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In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding	Docket No. 2006-3 CRB DPRA

THE WRITTEN DIRECT STATEMENT, WITNESS STATEMENTS & EXHIBITS OF NATIONAL MUSIC PUBLISHERS' ASSOCIATION, INC., THE SONGWRITERS GUILD OF AMERICA, AND THE NASHVILLE SONGWRITERS ASSOCIATION INTERNATIONAL

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Piracy in the Entertainment Industry

It Is Tough to Compete with Free

- This report takes an in-depth look at piracy in the entertainment industry and its potential impact on the companies in our coverage universe.
- We believe music industry piracy will grow from 35% of demand in 2002 to an estimated 40% in 2005, which would represent close to $20 billion in lost sales in 2005. However, the industry is reacting more aggressively and we expect sales to stabilize.
- The film industry is benefiting from important lessons learned from the music experience but the piracy threat is very much alive and kicking. By more effectively addressing the risks, we think the film industry can limit the worldwide impact to just 9% of total demand, or $5.4 billion in 2005.
- In terms of the impact of film piracy, we believe valuation sensitivity is greatest at Blockbuster and MGM, while total operating income dollar exposure is highest at Disney and Time Warner.
- The video game industry has been least affected by piracy to date, and vigilant efforts by console and software makers should keep the impact to a minimum in developed countries. Less developed countries with rampant piracy remain an untapped revenue source.

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The authors would like to thank Nikki Zadikoff for her significant contribution to this report.

In this report, we provide an in-depth analysis of piracy's impact on the entertainment industry, its origins, and potential developments. Among companies in our coverage universe, we believe Blockbuster and MGM are most vulnerable to piracy, while more diversified names such as Viacom may be less affected.

Piracy still hurts the music industry, but there might be hope. Piracy, long a problem in the music industry, became a much bigger issue with the rise of online file sending/sharing. We estimate piracy will cost the industry $20 billion in lost sales in 2003. However, an effort to punish pirates and offer legitimate alternatives to acquire music online has created some optimism. Lower pricing may also ultimately help. We believe the most likely outcome of delayed attempts by music companies to fight piracy is that legal sales should reach $30 billion in 2005, decreasing at an annual rate of 3.4% from 2002. The impact on the companies in our universe should be minimal—Time Warner, the only company with music assets, has an increasingly smaller exposure to the industry (about 4% of estimated 2004 OIBDA).

Piracy is a rising but controllable threat to the film industry. Although the film industry has learned key lessons from the problems suffered by the music labels, we estimate piracy will steal 9% of total demand, or $5.4 billion from the global film industry in 2005. Among the main reasons for the increased threat of piracy are innovations such as file compression and the growing penetration of high-speed Internet connections. The main challenges for the studios are: 1) pre-empting the proliferation of online movie sharing by offering smartly priced physical or electronic alternatives, and 2) employing education and public policy to change consumer behavior. We believe MGM and Blockbuster have the highest relative exposure to piracy, although on an absolute-dollar basis, Time Warner and Walt Disney bear the greatest risk.

DVD sales, a key growth driver, are most vulnerable to piracy. We do not believe box office revenues are at high risk given the overall appeal of going to the movies. However, the faster-growing DVD market should be most affected. In our base case, illegal sales and downloads of home videos are expected to grow to roughly 14% of home video demand in 2005 from 7% in 2002. As a result, on November 21, we reduced our target price on Blockbuster to $20 from $22, capturing a higher sensitivity to piracy risk to the company's future earnings potential. Given the industry's aggressive approach to piracy, we feel there is upside to this scenario. In this case, the pirated portion of demand would be about 1% by 2005, or about $400 million in sales.

The video game segment has been the least affected by piracy. We believe video game piracy in developed markets has been small due to current technological constraints. Given the industry's aggressive development of anti-piracy standards and other protection measures, we expect growth to be fairly immune to piracy in the U.S. and Europe. However, in our view, piracy in China and other emerging markets has led console and software developers to largely shun these markets, eliminating potentially large revenue sources.

Report Synopsis

In this report, we examine in detail what we believe is one of the most serious threats to growth in the entertainment industry: piracy. We walk through the negative impact that piracy has had on the industry to date, and then focus on the path we believe the music, film, and video industries are likely to follow and the opportunities afforded by more diligent piracy control. To accomplish this, we break down the report into five main sections: 1) Entertainment at Risk, 2) Piracy Primer, 3) Music...Will It Sing Again? 4) Film...Take Two and Action! and 5) Video Games Should Play On. Following is a synopsis of the key topics these sections discuss, as well as a company-by-company summary of the potential impact of piracy on earnings and valuation.

Entertainment at Risk

Sizing Up the Problem and Putting It in Its Place

The global music and film industries are expected to lose $24 billion in sales to piracy in 2003.

Our report seeks to size up the entertainment industry in dollar terms, giving investors a look at just how much money is at stake, what chunk piracy has already stolen, and how things will most likely look a few years down the road. In 2003, we estimate that, of total global music industry demand of about $52 billion, music studios will recognize only $32 billion (61%) as revenues, with the rest lost to piracy. For film, the impact of piracy has been smaller to date, with 2003 worldwide demand estimated at $56 billion and about 94% ($53 billion) being realized by film studios and legitimate media companies.

Figure 1. Estimated Impact of Piracy on the Film and Music Industry, 2003-05

$ in millions

Film	2003 Legal Sales	2003 Illegal Sales	2003 Total Demand	2005 Legal Sales	2005 Illegal Sales	2005 Total Demand
US	$31,477	$1,851	$33,328	$33,455	$3,290	$36,744
International	21,091	1,672	22,763	23,039	2,057	25,096
Worldwide	$52,568	$3,523	$56,091	$56,494	$5,346	$61,840

Music	2003 Legal Sales	2003 Illegal Sales	2003 Total Demand	2005 Legal Sales	2005 Illegal Sales	2005 Total Demand
US	$11,990	$7,626	$19,616	$11,392	$7,543	$18,935
International	19,562	12,443	32,005	18,586	12,307	30,893
Worldwide	$31,552	$20,070	$51,621	$29,978	$19,850	$49,828

Source: Smith Barney

Piracy may less directly impact the $28 billion video game industry, but revenues have still been "lost."

In contrast to music and film, the video game industry players have tended to avoid countries with significant piracy problems altogether, which has prevented some piracy but at a revenue-based opportunity cost. So, while we estimate that nearly 100% of the $28 billion in 2003 global ($14 billion domestic) video game revenues will be recognized by legitimate content owners, we also believe that potentially sizable demand and revenue opportunity is being lost in countries where console makers and software publishers are not yet earning a dime.

Piracy Primer

When looking at the problem of piracy, tracking the historical factors and events leading up to the current period is instructive. Specifically, we discuss three primary elements that have emerged in the past decade to speed the advance of piracy in the entertainment industry.

1 Digital formats of content (for quick, quality copies).

2 Compression technology (to store and transfer files).

3 Online penetration, particularly broadband (for access and distribution).

A confluence of these factors brought about the popularity of Napster and its successors and sent piracy flying into mainstream use. However, in our opinion, these three factors may have made fewer inroads into recorded music, the biggest victim thus far, if the product, pricing, and distribution models had kept up with changing consumer tastes and behavior.

Piracy moves through four stages: irritation, proliferation, opposition, and adaptation.

To generalize, we have identified four stages through which digital piracy progresses: irritation, proliferation, opposition, and adaptation. We have located each of the entertainment segments along this spectrum: music in adaptation, film in early proliferation (but moving quickly toward opposition), and video games in irritation.

With piracy farthest along in the music industry, a number of observations can be made and lessons learned.

Piracy Will Not Go Away on Its Own

Both types of piracy have recently seen accelerated or explosive growth: age-old physical piracy as well as the newer online kind.

In our view, the impact of piracy is very real and will continue to grow if not addressed. In the case of the music industry, piracy grew from 19% of global industry demand in 1999, when piracy was almost entirely composed of the physical kind, to nearly 35% in 2002, when we believe more than one-third of piracy came from illegal online downloads. Physical piracy itself has not slowed down, either, but in recent years has increased faster than demand growth. We believe this growth is due to the maturity of the CD format, the increased idle capacity at manufacturers coupled with falling prices for pressing commodity discs, and the growth of international piracy, particularly in Asia and Eastern Europe, where it has historically been rampant. As a result, we forecast further increases in music piracy to 40% of demand by 2005.

Aggressive Moves by Industry Coalitions Provide Some Protection...

Legal action by music industry groups has had some fast beneficial effect, and further moves like recently announced CD price cuts might also improve the outlook.

Recently, the Recording Industry Association of America (RIAA) has been aggressive in protecting the rights of music copyright holders by filing lawsuits against individuals and the peer-to-peer networks that enable illegal file sharing. The intended result has been swift, with a significant decline in illegal downloads since the spring of 2003. However, the October 2003 price cut by the leading music company, Universal Music Group, finally acknowledged what the consumer trends have indicated for years — that music should be offered at a reasonable price and that consumers want to buy music a la carte, whenever and wherever they want. We believe it was this refusal to adapt, as well as the reluctance to acknowledge or prevent and punish the growing problem, that led the music industry into dire straits.

It is only by addressing those issues — as the industry is beginning to do, by lowering prices and introducing appealing legal options to buy music online or advances in product (e.g., combined CD/DVD formats) — that the recorded music industry will be able to salvage some of its future, in our view.

The price/value proposition must always be in sync with the changing consumer, a lesson learned by the film industry earlier than the music industry.

...but Adaptation to Changing Demand Is the Key to Fighting Piracy

Until very recently, the music industry did not recognize two fundamental issues: consumer behavior had changed, and the recorded music business had not changed with it. The explosion of online music file sharing in the late 1990s demonstrated that, if given an opportunity, consumers would always choose a low-cost (free is even better) way to acquire music a la carte and get it delivered to their home. The industry is finally starting to address this preference, through legal online alternatives and through cutting prices. We believe the film industry recognized from the beginning the threat of digital piracy and acted accordingly. Film's latest and most successful home entertainment product, the DVD, was introduced at an attractive low price, designed for sell-through, and came with additional features such as director's cut versions or behind-the-scenes footage that consumers have thus far appreciated. Through aggressive digital rights management (i.e., copyright protection) that will be further enhanced in the next cycle of high-definition DVDs, early legal moves, and vigilant policy and education efforts, the film industry may be able to avoid the worst of what happened to its music brethren.

Changing Legitimate Offerings Can Perhaps Better Satisfy Demand

The music and film industries have made a number of changes to their revenue models to try to better service consumer demand. Examples include:

- Using recently revised pricing structures, online music retailers began to sell individual songs, enabling consumer to choose their favorites instead of committing to buying entire albums. iTunes is a particularly noteworthy example, having debuted on April 28, 2003, and sold 14 million tracks as of the third week in October. Apple CEO Steve Jobs has set a goal to sell 100 million songs before iTunes' first birthday (Apple is covered by Smith Barney analyst Richard Gardner.) We believe iTunes' success is likely attributable to its more flexible model (consumer can purchase songs a la carte) and somewhat flexible digital rights (which allow transfer of songs to two computers and recording to CDs up to ten times).
- Universal Music Group cut CD prices by 25%-30% in October 2003, addressing consumers' complaints about the high prices of music products. We estimate that this move should increase legal unit demand by a small amount, but that the per-unit revenue decline may more than offset any potential increase in revenues.
- Movielink was launched in November 2002 by a group of Hollywood studios seeking to introduce consumers to the idea of paying for movie downloads before piracy habits become entrenched. At $2.95–$4.95 per 24-hour rental, the studios take in only a fraction of the revenues they would from selling a movie to Blockbuster or Wal-Mart or through video on demand, but the objective is to help form consumption habits early. Other available legitimate networks include CinemaNow.com and CinemaPop.com.

Natural Evolution of Industry Dynamics May Also Bring Change

One example of how technology developments may actually help to reduce piracy is in the area of online video games, which require user registration. As online games move to subscription models with added benefits (e.g., tournament play, prizes, or awards), there will be increased incentives to pay for legal game units and acquire unique registration rights. This kind of technology advancement may also help filmed entertainment in the future, as high-definition televisions increasingly get networked with home PCs or advanced set-top boxes, and the industry can move toward a model under which only registered users may receive updated and fresh content.

Cost Cutting Is One Key; Consolidation Is Another

The music industry has aggressively cut costs, but can still improve efficiency, in our view, particularly in the back office, where companies' different labels often duplicate functions. Warner Music Group restructured in 2001 and cut approximately $120 million, or more than 3%, from its cost base of $3.6 billion. Mergers are also seen as options to cut costs and improve efficiencies. Earlier this year, Warner Music was locked in exclusive talks with Bertelsmann's BMG to combine their music operations. However, those talks broke down over management control and BMG initiated talks to merge its operations with Sony Music.

