumption of content.
- **Broaden Audience.** Hulu helps TV shows connect to a broader audience including TV households that don't have a VCR (or forgot to set it), or casual viewers that want to try a new show now rather than wait for next Tuesday. Also, sampling is easier on Hulu. Hulu combats the trend toward audience fragmentation on the TV.
- **Piracy.** Hulu fights piracy by making the premium TV content available free to consumers.
- **Discovery.** Explore, build, partner with new companies providing services in the digital world. Explore and experiment. Trying to figure out how to do this. General managers of channels are in synch with consumers. Want to be wherever the consumer is.
- **Innovation.** Online is a great platform. It's interactive and engaging. There are cool things you can do with the PC platform because it is two-way. You can have a direct relationship with the consumer, not filtered through a distributor. The TV platform is not as good.

Hulu's killer application appeal to content owners

- **Disintermediate** the distribution piece of the value chain to garner part or all of those profits.
- **Equity Upside.** As it creates a brand as an aggregator of high-quality video content, Hulu can add other non-affiliated high-quality content that advertisers would find equally compelling and share this growing revenue.
- **Control Disruption.** Hulu is owned by the content companies, not a Silicon Valley company. This gives its owners control over the pace and pricing of change, and minimizes the chance for rapid economic disruption.

Background & Overview

What is Hulu? Who owns it? Who watches it?

What is Hulu? www.Hulu.com is a website that transmits only commercial-grade TV shows and movies over the PC. Hulu offers Fox, NBC, and ABC programming on-demand such as The Simpsons, House, Lost and The Office over the Internet. In addition, Hulu streams other TV shows and movies from more than 120 sources, including the Food Network and Paramount Pictures. Hulu's stated goal is "to help people find and enjoy the world's premium content when, where, and how they want it."

Ownership and Cost Structure. Hulu management has done an excellent job of designing the site for users and Hulu has minimal fixed costs owing to revenue sharing. Big, deep pocketed strategic content owners suggest downside protection. We believe that Fox (NWS, Buy), NBC (GE, NR), and ABC (DIS, Hold) each own 30% and have 3 board seats and that Hulu management and Providence Equity hold the balance of the equity. We believe that the content owners' deal with Hulu is exclusive. They can only put their content on their own sites and on Hulu. No where else. Each content owner decides how many episodes and seasons to put onto Hulu and they can revise this at any time.

Viewership growth has been enormous. Launched in March 2008, by August 2009 Hulu delivered 488mm online streamed videos to 38.5mm unique visitors, implying

that the average viewer watched 12 videos, according to comScore. Hulu competes in the rapidly growing space of online video, which is growing double digits, as illustrated in Table 5.
Table 5

Online video usage is one of the fastest growing areas on the web

Overall Online Video Usage (U.S.)

	Sep-09	Year-Over-Year	Month-Over-Month
Unique Viewers (000)	139,334	12.3%	0.1%
Total Streams (000)	11,021,873	24.8%	-3.0%
Streams per Viewer	79.1	11.1%	-3.2%
Time per Viewer (min)	195.2	24.8%	-4.7%

Source: Nielsen VideoCensus
Note: Includes progressive downloads and excludes video advertising

In August 2009, according to comScore, 82% of the total US internet audience viewed at least one video online. The average person who watched online videos watched 582 minutes (9.7 hours) of online video in the month of August. YouTube dominated the online video space with 121mm viewers watching 10 billion videos, representing nearly 83 videos per viewer in August. The duration of the average online video viewing time was 3.7 minutes. These averages contrast sharply with the average Hulu viewer who watched 12.7 videos in August, totaling 1 hour and 17 minutes of videos per viewer.

<u>Hulu vs YouTube: Who Wins?</u>
There are important economic and strategic implications for Hulu and YouTube:

Hulu vs YouTube: Who Wins?