Warner Music is now focused on striking a deal with EMI Group, while also entertaining an offer by an investor group led by Edgar Bronfman Jr. EMI has offered about $1 billion in cash and an equity stake of 20%-25% in EMI for Time Warner's recorded-music operations (excluding music publishing). Assigning a value of $600 million to the equity stake and assuming Time Warner (co-covered with Smith Barney analyst Lanny Baker) could raise another $1.2 billion from the sale of the music publishing division values Time Warner's music business at about $2.8 billion. Mr. Bronfman, on the other hand, is preparing to offer $2.5 billion for Time Warner's entire music business. Although this is about 10% lower than EMI's offer, we believe Time Warner would still consider this option, as it would likely have a better chance of being approved by regulators. Any attempt by the top five music companies to merge (including Time Warner/EMI and BMG/Sony) could take at least a year to be approved by regulators, and approvals are not a sure thing. Filmed entertainment studios should also gain some efficiency from scale, which helps in diversifying revenue risks among a portfolio of products.

Government Is a Friend, at Least in the U.S.

Lawsuits filed by the U.S. government have been successful in stopping individual piracy offenders and possibly in deterring others. However, in countries such as China, some other Southeast Asian countries, and parts of Eastern Europe, we believe lax government enforcement of copyright laws threatens to destroy the potential for legitimate operators to make money in that market.

Music...Will It Sing Again?

Music piracy as a percentage of demand should continue to increase, from 35% in 2002 to 40% in 2005, in our view.

We believe that piracy has reached an uneasy equilibrium in terms of potential damage in the music industry but that the industry will continue to post losses to piracy in the coming years. We expect to see piracy account for 40% ($20 billion) of music demand in 2005 versus 35% ($18 billion) in 2002. In total, we forecast annual dollar demand growth to decline by about 1.7% from 2002 to 2005. By our analysis, the declines are representative of three primary trends: 1) a continued, albeit slower, shift from legal to pirated product, 2) a shift from higher-priced physical product to lower-priced downloads, and 3) declining prices for physical product in the form of lower retail prices for CDs. Looking at the range of piracy paths we consider reasonable, we have devised a scenario analysis to gauge the impact on music companies. Generally, we believe the impact should be in direct proportion to market share, and could feasibly range from an estimated 1.4% industry revenue CAGR in 2002-05, in the case of successful anti-piracy efforts, to (11.4)% in the case of a worsening environment; our base-case estimate is (4.3)%.

Film...Take Two and Action!

Global film piracy is more likely to reach just 9% of demand in 2005, by our estimates.

We think that with an earlier, more aggressive stance, film will never see the same magnitude of piracy damage as music. However, we also believe the industry has not yet reached a bottom and film may lose 9% of total demand ($5.4 billion) to piracy worldwide in 2005 versus just less than 5% in 2002[1]. The three kinds of piracy that exist in the film arena are theatrical first-run film copies, commercial disc replication, and illegal online downloads. We believe that each is more of a risk to home video rentals and sales and that the box office (at least in developed economies) will be relatively unharmed (shielding theatrical exhibitors from any major impact). Among the reasons these risks have increased in prominence are developments in technology, including digital copying and file compression, and the growing penetration of higher-bandwidth Internet connections and ease of networking. Efforts to counter the rise in piracy are proliferating just as quickly. Initiatives include building stronger legal protections (through new laws and increased enforcement); developing technologies with better protection, such as high-definition DVDs; and creating new business models and distribution options to provide better content delivery choices and better price/value appeal, such as legal download sites, erasable DVDs, and subscription rental programs, all of which are intended to increase the price/value appeal.

Video Games Should Play On

We believe video game piracy in the U.S. should be manageable.

We think the video game industry's proactive approach and natural advantages — larger file sizes, multiple standards resulting from three main console types, and the illegality of using modification chips to circumvent piracy controls and proprietary game machines — will result in only a minimal impact from piracy on U.S., Western European, and Japanese sales. However, we are not able to gauge the size

[1] Our piracy "market share" estimates are derived from industry estimates of illegal downloads and bootleg copies and our assumption that only 20% of these illegal copies replace potential box office revenues, 50% of the pirated copies replace home video, and 30% would not be a replacement for legitimate demand. Warner Bros. management, at an analyst meeting on November 5, 2003, estimated that piracy accounted for about 8.6% of demand in 2002, above our 4.8% estimate. In considering this discrepancy, we believe piracy, a clandestine activity, is very difficult to measure, and methodologies may differ materially.

of the current market for illegal game products in places like China and Latin America, where piracy is rampant and clearly accounts for the majority of sales. We do not foresee legitimate game publishers being able to recognize material revenues in these regions in the next several years, although the longer-term potential remains significant if it can be captured.

Some Companies Are More at Risk than Others

In reviewing exposure to piracy, we take into account both relative risk (as a percentage of a company's total revenues) or operating income and absolute risk (total dollars at risk).

Large-Capitalization Exposure

Time Warner Faces Sizeable Revenue Risk in Absolute, but Not Relative, Contribution Terms

Based on our sensitivity analyses, we estimate that likely scenarios for piracy would allow for less than $1 per share variance from our $17 target price on Time Warner...

Time Warner is exposed to entertainment piracy risk primarily through Warner Music Group and its Filmed Entertainment division, giving it the highest dollar exposure of all of the companies in our entertainment universe. With less than 10% of total company revenues coming from music (excluding the CD/DVD manufacturing assets being sold), relative risk is low, although revenue risk for the division from film piracy is estimated to be about 6% on the upside or 8% on the downside versus our 2005 revenue estimate, according to our sensitivity analysis. Because recorded music operating income before depreciation and amortization (OIBDA) is less than 5% of total company OIBDA, very little valuation variance results from piracy swaying to either side of the spectrum. On the filmed entertainment side of the business, Warner Bros. and New Line combined are No. 2 in market share at the box office this year. Together, these studios generate the most home video revenues of any company we cover, and it is in home video revenues that we see the most risk from film piracy. However, we believe Time Warner is also intensely aware of piracy. Having spearheaded the effort to launch one of the most successful home entertainment products, the DVD, the company remains committed to combating threats like piracy through aggressive digital rights management, legal action, and policy and education. For example, Time Warner is a big supporter of the high-definition DVD and of developing standards that will provide for better digital rights management. In total, we estimate the valuation impact from music and film piracy on Time Warner, under our best- and worst-case scenarios (discussed in detail later), should be less than $1 per share versus our current target price of $17 per share.

Disney Leads the Box Office Race but Diversification Protects Against Piracy Risks

...about $1 per share variance from our $26 target price on Disney...

Disney has leading market share at the U.S. box office this year and the second-largest contribution from film product in dollar terms. On a relative basis, the company will generate an estimated 28% of revenues and 19% of fiscal 2003 operating income from its film business. We estimate Disney's piracy risk to be more heavily weighted to the upside, as we are predicting healthy 7.1% annual growth from theatrical and home video sales combined from 2002 to 2005, when we estimate revenues will reach $6.3 billion. Using our company-wide target P/E multiple of 29.6x our fiscal 2004 EPS estimate (22.6x our 2005 forecast) for the studio division, we estimate the impact of piracy on our $26 target price to be $0.08–(1.13), or 0.3%–(4.4)%, in our bull- and bear-case scenarios. Disney is also actively

exploring ways to deflect piracy, testing new formats (the disposable EZ-D) and new business models (MovieBeam), and both efforts are being followed with keen interest.

...$1.41–$(0.69) variance from our $34 target price on Fox Entertainment...

...$1.18–$(0.57) variance from our $36.50 target price on News Corp...

Fox Entertainment Group and News Corp. Have Minimal Downside Risk from Film Piracy

Fox Entertainment (co-covered with Smith Barney analyst George Colman) has the second-highest relative film piracy exposure of the studio companies, with an estimated 43% of revenues and 38% of fiscal 2004 OIBDA estimated to come from the film division. In addition, a relatively high exposure to home video (roughly 50% of film revenues) versus box office or other related revenues heightens the company's risk. As a result, we expect that our Fox film division revenue estimate of $4.9 billion in fiscal 2005 could vary by as much as 10% on the upside and 3.6% on the downside, according to what we view as highly probable piracy profiles for the industry. This translates to a variance in valuation from our $34 target of $1.41–$(0.69), or 4.2%–(2.0)%. For News Corp. (co-covered with George Colman), which owns about 80% of Fox, we estimate exposure to the Fox assets could mean variance in valuation from our $36.50 target of $1.18–$(0.57), or 3.2%–(1.6)%.

...and $0.73–$(1.51) variance from our $54 target price on Viacom.

Viacom's Direct Film Exposure Through Paramount Is Low Relative to Total Company Size

We believe Viacom's exposure to film piracy is fairly limited outside of Blockbuster, with Paramount contributing only an estimated 10% and 5% of revenues and OIBDA, respectively, in 2003. With the mixed success of first-run theatrical releases, at least in the past year, Viacom has come to rely more heavily on theatrical and particularly home video releases based on the company's branded properties from its cable networks, such as Rugrats or SpongeBob SquarePants (whose first feature film is scheduled for 2004). In total, we forecast revenues from filmed entertainment of $2.9 billion in 2005, with a possible range of $3.0–$2.7 million, according to our sensitivity analysis. Due to the small relative contribution of Paramount, we believe piracy trends could result in variance to our $54 target price of less than $1 in either direction, or less than 1%. However, including the piracy risks faced by Blockbuster (see below) brings total valuation exposure to an estimated $0.73–$(1.51), or 1.4%–(2.8)%.

Small- and Medium-Capitalization Exposure

The largest percentage exposure to piracy is at Blockbuster, which we believe could see as much as 26% downside risk to valuation in a worst-case scenario.

Blockbuster Faces the Highest Risk from Film Piracy in our Entertainment Universe

Blockbuster faces significant risk from piracy due to its participation in the home video market, with only minor contributions from other revenue sources, such as video games and concessions. As a result, we estimate that a realistic impact from piracy could be revenues in 2005 that are 7.7% higher to 8.7% lower than our base-case forecast of $6.4 billion. This sensitivity analysis implies an OIBDA range of 10% greater than or 16% less than our forecast in 2005, implying valuation exposure of $3.17–$(5.25), or 15.8%–(26.3)% versus our current $20 target price.

We do not expect Electronic Arts to feel an impact from video game piracy in the next several years.

Electronic Arts Gives Up Potentially Big Market Opportunities Due to Piracy Risks

We forecast only a minimal impact on Electronic Arts from piracy in the video game sector. More important to the company are lost revenue opportunities in certain markets such as China, where the high rate of piracy has discouraged console manufacturers from even entering the market for decades, although Nintendo launched a special console in this market in October 2003. Should Nintendo's

efforts prove successful in generating demand for legitimate product, and this and other currently off-limits markets open up to publishers, Electronic Arts could see substantial benefits. With no significant change in U.S., Japanese, or Western European sales growth expected to result from piracy, we are comfortable with our target price of $115 and do not expect piracy to impact this target in the near or medium term.

Lack of material international exposure protects GameStop from piracy.

GameStop Should See No Material Loss from Video Game Piracy

As discussed, we see only a minimal impact on video game sales from piracy in the developed markets in which GameStop operates, so we remain comfortable with our $20 target price.

With the second-highest relative exposure to piracy, we estimate $1.91–$(2.85) variance from our $15 target price on MGM.

MGM Faces the Highest Risk Relative to the Size of the Company

Of the companies in our universe, we found that MGM has the most relative exposure to film piracy, with more than 90% of its revenues coming from filmed entertainment while other segments generate negative income. This is true even though, with the company's small absolute size, it has the lowest film box office and home video revenues of the group. Based on our sensitivity analysis, we think a realistic set of outcomes could show 6.9% upside or 6.2% downside risk to our current film revenues forecast of $1.8 billion in 2005. The corresponding valuation impact is estimated to be $1.91–$(2.85), or 12.7%–(19.0)%, from our current target price of $15 per share.

Box office revenues are expected to grow at a CAGR of 4.2% from 2002 to 2005, with a minimal impact from piracy.

No Piracy Impact Expected for Domestic Theater Exhibitors AMC and Regal Entertainment

Due to our expectation that film piracy will affect home video revenues rather than box office revenues, we believe the impact of piracy on theater exhibitors will be minimal. Our expectation of a 4.2% CAGR for U.S. box office revenues in 2002–05 is unchanged by the conclusions of this report, with growth expected to come from increases in attendance and ticket prices. With average concession revenues increasing at a low single-digit rate, our low single-digit box office admissions growth forecast, and both companies opening new locations at a modest pace, we estimate revenue CAGR of about 4% for AMC Entertainment and more than 5% for Regal Entertainment in 2002–05.

Figure 2. Film Sensitivity to Piracy, 2005E

$ in millions

	Time Warner	Disney	Fox	MGM	Viacom	Blockbuster
BULL CASE						
CAGR (2002 - 2005E)	8.5%	10.1%	9.8%	11.1%	7.5%	7.6%
Film Revenues[1]	12,422	6,423	5,421	1,915	3,061	6,867
% Upside from Base	5.5%	1.7%	10.0%	6.9%	3.7%	7.7%
BASE CASE						
CAGR (2002 - 2005E)	5.5%	7.1%	6.8%	8.1%	4.5%	4.6%
Film Revenues[1]	11,774	6,317	4,929	1,792	2,953	6,378
BEAR CASE						
CAGR (2002 - 2005E)	1.5%	3.1%	2.8%	4.1%	0.5%	(0.9%)
Film Revenues[1]	10,870	5,632	4,752	1,681	2,675	5,825
% Downside from Base	(7.7%)	(10.8%)	(3.6%)	(6.2%)	(9.4%)	(8.7%)

	2005E Total Company OIBDA	OIBDA Piracy Risk		Value at Risk / Share			Potential % Impact on Target Price	
		Upside	Downside	Upside	Downside	Target Price	Upside	Downside
Time Warner	11,438	104	(226)	$0.30	($0.65)	$17.00	1.8%	(3.9%)
Disney	4,833	13	(171)	0.08	(1.13)	$26.00	0.3%	(4.4%)
Fox	2,638	98	(48)	1.41	(0.69)	$34.00	4.2%	(2.0%)
Viacom	7,360	17	(67)	0.13	(0.52)	$54.00	0.2%	(1.0%)
Blockbuster	766	73	(122)	3.17	(5.25)	$20.00	15.8%	(26.3%)
MGM	110	18	(28)	1.91	(2.85)	$15.00	12.7%	(19.0%)

[1] Revenues generated by box office and home video sales.

Source: Company reports and Smith Barney

Entertainment at Risk

- The film, music, and video game industries are estimated to generate approximately $92 billion in worldwide revenues to content owners in 2003, but we believe that number would be almost 30% higher if there were no piracy.
- Piracy has long been a problem for the entertainment industry, but digitization of content has exponentially increased its speed, quality, and reach.
- In our view, the necessary conditions for digital piracy to spread are in place: digital formats of content (for quick, quality copies); compression technology (to store and transfer files); and online penetration, particularly broadband.
- We have identified four stages through which digital piracy progresses: irritation, proliferation, opposition, and adaptation. In our view, music is in the adaptation stage, film in early proliferation but possibly leapfrogging to opposition, and video games still in irritation.
- In 2005, we believe piracy will continue to steal 40% ($20 billion) of music demand; with an earlier, more aggressive and proactive stance, film may lose just 9% of demand ($3 billion) to piracy.

What's at Stake?

Digitization has brought piracy to a new level of risk, increasing speed, quality, and reach.

Revenue losses from piracy are a reality and are threatening more and more of the entertainment industry. It has long been a major problem for the music industry, starting with physical (tapes and disc) piracy and increasingly moving to online distribution. In our view, piracy is now an escalating threat to the film and video game software industries. Combined, these three industries will generate an estimated $92 billion in global revenues in 2003. We estimate that the number would be about one-third higher without piracy. The entertainment industry has been around for many decades, and piracy has been an annoyance for almost as long. We believe this annoyance has now become a serious threat because of digitization, which has completely changed the landscape — increasing the speed, quality, and reach of piracy exponentially. We believe there are a few necessary conditions that must be in place for piracy to become widespread: 1) digital formats of content (for quick, quality copies and play on home computers); 2) compression technology (to store and transfer large music and film files); and 3) online access, particularly broadband penetration. These conditions are all falling into place; coupled with the lure of "free" content, they make piracy a much-feared threat to the commercial models of intellectual/artistic property, by our analysis.

We believe film companies will be less affected than music companies have been.

Piracy is the general term we use for illegal online file downloads and counterfeit and bootleg physical mediums, primarily CDs and DVDs. The worst victim of piracy to date has been the music industry, which has seen its sales volume fall by almost 20% over the past four years as CD penetration matured and online distribution grew widespread. We believe music revenues are near their trough, and the industry is finally taking the right steps to turn the problem around and adapt to a new business model. Film piracy, we believe, will likely get a little worse before it gets better, but the film industry has learned lessons from the music experience. With a more aggressive, proactive stance, we think the movie companies have a better shot of stemming the tide and preventing as much hemorrhaging as music has experienced. The film industry also has an advantage in that digital video replication debuted later than audio, and broadband penetration (which is necessary to share the very large video files) is not yet as widespread as dial-up. With the necessary conditions for film piracy to spread still not universally available (particularly in broadband penetration), film has had more time to ready its anti-piracy plan. Therefore, we think the industry will remain stable. Meanwhile, in the video game industry, software and hardware manufacturers have worked together closely and built in protection that has effectively limited piracy to the technically savvy in the U.S. and to some international emerging markets.

Worldwide Entertainment Market

In 2002 the film and music industries lost an estimated 24% of market demand to piracy.

In 2002, we estimate there was about $84 billion of market demand worldwide (in terms of revenues) for film and music. However, we estimate that the film and music companies only captured about 76% of that demand, with the remainder being lost to piracy. Music felt the bulk of that pain, losing an estimated $18 billion (35%) in revenues. Due primarily to more aggressive legal steps and recent attractive industry-backed alternatives to illegal downloads, we believe the music industry should slow the rate of loss to piracy over the next few years. As broadband penetration increases and file sizes further compress, we expect the film industry's situation to get a little worse in 2003 than it was in 2002, when piracy took an estimated 4.8% ($1.5 billion) of the market demand. However, we do believe film revenues will continue to increase, growing at about 3.4% annually from 2002 to 2005. We are optimistic long term due to earlier and what we believe are more effective anti-piracy efforts, as well as lower broadband penetration than dial-up. Thus, we do not see revenues for filmed entertainment continuously and rapidly deteriorating due to piracy, as they did in the music industry.

Figure 3. Worldwide Demand, Revenues and Piracy Impact Sensitivity Analysis, 2002 and 2005E

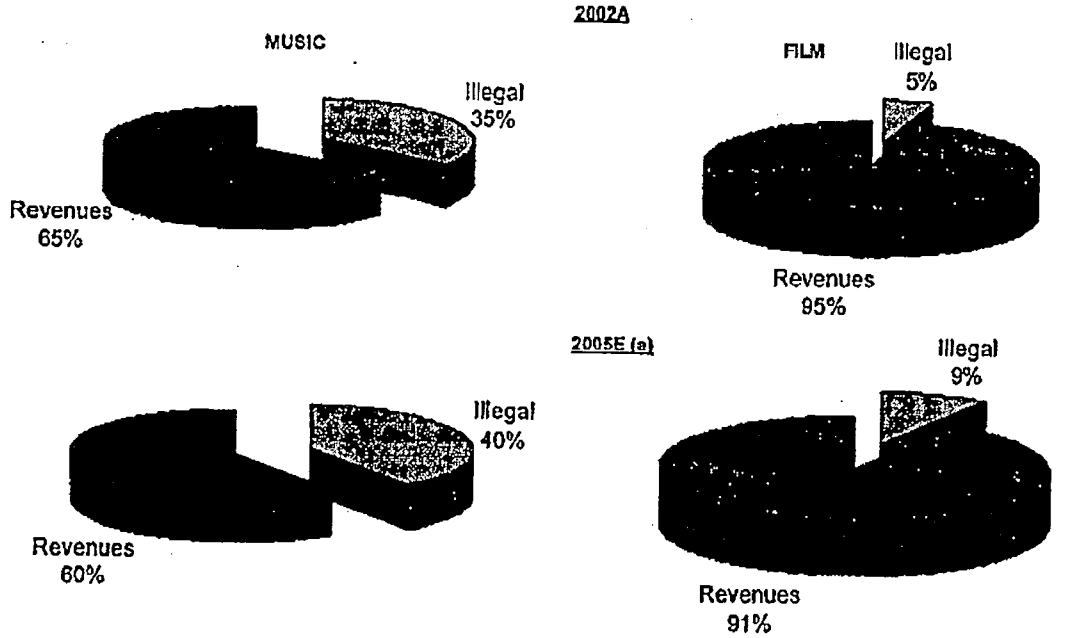
$ in billions

	2002A			2005E - Bear			2005E - Base			2005E - Bull		
	Demand	Revenues	% of Demand Pirated	Demand	Revenues	% of Demand Pirated	Demand	Revenues	% of Demand Pirated	Demand	Revenues	% of Demand Pirated
Music	$ 52,508	$ 34,208	34.8%	$49,828	$ 23,763	52.3%	$49,828	$29,978	39.8%	$49,828	$35,636	28.5%
Film	31,741	30,230	4.8%	36,744	29,322	20.2%	36,744	33,455	9.0%	36,744	36,357	1.1%
Total	$ 84,248	$ 64,438	23.5%	$86,572	$ 53,085	38.7%	$86,572	$ 63,433	26.7%	$86,572	$ 71,993	16.8%
		CAGR 2002-2005		0.9%	-6.3%		0.9%	-0.5%		0.9%	3.8%	

Source: Smith Barney

Figure 4. Revenues and Lost Revenues for Music and Film, 2002 and 2005E

Percent of total demand



(a) Base case as defined in Figure 3.
Source: Smith Barney

We believe MGM has the greatest exposure to entertainment piracy "risk."

Media Companies Face Different Levels of Exposure

Of the entertainment companies we cover, Time Warner has the most film and music exposure from a total dollar perspective (an expected $14.8 billion in revenues in 2003). However, Time Warner is a diversified company, so we do not feel that the "risks" of entertainment piracy would have as great an effect on the overall company as they would for MGM. Fox Entertainment Group has the highest-percentage exposure to filmed entertainment product of the large-cap companies (it could be higher still considering Fox's advertising-related revenues,

which rely on television programming). While Disney's exposure is lower than Time Warner's in absolute dollars and Fox's lower as a percentage of revenues, Disney is more levered to filmed entertainment brands, and many of its assets are interrelated, so we feel piracy could potentially have greater indirect implications, although we only measure the direct impact from piracy. Viacom's film division is relatively small, accounting for only 10% of the company's total revenues. However, including revenues from Blockbuster, Viacom's exposure is the second highest in dollar terms at $8.6 billion, or 33% of revenues. Of all the studio companies, MGM has the greatest percentage of its revenues (87%) coming from film, making it by far the highest-risk player. As expected, MGM, therefore, has the greatest risk to company value due to piracy (with the exception of Blockbuster). (See the section "There Is Light in Sight" later in the report for the assumptions behind the piracy risk on company value.)

Figure 5. Company Exposure to Piracy, 2003E and 2005E

$ in millions

Company & Division	Revenues 2003E	% of Company Exposed
Time Warner	$42,649	
Music	4,217	10%
Film	10,561	25%
Total Music+Film	14,778	35%
The Walt Disney Co.	$27,245	
Film	7,543	28%
Viacom, Inc.	$26,279	
Film	2,651	
Blockbuster	5,926	
Total Film+Blockbuster	8,577	33%
Fox Entertainment Group	$11,002	
Film	4,498	41%
MGM, Inc.	$1,784	
Film	1,550	87%
TOTAL	$108,960	
Music	4,217	4%
Film	26,803	25%
TOTAL Music+Film+Video	31,020	28%

Note: Time Warner music revenues include the CD/DVD manufacturing business, which is roughly a $1.2 billion business that was recently sold, with the deal expected to close by the end of 2003.

Source: Smith Barney

It's a Slippery Slope

Digital piracy seems to move through a progression of distinct stages.

Piracy is not a phenomenon that popped up overnight. The music industry has been the unfortunate trailblazer and also the greatest victim to date. Looking to music's experiences, as well as to the early impact on film and video games, we can see a clear progression of the proliferation of piracy, its effects on company fundamentals, and industry attempts to stave it off. Because piracy becomes so much more threatening with digital replication, we will focus our discussion on digital piracy. In digital piracy we have identified a pattern that we think is useful in considering the future. We have identified four stages through which piracy progresses:

1 Irritation

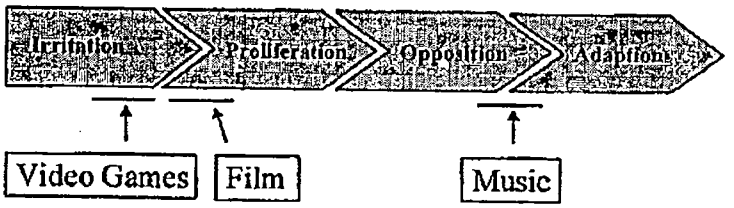
2 Proliferation

3 Opposition

4 Adaptation

In our view, video games are still in the irritation stage, film is in proliferation, and music has moved to late opposition/early adaptation. See Figure 23 and Figure 63 for the specific timelines for the music and film industries, respectively.

Figure 6. The Stages of Piracy



Source: Smith Barney

During irritation, digital piracy is confined mainly to technically savvy individuals.

➤ *Phase 1 — Irritation.* At this stage, piracy is really an underground problem, with small-time bootleggers making copies primarily to sell on the street and individual computer experts sharing files online. Mass consumers are probably not even aware of the availability of the pirated products, and if they are, they do not know where to get them or perhaps how to use them once obtained. Music went through this stage, starting with friends sending each other e-mails with attached files, and slowly moving beyond personal networks to Internet-facilitated sharing. Film seems to just be exiting this stage as broadband Internet access expands, DVD penetration grows, and mass copying becomes more viable. With the anti-piracy devices placed in the hardware required to play video games (e.g., Xbox, Playstation 2), video games are still in Phase 1. A small group of gamers has figured out how to overcome the anti-piracy by altering the chip in the hardware, but it is not yet a widespread problem in developed markets, in our view.

The proliferation stage creates new consumer behavior patterns.