- **<u>Content</u>.** YouTube airs primarily short, user-generated, video clips (therefore, advertisers are scared to death of this environment), whereas Hulu is 100% professional content.
- **<u>Size</u>.** comScore's Aug 2009 report stated that 158mm Internet users in the US watched online video during July 2009, the largest audience ever recorded, and that a total of 21.4B videos were viewed in July 2009. Of total online video, 120mm viewers watched 8.9 billion videos on YouTube.com (or 74 videos per viewer). Hulu is about 10% as big as YouTube. In July, 38mm viewers watched 456mm videos on Hulu, or 12 videos per viewer.
- **<u>Engagement.</u>** Average viewer duration on Hulu totaled 1 hour and 17 minutes as compared to the duration of the average online video watched at 3.7 minutes in August.
- **<u>Economics</u>.** We estimate that YouTube will generate $250mm of revenue in 2009, vs Hulu at about $166mm (see Table 1). We estimate that YouTube will lose about $200mm in 2009, owing primarily to much higher streaming and storage costs, and that Hulu will lose $33mm (see Table 3). We believe that YouTube and Hulu will have approximately the same revenue in 2010, at about $300mm.
- **<u>Economic Upside.</u>** Hulu has the right to sell advertising around every video on its site. YouTube only has that right for a small percentage (our estimate is <5%) of its videos because many include copyrighted songs or video "mashed" into the clip, which would subject YouTube to copyright infringement lawsuits if they generated revenue from these.

- **User Experience.** The search experience is simpler and cleaner in Hulu. Also, YouTube videos tend to be small and grainy since they are user generated. Hulu has a much larger screen and airs only high-resolution video content that was previously aired by the broadcast networks and studios. These clips have often cost the creator thousands or millions of dollars writing, filming, and editing.
- **International Exposure.** YouTube generates about 50% of its revenues from offshore, while Hulu has no revenue outside the US market.
- **Ownership.** Google (a distribution pipe) bought YouTube for $1.65 billion in late 2006. Hulu is a JV of the largest content creators.

What to Do with the Big Cap Media Stocks.

Stock Recommendations

Timing matters. We are coming out of the worst ad cycle in 30 years. We expect most media stocks to overdeliver EPS growth in 2010 because they cut costs by 10-20% over the past 12 months. When revenue rebounds with the cycle they typically can not add costs as quickly. Marginal profits on advertising revenue are >80%. Therefore, we like many ad-driven media stocks cyclically for the next 12 months.

We are starting to think about what the next value drivers are for media shares. The height of the "V" at the top of the recovery will in part be predicated upon the future of the TV value chain and whether its risk/reward ratio is being properly valued by the markets today. We suggest a cautious assessment of the risk associated with moving professional TV and film content to the web as developments unfold over the next 12 months.

Appendix A

<u>The Market Capitalization of TV-Related Public Companies</u>

Source: Bloomberg as of October 20, 2009

GRAB Index DES
At 15:30 Op 69.96 Hi 69.96 Lo 69.21
INDEX DESCRIPTION PAGE Page 1/ 3
BUSMEDA – BBG AMER MEDIA INDEX

The Bloomberg Americas Media Index is a capitalization-weighted index of the leading media stocks in the North, South and Central American region. The index was developed with a base value of 100 as of December 31, 1998. The parent index is BWORLDUS.

		Value	% Chg	Net Chg
1)GIP	Prices			
	Year_to_Date	55.23	+26.272	+14.51
2)TRA	52 Weeks Ago	58.19	+19.849	+11.55
3)GPO	52 Week High	70.10		on 10/19/09
	52 Week Low	37.04		on 03/09/09
	Trading Hours	09:30-16:15	Local	
	Fundamental Information			
	Price/Earnings	12.30	Ex-Dvd	-.0061
	Dividend Yield	4.79		on 10/13/09
	Index Information			
	Currency	USD		
	Volume	161,599,280	on 10/19/09	
	* Market Cap	330.4BLN		
	Divisor	4737.64791995		

No Industry Groups
4)MEMB 31 Members ↑10 ↓18 →3
5)MOV Today's Movers by Index Pts

Leading Movers	6)	TIME WARNER	+.133
	7)	VIACOM INC-B	+.053
	8)	GRUPO TELEV-CPO	+.034
	9)	CBS CORP-B	+.023
Lagging Movers	10)	WALT DISNEY CO	-.228
	11)	NEWS CORP-A	-.042
	12)	COMCAST CORP-A	-.021
	13)	NEWS CORP-B	-.020

14)CN News on Today's Movers
No Futures Available
No Options Available

* Index Market Cap Index value calculated by Bloomberg every 5.00 min.
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2009 Bloomberg Finance L.P.
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By: Laura Martin

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Companies Mentioned
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