➤ *Phase 2 — Proliferation.* The two primary elements that facilitate the move from Phase 1 to Phase 2 are technology and consumer attitudes. We saw this transition in the music industry when the combination of more-widespread

adoption of broadband Internet access and peer-to-peer file sharing facilitated mass consumer downloading of music, without comprehension that this was illegal and unethical. Also, the cheaper availability of CD burners added fuel to physical piracy. Other elements of this stage have included the beginning of industry recognition of a problem, although this element seems to have moved earlier in film, as that industry is benefiting from the lessons learned by the music industry. As this phase progresses, companies really begin to see the effect on revenues. But perhaps the most troubling characteristic of this phase is the creation of new consumer behavior patterns that are difficult, if not impossible, to reverse. While music has already gone through this phase, which was exacerbated by the proliferation of online downloading, we believe film has yet to truly encounter it, due to the lower penetration of broadband and the greater size of film files (which means longer download times).

Opposition is marked by coordinated efforts to fight piracy through the courts, technology, and education.

➤ *Phase 3 — Opposition.* While proliferation is a consumer issue, opposition comes from industry. Opposition is difficult to distinguish as a unique phase. Opposition to piracy clearly begins as soon as the industry realizes there is a problem, but the key indicator of entry into this phase is a more coordinated and concerted effort to stave off the problem. Opposition, to be effective, is characterized by a three-pronged attack, through legal means, technology counterattacks, and consumer education. Music entered opposition when the industry began filing lawsuits against offenders and working together to find a viable technological solution. Also, the music companies' struggles might aid the other entertainment sectors by setting legal precedents. The film industry seems to be leapfrogging to this stage and is already taking an aggressive stance legally and introducing its digital format, the DVD, with built-in encryption.

The key to survival for content companies may be adapting to a new business model and offering alternatives.

➤ *Phase 4 — Adaptation.* Key indicators of this phase are the development of new business models and new players, primarily in distribution. This phase most likely means that content and production companies relinquish some control over their product to boost profits. Looking to history as an example, the movie studios once battled the VCR as a threat to theater attendance, only to see the technology give birth to the vastly successful home video business. The music industry is entering this stage as legal online downloading ventures seem to be beginning to gain traction and the companies are examining their cost structures to be profitable in their new reality. The film industry is also experimenting with adaptation by offering consumers alternatives to illegal downloads and discs (e.g., MovieLink), as well as doing extensive market research to continuously enhance the digital physical product, keeping it at a lower price point, and working on the next-generation format, the high-definition DVD, which may make its appearance as early as 2006.

Piracy Primer

- The three primary types of piracy are: illegal downloading (enabled by the Internet, compression, and reduced file storage costs); counterfeiting (enabled by excess capacity on CD/DVD factory lines, CD burners, and recordable discs); and bootlegging (e.g., copies of newly released or exclusive content).
- The law is on the side of the content companies; the 1998 Digital Media Copyright Act is the cornerstone law protecting digital copyrighted material, but the notion of "fair use," whereby individuals have the right to back up owned content for personal use, is challenging it.
- Napster, the online music sharing service, was taken offline due to copyright infringement, but the legality of replacement peer-to-peer file sharing sites has been held up in courts due to their decentralized structure — they do not store any content on central servers.
- The content companies are beginning to target individuals sharing copyrighted material with lawsuits, equating file sharing with shoplifting. We think this is a move in the right direction, but it might prove to be offensive to consumers.
- Already aware of the potential dangers of digital piracy, the film and video game industries developed their digital formats with anti-copying protection. These defenses have been hacked, but have helped to limit the problem, in our view.
- In the international arena, particularly in Asia and Latin America, piracy is a significant problem. Due to weak or nonexistent copyright laws and the difficulties in enforcement, we believe that international counterfeiting will continue to worsen.

A Brief History of Piracy

Until relatively recently, piracy was limited due to physical copying and distribution constraints.

Until recently, intellectual property had been protected by physical — primarily technological — constraints as much as by copyright laws. Entertainment and culture have largely involved things one could hold in one's hand — videos, books, cassette tapes, or CDs. Copying any of these mediums took time and money. For example, to commercially pirate a movie, one needs a method of delivering the content to an individual, e.g., a video machine (a VCR in the early 1980s and a DVD player since the mid-1990s). Next, a would-be film pirate would have to make a video copy of a first-run movie, go to a factory, and begin printing and distributing

copies. This would require the involvement of dozens, even hundreds of people, in an illegal activity. And the quality of the product would be shoddy in its initial copy, and in the case of VHS would further degrade over time.

Technology has exponentially increased the ability to share copyrighted material.

Today, in the digital world, this process is easier. Using the latest technology, a song, movie, or video game can be produced, stored, edited, and distributed to millions of people with a few clicks of a mouse, without any deterioration in quality. Sharing of copyrighted information has always been around, but it had been limited by physical constraints. Technology has expanded the notion of networks in that people now have access to one other and to content that they did not have before.

It Hits the Mainstream

We believe consumer attitudes are a concern because many people do not believe copyrighted file sharing is unethical, let alone illegal.

Music piracy went mainstream in the late 1990s, when Napster became a household word. Using a program devised by an 18-year-old, millions of people have searched the web and downloaded hundreds of millions of songs. Napster was certainly not the first instance of entertainment piracy, but it was the first evidence of how quickly and widely digital piracy could spread. In our view, more alarming than the volume of downloads is the effect that Napster has had on consumer behavior. Most users were very excited about this new access to music and did not feel that there was anything wrong, let alone illegal, with acquiring free music. We think this attitude was particularly prominent in the teen generation and with college students. These demographic groups have been swapping, lending, or borrowing cassette tapes or CDs from one other's privately held libraries for years. We believe sending a music file to a friend via e-mail or finding a file on a computer network felt like a natural extension of prior behavior. The issue, at least for the owners of the copyrighted material — the music companies — was that this natural extension let listeners tap into the "libraries" of millions of people. However, even if the swappers/downloaders were aware of the illegitimacy of their actions, the network was anonymous, so the fear of being caught was minimal, in our view.

After Napster's demise, new online sharing services, which are harder to control, formed.

Although Napster was eventually shut down by a court order because it was sharing copyrighted material through its servers, its advent was an alarm bell, marking the first time that digital technology powerfully undermined the intellectual property protections that have been part of U.S. laws for decades. A growing number of powerful programs that do exactly the same thing as Napster in a variety of media. For example, peer-to-peer networks like KaZaA and Morpheus allow users to easily trade music tracks and film files online. These networks are harder to control and their legality has held up in court because they do not have central servers and do not hold any copyrighted content themselves. CD and DVD recorders allow for easy replication that is both quick and of high quality. At the same time, technology can be used to protect and effectively distribute content as well. Entertainment industries, working with some technology companies, are racing against pirates to find a viable solution.

Pirates Have Many Faces

Piracy today includes online downloading and physical counterfeiting and bootlegging.

Piracy grew in part out of the entertainment industry's foray into new technologies that would create alternative revenue streams and allow consumers to have more elaborate entertainment experiences. However, these technologies have also opened the door to new forms and greater ease of piracy. The industry had battled analog

piracy for years, but had taken some solace in the fact that tape quality (VHS and cassette) is generally bad and continues to degrade with further reproductions. The equation has changed in the digital world, where copies are exact, can be put on the Internet for downloading onto almost any computer anywhere, and can be replicated countless times while maintaining high levels of quality.

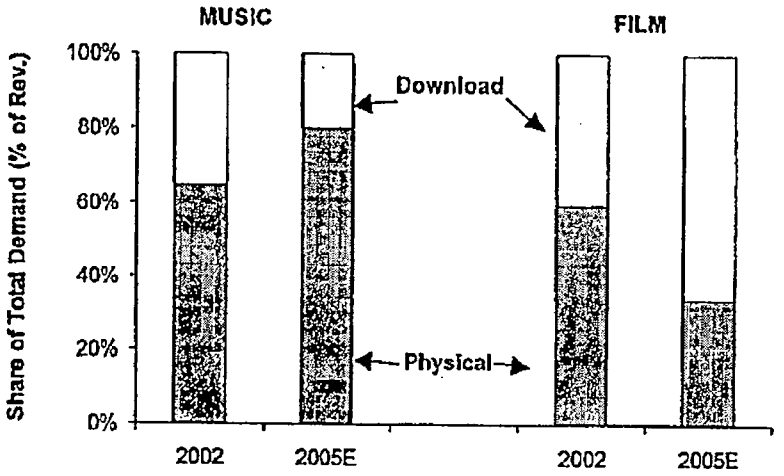
Today, the entertainment industry faces various forms of piracy that fall into three main categories:

1 Online piracy — enabled by the Internet, compression, and reduced file storage costs;

2 Counterfeits — enabled by excess capacity on CD/DVD factory lines, CD burners, and recordable discs; and

3 Bootlegging — making early copies of just-released or exclusive content.

Figure 7. Types of Piracy by Revenue Share, 2002–05E



Note: Physical includes counterfeiting and bootlegging.
Source: Smith Barney

The Internet has facilitated the spread of piracy.

Online Piracy — Technology Facilitating Widespread Copying

Three elements of technology have made widespread file sharing and copying possible: 1) the Internet; 2) compression of file sizes, and 3) reduced storage costs. The Internet provides tremendous opportunities for new business models to develop and for more content (including music, film and games) to be made available in a variety of ways. It also presents some major challenges. Music piracy has been around for a long time, but digitization has made music particularly vulnerable to online distribution. Over the past six-plus years, piracy has gone through an evolution, from friends sending music files to each other via e-mail, to network users searching for songs through centralized servers, to peer-to-peer network participants trading files over decentralized networks.

MP3 Should Stand for "Makes Piracy Three Times Easier"

MP3 technology allows users to play and share music files on computers.

The key to illegal distribution of music online is the MP3 format. MP3 is the popular name for MPEG-1 layer 3, a digital compression format from the Moving Picture Expert Group, and it is the hi-tech equivalent of home taping. The software allows audio files — which are usually very large — to be compressed to one-twelfth of their original size. These files can then be stored on a PC's hard drive, burned onto a blank CD, e-mailed to a friend, posted on a website, or loaded onto a personal player. To listen to MP3 files, all a user needs to do is download an MP3 player for free from the Internet and then go to one of many websites to download tracks. The software also allows users to convert personal CDs and tape recordings into MP3 files. This means that a consumer can acquire a disc, upload its contents, and store it as a file on a computer to be played or shared. The smaller file size reduces storage and distribution costs, so users can store a great number of files on a personal computer without eating up all of its memory and can transfer files in a reasonable amount of time. MP3 was initially touted as an ideal way to make the music of bands without recording contracts freely available to anyone on the Internet. But the technology created by MP3 allows anyone to make illegal pirated copies available to anyone else on the Internet. In the movie realm, MPEG2 and MPEG4 files are the compressed equivalent and allow for the downloading, sharing, and playing back of digital video files.

Expanding One's Network

Online peer-to-peer networks have expanded sharing reach exponentially.

Peer-to-peer services that encourage and assist this widespread unauthorized copying have been established. These services are networks on which users share files online. The creators set up networks through which users may make their music available to others, and in return they are able to search other users' computers for music to download. Through these networks, files can easily be downloaded in breach of copyright and without payment to the artist or record company. One person first has to acquire (legally or otherwise) the music file and upload it to a computer. The file (song, movie, or game) can then be shared with millions of people, who can listen to it via streaming on a computer (temporarily possess the file), download it to a computer or portable player (retain the file), or burn it to a disc to be played on a CD or DVD player or in a computer.

Most legitimate file sharing sites limit the ways consumers can use music, making the sites unappealing.

Napster was the first and best-known file-sharing network, but many other services have emerged. In addition to the sites offering free music, there are also a number of legitimate sites selling music from established artists in the MP3 format. However, until recently, most of these sites have limited the ways in which consumers can use the music they purchase — for example, forbidding the copying of songs to discs. Recognizing this shortfall, some of the legitimate sites are just now beginning to offer more appealing services.

Broadband Will Provide the Means

More than half of all U.S. households have online access.

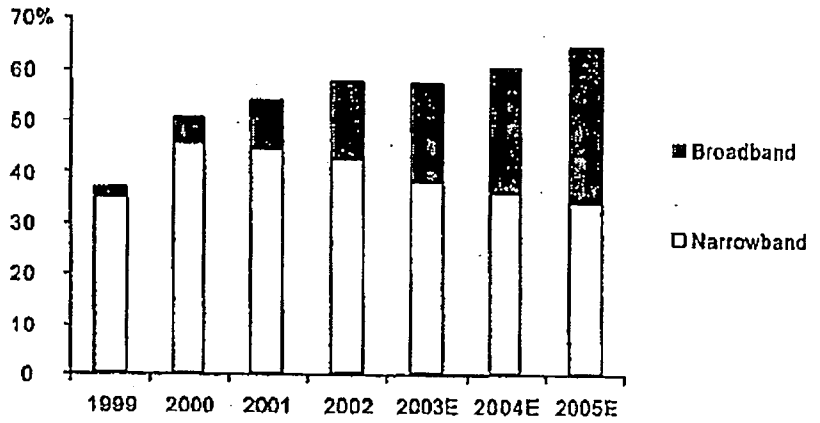
Besides shrinking the size of the file, another important facilitator in sharing content online is reduced transfer times, i.e., faster online connections. This is particularly true for film files, which are 100–200 times as large as music files. U.S. household online access is quickly moving from primarily dial-up connections to high-speed broadband connections, and by 2005 we estimate there will be almost a 50-50 split

between the two. By the end of 2003, we estimate that 55% of U.S. households (60 million) will be online, with 30%–35% of those (approximately 22 million households) having broadband access. By 2005 we expect almost 35 million households to have a broadband connection and 60% of all households (70 million) to have Internet access.

We expect strong international broadband growth.

The U.S. represents half of the current worldwide broadband market, but we believe the near-term estimated broadband growth will be driven in large part by international penetration, which is more threatening from a piracy perspective due to less-protective copyright laws outside of the U.S. and Western Europe.

Figure 8. Percent of U.S. Households with Online Access, 1999–2005E



Source: Company reports and Smith Barney estimates

As broadband penetration increases, we expect more file sharing, particularly of films.

Online networks have not yet become as widely used for sharing films or video games as they have for music, primarily due to the large size of film and game files and the longer time required for downloading them. As penetration of high-speed Internet access increases, we feel these segments will become increasingly vulnerable. This is because it takes approximately 24 hours to download a two-hour movie using a dial-up connection, and only two to three hours on a high-speed connection. This is in contrast to a five-minute song that would take five minutes with a dial-up and less than a minute with broadband. Also, broadband users are connected 24 hours per day, allowing downloads all the time.

Some disc manufacturers with excess capacity engage in illegal production.

Counterfeits — Driven by Excess Capacity and Cheap Technology

There are two types of pirated discs: pressed discs and CD-recordables (CD-R), and production is split approximately evenly between them. Pressed discs are CDs and DVDs that are made on factory production lines (optical disc plants), and many times pirated discs are made on the same lines as legitimate discs. Over the past couple of years there has been growing overcapacity in many of these plants, due in part to the decreased music market (demand) and overinvestment in plants (supply). Piracy on pressed discs is a significant problem in Taiwan and Hong Kong, where many of these plants are located.

The advent of recordable CDs with inexpensive equipment has increased the supply of counterfeit discs.

Counterfeiting of CD-Rs, which are recordable discs, is usually done through smaller-scale CD-R operations in such locations as garages and labs. Advances in technology have led to the availability of inexpensive high-speed CD recorders (called burners) and CD-R replication equipment, priced in the range of $250–$500, thus lowering the barriers to entry for commercial pirates. CD-R replication is particularly troubling for the entertainment industry because CD-R operations are smaller, easier to conceal, and more portable (thereby harder to discover and break up) than optical disc plants. Also, in the music industry, CD-R growth is increasing the pirating of local content. Previously, music companies were only concerned with the replication of major international artists that have widespread appeal and exportability, but now counterfeiters are also infringing on the markets for more up-and-coming and newly established acts. Finally, cost (cheap production) is driving the growth of piracy through recordable discs. CD-R blank discs are falling in price rapidly as producers, largely from Taiwan, have overproduced blank CD-Rs. Being able to purchase blank CD-Rs for as little as $0.20 each provides even more incentives for commercial counterfeiters who burn and sell them for more than 25 times that amount. An estimated 6 billion blank CD-Rs were purchased globally in 2002, up 85% from 3.25 billion in 2000.

Asia and Latin America have major piracy problems.

Counterfeits are a big problem internationally, especially in Asia and Latin America. The excess capacity in optical disc plants and cheap replication capabilities, combined with delayed music and movie release dates in non-U.S. markets, sometimes limited legitimate availability, and weaker copyright laws and enforcement have created a large international black market.

A Burning Problem

DVDs' first line of defense against piracy is their layer of copy protection.

To help prevent counterfeits, the film and video game industries built in an added level of protection. When DVDs were first developed, they were created with the content scrambling system (CSS), a scrambling technology that is recognized by DVD players and allows only legitimate discs to be played. Hackers have broken this protection, but CSS does prevent the average user from easily copying DVDs.

Video game consoles have anti-piracy chips, but these have been hacked.

Similarly, video game consoles contain software that limits the games that can be played on them. This is not to say that copied games cannot be played, just that hardware also has to be modified in order to play pirated games. To this end, hackers have created chips, known as "mod chips" (for "modified"), that must be installed in consoles in order to play pirated games. Once in place, these chips allow consoles to recognize and play games not intended for the given consoles, such as copies or games designed for different geographic regions. Although there have been lawsuits that have halted the selling of mod chips by some manufacturers, it is still easy to find retailers on the Internet. Some consoles require a chip alone to enable unintended uses, while others require accompanying software. Chips can either be purchased with instructions for self-installation for $35–$50, or consumers can pay for chip retailers to install them. The legal rationale for allowing the sale of mod chips is that users should be able to back up games that they have purchased for their own personal use, or they should be able to play games designed for a different region.

Bootlegging — A New Twist on an Old Crime

"Screener" bootlegs are rampant, but their damage is probably limited due to typically poor quality.

Although technology has changed the landscape and intensity of piracy, "old-fashioned" analog piracy still exists. In this case, pirates use hand-held video cameras to record motion picture films in theaters, or audio recording equipment to record live concerts. They then copy these recordings onto blank cassettes or optical discs for illegal distribution. These copies are usually not only distributed through illegal channels in the U.S., but are shipped overseas and sold even before the film's international theatrical release. Other illegal copies are sometimes made from legitimate advance copies used for screening and marketing purposes, but in the broad scheme of the topic, this source is not a significant problem due to typically poor quality.

They're Not Alone — Books and Software

The software and publishing industries also struggle with piracy issues.

Piracy in the entertainment industry is a huge issue, but those in music, film and video games should realize that they are not alone. The software industry has been fighting the issue for many years, and finally seems to be getting a hold on it. The publishing industry also seems to have stunted innovation from fear of piracy. While their experiences do not translate directly into expectations for the entertainment industry, it is useful to draw parallels.

Software has limited piracy with increased policing and harsher penalties.

In 2002, there was a modest reduction in software piracy levels, bringing to an end two consecutive years of piracy escalation. Software piracy is 10% below the 1994 level, the point at which the industry first confronted the problem on a united front, suggesting the group's anti-piracy lobbying and education initiatives are showing results. Some of the probable reasons for the improvement are stepped-up policing efforts and harsher penalties. Software differs from entertainment in that a large degree of software piracy occurs at the workplace. Therefore, some of the efforts are aimed at this audience. For example, once a company has been identified as having significant non-compliance issues, it lessens its chances of getting the best discounts and licensing deals. The "Scarlet Letter" will follow the firm long after the software non-compliance fees and fines have been paid. The parallel here is to also target the users, rather than the producers and suppliers, of the pirated content. This is exactly what the music and film industries are beginning to do with public service announcements and individual lawsuits.

Publishing has not entered the digital age, possibly due in part to fear of piracy.

The publishing industry has not been hurt by piracy to the same extent as these other industries, but we feel it has lost out on potential new revenue streams due to fear of piracy. In 2000, it seemed the publishers were starting to take their first tentative step into the digital world with e-books. Then the era of Napster hit, and, given the specter of books being traded online, the publishers seem to have pulled back their efforts. E-books have stagnated (probably due in part to fear of piracy and in part to lack of consumer demand), and there are no evident prospects for new distribution channels.

Running Up Against the Law

The 1998 DCMA is the cornerstone law protecting digital copyrighted content.

The entertainment industry is leaning on the law to a great extent to help stave off piracy. The fundamental anti-piracy legislation dates back to 1976, when the Copyright Act was passed in United States. This act gave content owners the

exclusive right to reproduce, distribute, perform, display, or license their works. However, technology ran ahead of the law, and content owners sought to find protection against infringements on digital content. In 1998 the Digital Media Copyright Act (DMCA) was passed. This law was meant to stop pirates from circumventing technical protection measures used to safeguard copyrighted works. The primary element of the law that has been challenged over the years is the notion of "fair use." Fair use says consumers can copy legally acquired media, including videos, TV shows, music and other items, for personal, non-commercial purposes. The difficulty in upholding fair use with digital media is that it is tough to easily distinguish what is going to be used for personal consumption, what is being shared peer to peer, and what is intended for commercial use. Most of the action had been in the music arena, but with technological developments on the DVD front and the benefits from music's legal experience, the film industry is also beginning to become actively engaged. It seems to have learned the lessons of music and became more aggressive earlier.

There have been a number of cases challenging the notions of circumvention and fair use. In general, these cases are divided into two categories: the online sharing of copyrighted content and the descrambling and physical copying of discs.

Napster — Music Won the Battle but Not the War

Current peer-to-peer file sharing networks are particularly dangerous because they are difficult to monitor and have been declared legal.

Early on, the music industry enjoyed some victories in the area of online distribution, the greatest of which was shutting down Napster. In July 2001, a U.S. court ordered that Napster keep its free service offline until it could fully comply with an injunction to remove 100% of copyright music from its servers. Unable to do so, it was forced to go offline. (Roxio subsequently bought Napster in bankruptcy court and recently relaunched Napster 2.0 as a subscription service. See "Adaptation...Thriving in the New Competitive Landscape" in the music section for more details). However, in April 2003, the industry suffered a major defeat in its suit against peer-to-peer (P2P) networks Grokster and Streamcast (operator of the Morpheus online network). A judge ruled that the software companies are not liable for copyright infringements by users of their software and they were allowed to continue in business. The primary difference between these networks and Napster is that Napster's network went through its own central server while P2P networks, such as Streamcast's Morpheus, Grokster, and KaZaA, are decentralized. This type of network is more difficult to monitor, and declaring that its owners are not liable for what the users do with the material increases the incentive for such networks to proliferate. This ruling opens a potentially precarious gate for content owners.

The music industry is successfully targeting individuals, equating online sharing to shoplifting.

On the positive side, in April 2003 a court ruled that Internet Service Provider Verizon must turn over to the RIAA the names of two customers who allegedly offered copyrighted music for download. Additionally, the music industry has filed lawsuits against four college students who supposedly downloaded copyrighted files and ran internal campus file sharing networks. The students agreed to pay damages ranging from $12,000 to $17,500 each.

In early September 2003, the RIAA filed suit against 261 individuals, with potential copyright violations capable of meriting damages as large as $150,000 per violation. This tactic marks a new approach, making individuals personally responsible and

equating file sharing to physical shoplifting and theft. This approach will be a more tedious path than trying to shut down the networks at their source (which was attempted unsuccessfully), but we believe it will be effective in reducing illegal sharing. Most downloaders do not currently consider what they are doing to be illegal or unethical, and the industry is working to change that perception and ultimately the associated behavior.

While it is early to gauge the end result of the RIAA's efforts, some recent evidence suggests that it is having success. A study conducted by NPD Group shows that music piracy on the Internet has declined since the RIAA and labels began threatening lawsuits against individual users this spring, first with email warnings in late April and then with more specific threats of lawsuits for up to $150,000 per copyright violation for the worst offenders. An NPD survey of 40,000 panelists shows that music files acquired (swapped illegally, downloaded from paid sites, or ripped from CDs) declined from a high of 852 million files in April 2003 to 655 million files in June 2003, while the number of U.S. households acquiring music files hit a high of 14.5 million in April 2003 before falling to 12.7 million in May and then to 10.4 million in June. More recently, about 4.8 million people used KaZaA in the week ended August 17, down from 6.5 million seven weeks earlier.

The Battle for DVDs

The film industry lost a key legal case that ruled that DVD copying technology is legal given "fair use."

The industry struggles surrounding disc replication have more recently hit the courts and the key decision is still pending, but early indicators are mixed for the film industry. Looking to a precedent to get a hint of what may follow, the U.S. Supreme Court in 1984 ruled in favor of Sony in a case claiming its VCRs could be used to record copyrighted programs. This judgment seems to indicate that disc copying technology will likely remain legal just as analog copying did. In January 2003, Jon Lech Johansen, also known as DVD Jon, was acquitted of charges over his development and distribution of DeCSS (also known as De Contents Scramble System), a program that can be used to break the digital copy-protection mechanism of DVDs. The court found that Mr. Johansen was entitled to access information on a DVD that he had purchased and was therefore entitled to use his program to break the code. This is the notion of "fair use." Since this program could be useful for both legal and illegal purposes, like many other devices such as a VCR, it was found to be permissible. However, an August 25, 2003 decision by the California Supreme Court reversed an earlier court decision and stated that it could block individuals from posting to websites codes for illegally copying DVD movies. In doing so, the court ruled that such codes are legitimate trade secrets under the Uniform Trade Secrets Act, and thus cannot be posted online. The specific case in question involved a suit by the DVD Copy Control Association against Andrew Bunner, a computer programmer; in 1999 Mr. Bunner posted a code on the Internet to crack an encryption program designed to prevent illegal movie copying.

Another key legal case involving DVD copying software is pending.

The most significant case currently pending is against 321 Studios. This company manufactures software, DVD Copy Plus, and DVD X Copy that essentially provide the key to descramble protected movies to allow them to be copied. In April 2002, 321 Studios tried to preempt a studio lawsuit and filed for a judgment declaring its software legal. In January 2003, seven major Hollywood studios — including

MGM, Warner, Disney, and Universal — filed suit against 321 Studios saying its software violated the Digital Millennium Copyright Act (DMCA), but 321 argues fair use, saying its software can be used to make backups. We will need to watch the outcome of this case carefully, which we expect in late 2003 or early 2004.

Modification Chips — Making Copied Discs Work

Modification chips that facilitate video game piracy have been declared illegal.

Video game consoles (Microsoft's Xbox, Nintendo's GameCube, and Sony's Playstation2) have software installed that allows users to only play manufacturer-approved games, i.e., copied games will not work (Microsoft is covered by Smith Barney analyst Tom Berquist). Hackers have been able to overcome this protection with the use of modification chips that can be purchased and put into consoles. The industry has been active in trying to end mod chip manufacturing and sales. Two websites selling these products have been halted, Lik-Sang and isonews.com. The owner of isonews.com was found guilty of violating the DMCA and was sentenced to five months in prison, five months of home detention, and three years of probation and ordered to pay a $28,000 fine. Even with these minor victories, there are still plenty of places online to buy the mod chips.

Free Speech Fights Back

"Fair use" advocates are trying to eliminate DVD copy protection.

Finally, free speech advocates are promoting what they believe to be consumer rights, and two U.S. Representatives have introduced a bill targeting the DMCA called the Digital Media Consumers' Rights Act (DMCRA — H.R. 107). The bill focuses on "fair use" and seeks to preserve the rights of consumers to copy legally acquired media, including videos, TV shows, music, and other items for personal, noncommercial purposes. The two key provisions that H.R. 107 addresses are the ban on circumventing any technical copyright protection measure and the prohibition on the manufacture or sale of technology enabling such circumvention. This is essentially fighting to uphold the DVD Jon decision and eliminate DVD anti-copying CSS protection.

Figure 9 gives a summary of the most significant court cases and their implications.

Figure 9. Key Legal Cases Involving Piracy

Legal Case / Legislation	Primary Industry Affected	Outcome / Implications
General		
1976 - Copyright Act	All	The fundamental anti-piracy legislation. WIN
1998 - Digital Millenium Copyright Act	All	Protects against any means that is designed to bypass copy-protection schemes. Allows copyright owners to file civil suits and for the government to file criminal charges. WIN for all content-producing industries, providing justification for most of the anti-piracy lawsuits that have been filed.
Pending - Digital Media Consumers' Rights Act (H.R. 107)	All	Two representatives have introduced a bill claiming to preserve "fair-use" for consumers, which allows users to copy legally acquired content for personal use. If passes will be a major DEFEAT as it is hard to police what is "fair use" and what is intened for piracy.
Online Distribution		
July 2000 - Napster	Music	Napster was ordered to shut down until it could comply with the injunction to remove all copyright music. WIN for music industry, closing all online services that go through central servers.
April 2003 - Grokster & Streamcast	Music	Judge ruled that P2P networks are not liable for copyright infringements by users of their software. DEFEAT for music industry, removing risk for software makers and essentially increasing incentives to create P2P networks. Appeal filed August 19, 2003.
April 2003 - Verizon ISP	Music	Court ruled that ISP Verizon must turn over to the media companies the names of two customers who allegedly offered copyrighted music for download. WIN for music industry, as a step towards shutting down copyright-infringing P2P networks.
Disc Distribution		
January 2003 - "DVD Jon"	Film	"DVD Jon" is acquitted of charges over his development and distribution of DeCSS, a program that can be used to break the digital copy-protection mechanism of DVDs. DEFEAT for film industry. It is legal to copy DVDs for "fair use" but provides the mechanism to copy for any use.
August 2003 - DVD Copy Control Association v. Andrew Bunner	Film	California Supreme Court decides that courts may block individuals from posting to websites codes for illegally copying DVD movies, providing protection for such codes under the Uniform Trade Secrets Act. WIN for the film industry and potentially others.
January 2003 Pending - 321 Studios	Film	Hollywood studios filed suit against 321 Studios which distributes software that allows consumers to copy protected DVDs. Winning this would be a major WIN, however given the results of the "DVD Jon" case the likely outcome is not favorable as the courts seem intent to protect "fair use".
Video Game Modification		
December 2002 - ISOnews.com	Video Games	Department of Justice used the DMCA to shut down ISOnews.com, a web site partly used to distribute x-box hacking tools and to imprison the site's owner. WIN for games industry.
Microsoft, Sony and Nintendo v. Lik-Sang	Video Games	The high court in Hong Kong ordered Lik-Sang to stop selling Mod chip products. WIN for games industry.
Australia mod chips	Video Games	Court ruled that Mod chips made for Playstation 2 are not illegal. The makers of the chips accused the platform holders of artificially denying Australian consumers the right to purchase goods from abroad by enforcing the software regions system. Significant DEFEAT for games industry.

Source: Smith Barney

citigroup
Smith Barney

International Offenders

Currently emerging markets may be the growth engines in five to ten years.

While the U.S. is the largest entertainment market in the world, in 2003 it will account for roughly 50% of an estimated $84 billion in worldwide film and music revenues to content owners. The global landscape brings its own opportunities and challenges. The leading entertainment markets of today are likely to remain the leading markets over the next three to five years. Based on sheer market size and wealth, the U.S., Japan, and Western Europe continue to represent the best revenue potential for today's largest global entertainment companies. However, with heavy competition and penetration of these established markets, looking forward five to ten years, the industry needs to be positioned to realize the growth potential of currently emerging markets.

However, many emerging market countries have loose copyright protection.

Target markets for geographic expansion will continue to be those with strong economies and sufficient per-capita income to justify discretionary consumption spending. Ideally, target markets would have strong, steady GDP growth comprised of a significant percentage of consumer spending as well as high levels of consumer confidence. While less-developed economies may appeal to expanding companies as a result of less competition and lower existing penetration, these markets may also bring challenges, most significantly loose copyright protection. Finally, because these markets have been underserved, commercial pirates have created their own markets. This develops behavior and price expectations among local consumers and makes it difficult for legitimate players to eventually move in.

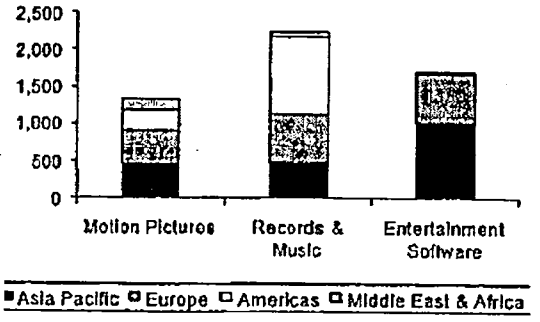
Weak International Copyright Laws

The IIPA estimates that U.S. entertainment companies lost $5.3 billion in exports due to piracy in 2002

Outside of the U.S., more than 80 countries have copyright laws, but in many they are weak or nonexistent. Therefore, these companies need to look beyond their own backyards to find some of the biggest offenders. The International Intellectual Property Alliance (IIPA) and its member associations estimate that U.S. companies lost $5.3 billion in 2002 in trade losses due to piracy in film, music, and entertainment software. This number only includes physical piracy, so the actual number including losses from free downloads is probably much higher.

Figure 10. U.S. Trade Losses Due to Piracy by Industry, 2002

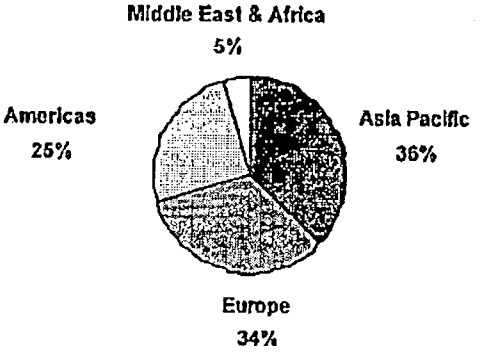
$ in millions



Source: IIPA and Smith Barney

Figure 11. U.S. Trade Losses Due to Piracy by Region, 2002

Percent of total



Source: IIPA and Smith Barney

More than 90% of Chinese entertainment content sales involve pirated goods.

The IIPA conducts an annual review process, a key element of the U.S.'s principal trade tool, and identifies countries with the highest levels of piracy. Then it works with local private representatives, U.S. government officials, and U.S. embassy officials to address and resolve copyright problems. Figure 12 highlights the countries that are the greatest offenders, as measured by piracy level (the share of a country's market that consists of pirated materials) and total estimated annual dollar losses. For example, piracy in China is estimated to be 91% of film, 90% of music, and 96% of entertainment software (video game) sales. The losses amount to an estimated $666 million in annual sales that would otherwise have been earned primarily by U.S. companies. However, the net effect to U.S. companies might be less than $666 million because a legal sale might never have occurred due to the higher price point of a legitimate copy.

Figure 12. Selected International Piracy Levels and Export Losses, 2002

$ in millions

	Motion Pictures		Records & Music		Entertainment Software		TOTAL
	Loss	Piracy Level**	Loss	Piracy Level**	Loss	Piracy Level**	Loss
Taiwan	342	44%	$99	47%	$596	56%	$737
China	168	91	48	90	450	96	666
Russian Federation	250	80	372	68	NA	90	622
Brazil	120	35	320	53	NA	NA	440
Poland	2	30	45	45	338	91	385
Paraguay	2	80	204	99	NA	NA	205

* Loss estimates the amount of lost exports due to markets otherwise served by pirates.
** Piracy level is the percent of goods sold that are pirated.
Indicates the highest levels of loss in each category

Source: IIPA and Smith Barney

Piracy levels, together with losses, provide a clearer picture of the piracy problem in different countries. Low levels of piracy are a good indication of the effectiveness of a country's copyright law and enforcement practices, in our view.

Music...Will It Sing Again?

- The music industry has been the unfortunate trailblazer in the realm of entertainment piracy, and in 2003, is expected to lose more than one-third of the $52 billion consumer demand for music to illegal online downloads and physical disc piracy.
- The retail/distribution model has historically not kept up with changing consumer behavior (the desire to purchase individual songs rather than only full-priced CDs) and technology (digital duplication and download capabilities). However, we think the industry is just beginning to react to market demand and music sales are beginning to stabilize.
- Music companies are finally taking more aggressive legal action and offering new legitimate alternatives to acquire music that seem to be more attractive to consumers.
- Even though Napster was declared illegal, new peer-to-peer networks have emerged that are potentially more damaging due to decentralized structures that make them more difficult to police.
- The outcome of the piracy battle hinges on whether illegal downloads are kept from flourishing further, legal alternatives gain traction, and copyright enforcement is enhanced overseas, where physical disc piracy is rampant.
- Based on our piracy sensitivity analyses, we think Warner Music Group could see 14% upside or 15% downside to our 2005 OIBDA estimate. Due to Warner Music's small relative contribution to Time Warner, this variation translates to only about a nickel per share or less, than a 1% change in company value.
- We believe that even if a viable business solution were found, there is a risk music company sales may take a haircut as consumers primarily purchase individual songs instead of complete CDs.

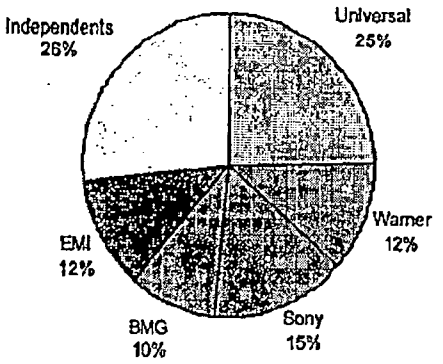
A Struggling Oligopoly

Five major companies dominate the music industry.

The music industry, which will generate an estimated $32 billion in legal sales in 2003, is dominated by five major players that account for almost 75% of total sales: Universal Music Group (owned by Vivendi Universal, which is covered by Patrick Wellington); Sony Music Entertainment (Sony); Warner Music Group (Time Warner); BMG Entertainment (Bertelsmann); and EMI Recorded Music (EMI Group). However, deals are currently under discussion, which could reduce the

number of major players to three. Sony and BMG recently announced a plan to merge and Warner Music Group is considering offers from both EMI and an investor group led by Edgar Bronfman Jr.

Figure 13. Music Industry Market Share, 2002



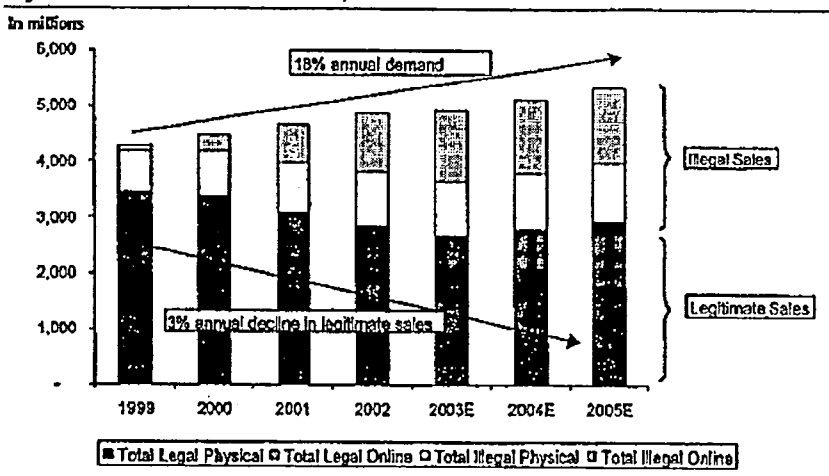
Source: *Music & Copyright* and Smith Barney

Piracy has seriously impacted music sales (by 40% in 2002), but we think a reversal is possible.

Piracy's Damage

According to our analysis, piracy will steal about 35% of global music demand this year, resulting in estimated lost sales of $18 billion — almost 2 billion albums and album equivalents (we define ten downloaded songs as an album) in 2003. This piracy, in our view, contributed to the approximately 8% decrease in legal sales since 1999, the peak sales year. We believe one of the primary problems has been that the retail distribution model has not kept up with changing consumer behavior, consumption patterns, and technology. In addition, the pricing model was out of whack with demand. We feel the industry is finally adapting to the current consumer environment, and it will likely be possible for the music companies to stem their losses and slow the rate of loss to piracy. We have seen evidence of this improvement with the early success of legitimate online music services (iTunes), more aggressive legal actions, and Universal Music's recent price cut. In our view, illegal sales should basically level out in absolute terms and actually decline slightly in 2004 and 2005. However, illegal sales will continue to grow as a percentage of overall demand, based on the lower price point of unit demand due to the shift to downloading from physical product and CD price reductions. Therefore, as a percentage of total music demand, we estimate piracy may rise from 35% of demand in 2002 to 40% in 2005.

Figure 14. Estimated Unit Music Demand, 1999–2005E



Source: Smith Barney

Piracy should affect each of the music companies in proportion to its market share.

Piracy is an equal opportunity offender. In particular, physical piracy of discs has not had a significant effect on the distribution of this market share, as we estimate that it has impacted each company (except independents) in almost direct proportion to its market share. This is because hit albums drive both revenues and production of pirated discs, so companies generating the most from successful albums — with the highest resulting market share — are also losing the most from pirated discs. This has traditionally been the case because the process for copying discs was complicated, required expensive equipment, and was only worthwhile doing if there was a relatively high level of resulting illegal sales per title.

Figure 15. Music Market Value and Market Share 1999–2002

$ in millions

	World Market Value	MARKET SHARE					
		Universal	Sony	EMI	Warner	BMG	Other
1999	$35,800	21.7%	17.0%	11.8%	11.4%	10.1%	28.0%
2000	35,200	22.9	14.4	13.5	12.0	8.4	28.8
2001	33,600	23.5	14.7	13.0	11.8	8.2	28.8
2002	31,248	24.6	14.8	12.0	11.9	9.8	26.9

Source: *Music & Copyright*

"Risk" to Warner Music Group

Piracy "risk" may impact Time Warner values by only 1% on the upside or downside

In order to determine the potential impact music piracy at Warner Music Group could have on Time Warner, we conducted a sensitivity analysis with varying scenarios depicting possible outcomes for piracy. This analysis indicates Warner Music Group's OIBDA could swing significantly from the base case, from 14% upside in our best-case scenario to 15% downside in our worst-case scenario. However, we estimate that Warner Music Group will make only a small contribution to Time Warner's value in 2005 (less than 3%). That means we expect less than a 1% upside or downside impact on the parent company's value due to music piracy risks.

Figure 16. Music Piracy "Risk" to Time Warner Value, 2005E

$ in millions

	Warner Music Group 2005 OIBDA	Difference in OIBDA From Base Case	Difference in OIBDA From Base Case	Estimated Impact on Target Valuation of Company
Bull	$294	$36	14%	< +1%
Base	$258			
Bear	$218	($40)	(15%)	< (1)%

Source: Company reports and Smith Barney

Music Industry Sales Challenged

Music has been hit hard by piracy, especially since 1999, from both online downloads and physical counterfeit discs. Only now are companies starting to work within the new industry framework. Existing players are adjusting their current cost structures and modifying their business models, and new entrants (primarily in distribution) are emerging.

We have observed several trends resulting from music piracy over the past several years, including:

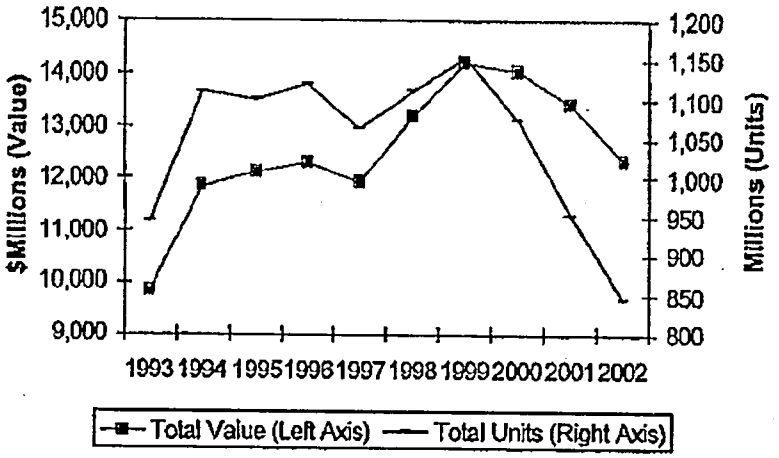
- changes in the overall market size,
- the emergence of new music formats, and
- a shift of music consumers' profiles and behavior.

Sales Are Decreasing, but Not Consumption

Dollar sales have been falling since 1999, but not as quickly as unit sales.

From 1999 to 2002, legal worldwide music sales fell at a compound annual growth rate of approximately 6%, bringing total unit sales to their lowest level since 1991. Both volume and value have fallen, but the value of the market has not decreased as much as total volume because of a mix shift and price increases. In 2002, approximately 845 million album units were shipped by legal manufacturers in the U.S., valued at $12.3 billion, compared to 1.2 billion album units valued at $14.2 billion in 1999, or a decline of 27% in units and 13% in dollar sales. We believe at least part of this less-rapid decline in dollar sales versus unit sales is attributable to the escalation of sales of CDs, which have a higher price point than cassettes and vinyls.

Figure 17. U.S. Recorded Music Manufacturers' Shipments, 1993–2002

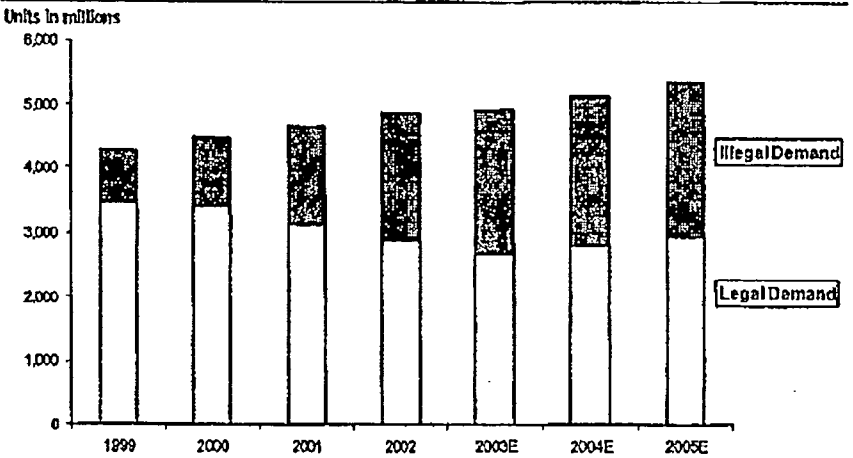


Source: Recorded Music Industry Association of America

Declines in legitimate music sales have been more than offset by growth in illegal sales.

However, this trend is not necessarily reflective of a decrease in demand and consumption, but perhaps a change in how consumers are acquiring their music. We estimate that during this same period (1999–2002), illegal unit sales and downloads increased at a compound annual growth rate of about 33%. This means that if total consumption is taken into account, worldwide demand for music units actually increased over those three years at an annual rate of 4%, while dollar demand increased by about 4.5%. We expect total demand in dollar sales to continue to grow below this 4.5% historical annual rate and actually fall by1.7% annually from 2002 to 2005, with a 4.3% decline in legitimate demand partially offset by a 2.7% increase in illegal demand. Figure 18 illustrates our expectations for the growth of total demand, with the past decline in legal sales being offset by the growth in illegal sales.

Figure 18. Unit Album Demand, Legal and Illegal, 1999–2005E



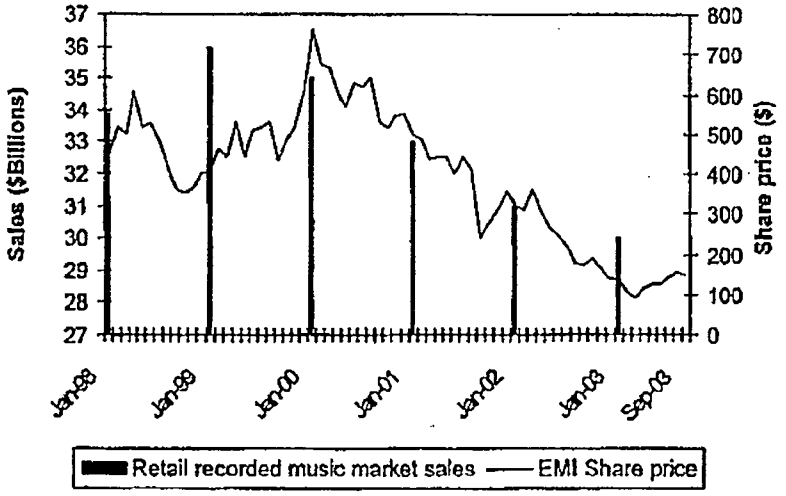
Source: Smith Barney

EMI's share price drop has mirrored the decline in music sales.

Nevertheless, actual sales have been consistently decreasing, which has had an effect on company valuations. In Figure 19 a clear trend is evident, which shows the decline in pure-play music company EMI's share price mirroring the decline of worldwide music sales. EMI's share price dropped by 68% from 1998 to September 2003 (versus a 20% decline in the FTSE 100 Index, where EMI.L trades) while total worldwide music sales declined by 11%.

Figure 19. Recorded Music Sales Drives Share Price

$ in billions, except per-share data



Source: IFPI, company reports, and Smith Barney

Diminished sales are leading to smaller budgets, which in turn may result in less quality content.

Music Industry Downturn Has More to Blame than Just Piracy

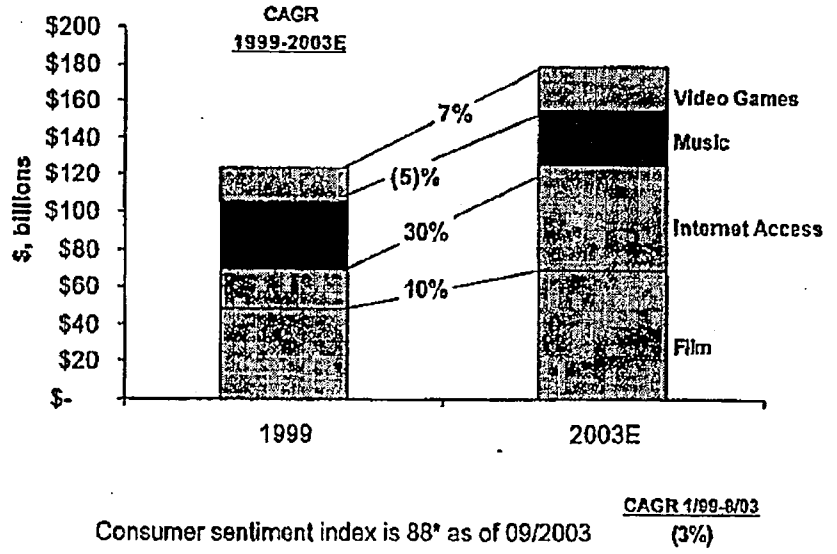
There is a keen debate over the extent to which piracy is responsible for the decline in music industry sales. We believe that piracy is not the only factor and that a number of forces are driving down sales, including a slow economy driving increasing competition for consumer spending and fewer hit songs and established artists. However, we agree with most people in the music industry that piracy is probably the primary cause of the sales decline. It not only directly steals sales, but it might also be an indirect cause of the decline in hit songs and established artists, in our view. Most of the major music labels have begun scaling back on their artists and repertoire (A&R) budgets — used for scouting and developing new artists — because of lower overall sales. That decreased investment could be a contributing cause of fewer hits.

Lower levels of consumer confidence might also be a factor in decreased music sales.

Competition for Consumer Spending

Economic uncertainty has been a driver of the slow growth of consumer spending over the past couple of years, which is likely to continue in the near term. Consumer sentiment, as reported by the University of Michigan Survey of Consumer Sentiment, declined 31% between the beginning of 2000 and March of 2003, with only a modest rebound since then. Specifically, consumer confidence hit a high of 112 in January 2000 and then fell to 77.6 in March 2003. The index rebounded to 87.7 in September 2003, a 13% increase, but is still 22% below its January 2000 level.

Figure 20. Consumer Spending on Entertainment, 2003E



Base = 100 from 1966

Source: Survey of Consumer Sentiment by University of Michigan and Smith Barney estimates

New entertainment technologies are competing for consumers' discretionary dollars.

At the same time, next-generation technologies in the Internet, home video, television distribution and video game segments have developed and are attracting more consumer dollars. This has occurred in the same period during which music sales have declined, and we believe that one of the reasons for this decline is this

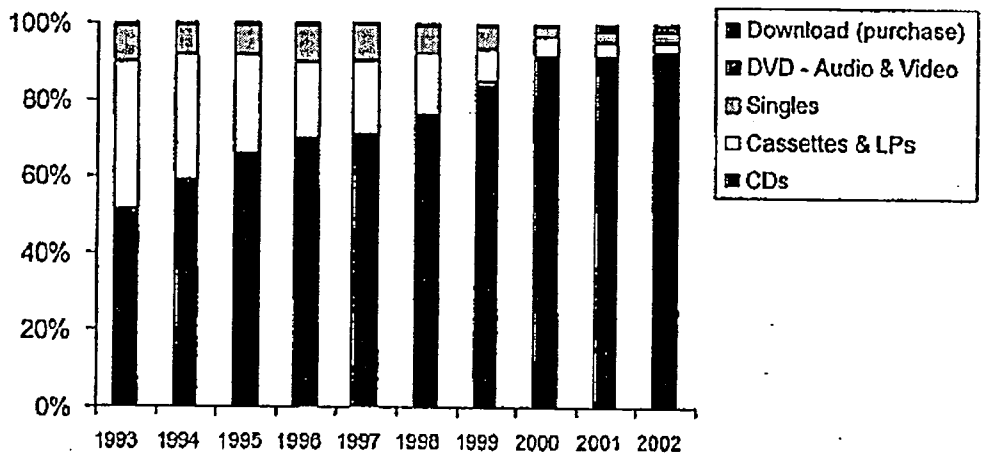
increased competition for the consumer dollar. The compound annual growth rate of consumer spending in the film, TV, and video games categories has been 7%–10% since 1999 and 27% for Internet access. On the other hand, music sales declined at a compound annual growth rate of 4.6%, and music's share of consumer spending on entertainment has shrunk from 30% to 17%. This is quite a significant "share of wallet" shift, and we believe music may have permanently damaged itself in the competition for consumer dollars by not dealing effectively with piracy.

Digital formats were a driver of sales and piracy.

Digital Revolution — A Double-Edged Sword

Historically, the advent of new technology has been one of the key drivers of growth in the music business. The introduction of LPs, the entrance of hi-fi stereos, and the adoption of compact discs have all spurred industry growth. Today the impetus is no different, and the key growth drivers for the music industry should be the wide-scale penetration of digital and other technologies that are already changing the industry's distribution methods. It is evident that over the past ten years, this evolution has gotten well under way as digital formats have increased from just over half of music sales in 1993 to more than 90% in 2002. The most relevant factor in this medium shift is that these new digital formats make piracy easier since they are much easier to copy and share en masse.

Figure 21. Percentage of Total Music Sales by Medium, 1993–2002



Source: Recording Music Industry of America

Younger consumers seem to be buying less music, which is partly attributable to consumption of illegal downloads.

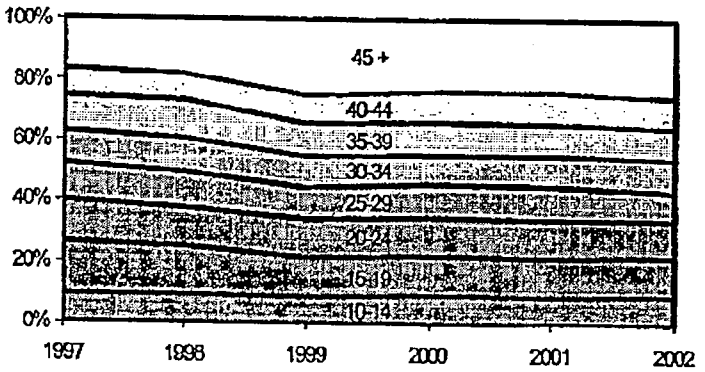
The New Face of the American Music Buyer

There has been a definitive shift in the profile of consumers who are purchasing music. The most dramatic change since 1997 has been the shift toward older buyers, those over 45 years of age. Between 1997 and 2002, the 45-plus age group increased its share from 16% to 25%, while the share for 15- to 29-year-olds fell from 42% to 34%. There are a number of possible explanations for the transition, including the aging of the population and the availability of music fitting respective music tastes. We believe these factors have contributed to the changing profile of

the American music buyer, but we also feel the proliferation of free online music distribution options has had a significant bearing on this change. Younger consumers are choosing to download music for free rather than make legitimate purchases, in our view; since that illegal music consumption is not captured in sale statistics, their recorded share of purchases declines.

Figure 22. Age of American Music Buyers, 1997–2002

Share of sales



Source: Recording Industry Association of America

Changing acquisition behavior patterns will likely be difficult.

The primary implication of this shift is that aging baby boomers are still buying music and will likely continue to be the biggest consumers of physical discs. At the same time, younger adults and kids are more likely to use online distribution, both illegal and legitimate, with many not even knowing the distinction between the two. So while the younger segment of the population is still listening to and acquiring new music, at least part of what they acquire is not appearing in the official statistics. The potential long-term consequences will result from the detrimental effect of this learned behavior. Young music listeners going online and downloading music do not consider the legality of their actions. As they become trained to get music in this manner, changing acquisition behavior will be difficult.

Recent Developments: Price Cuts May Spur Legal Sales Growth

In a dramatic move, Vivendi Universal's Universal Music Group announced on September 3, 2003 that it would cut the prices on most of its CDs in October, a process that has begun. The majority of titles going forward will be released at $13, down from the current $16.98–$18.98, in the hopes of reviving demand for the product. It is too soon to know whether this move will be successful. None of Universal Music Group's major competitors has yet matched the price reduction, though if the move leads to greatly improved unit sales, others may follow suit.

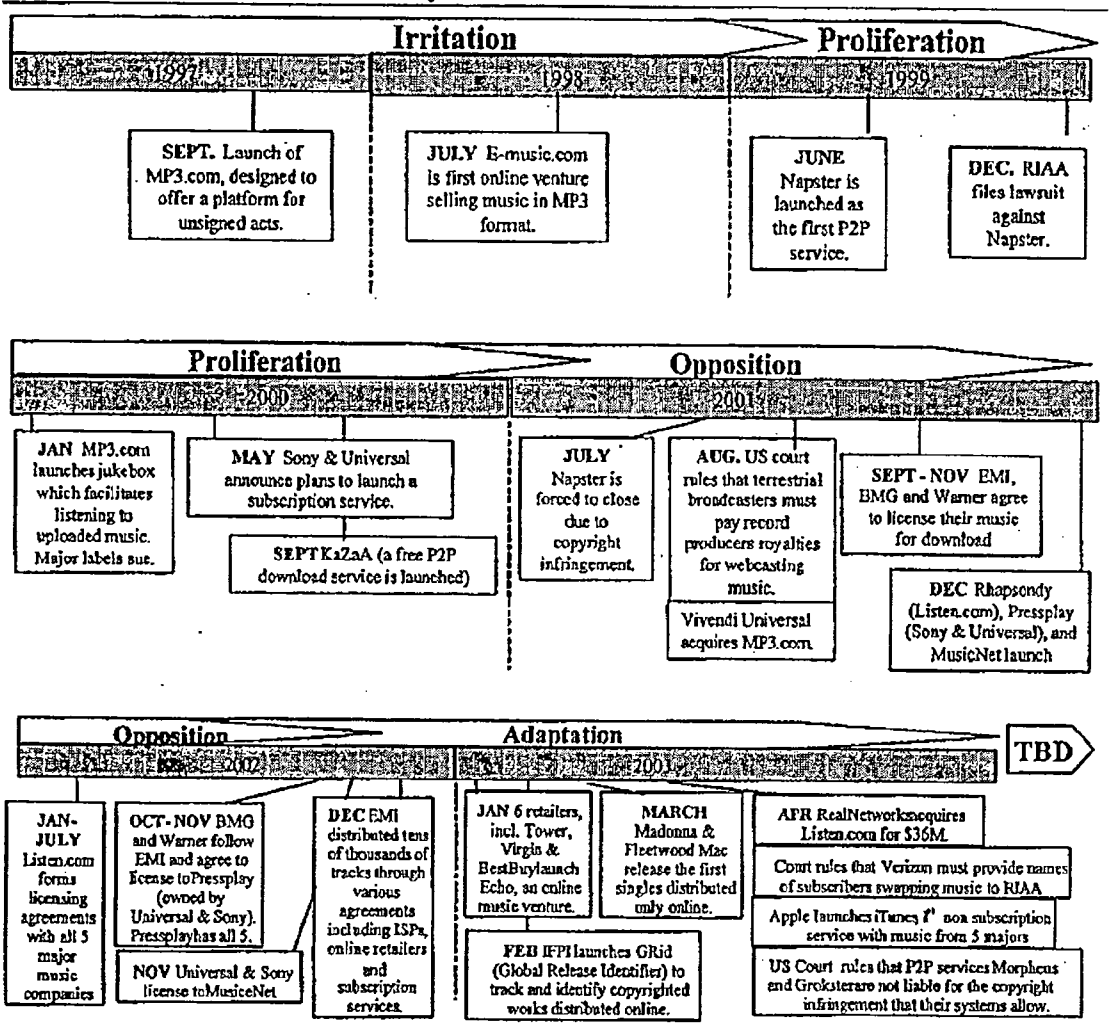
The Progression of Music Piracy

The music industry's struggle with adaptation continues.

As described in the first section, we have observed a progression in the music industry as it has moved through the four phases of piracy — irritation, proliferation, opposition, and adaptation. The following timeline highlights major events in the growth of music piracy and the industry's reaction. Our discussion will focus

primarily on online piracy, as that is where we believe the greatest threat will be going forward.

Figure 23. Timeline of Music's Progression, Four Stages: 1997–2003



Source: Smith Barney

Piracy began to expand from a confined problem in 1999.

Beginnings of a Tremor: Stage 1

Piracy was a much smaller problem through early 1999, when technology started to catch up with consumer demand for music. With the proliferation of CDs, online access, and MP3 players, the problem began to swell. Counterfeits remain more of a big city and emerging market problem, although as better and more-affordable CD recorders have come to market, enabling CD replication operations to function profitably on a smaller scale, these too are expanding their output and reach.

In 2001 the industry began to show signs of coordinated opposition, but the retail system remains under pressure.

Ground Starts to Shift: Stages 2 and 3

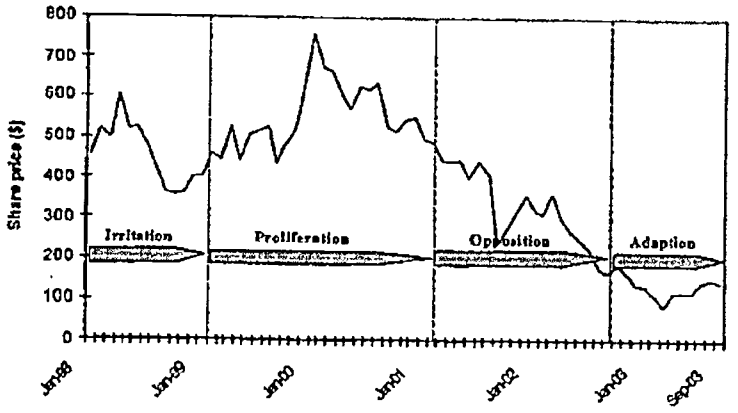
Throughout 1999 and 2000 music piracy grew significantly, with only occasional one-off attempts to stop it by industry participants. Finally, in 2001, the music industry began to fight back in a coordinated way and the RIAA enforcement division became increasingly vocal and aggressive. Industry efforts to combat piracy have included filing court cases to shut down offending websites, making raids to halt the production of counterfeit CDs, and placing decoy music files online to try to stop individuals from downloading files illegally. More recently, the RIAA's approach has been to try to affect individuals' behavior rather than only focusing on providers of pirated music. To that end, the RIAA has been targeting businesses and universities, asking them to disallow illegal networks on their systems. And legal actions have moved down to a personal level, with even individuals on illegal networks being sued. This is akin to prosecuting shoplifters. One thing that remains clear is that the traditional retail distribution market is under pressure. Therefore, even while this opposition strategy continues, over the past year music companies, retailers, and new distribution entrants have been trying to find ways to continue profitably within the emerging model. One example of this evolution is a partnership between in-store retail and online, as with the recently announced cross-promotions by RealNetworks' Rhapsody online service and the consumer electronics merchant Best Buy. Since August 18, 2003, customers at the 560 American Best Buy stores are now able to sign up via interactive kiosks for Rhapsody, and Best Buy salespeople also endorse Rhapsody when selling computers. It is too soon to tell what kind of synergies may develop or what the revenue potential is for the partnership.

EMI's share price fell as piracy progressed.

Looking again to EMI's experience, we can see how the stock has performed against the backdrop of the progression of piracy in the music industry. As piracy really began to take hold, the stock dropped sharply. This is not implying that piracy is the only reason for the drop in the share price, but we believe it is a significant one.

Figure 24. EMI's Share Price and Piracy's Progression, 1998-2003E

Price in British pounds



Source: StockVal and Smith Barney

Companies that will be the most successful and are able to maintain or even improve their valuations are those that take a two-pronged approach: achieve efficiencies in their current model and develop a strategic advantage in the emerging distribution model.

Adaptation — Thriving in the New Competitive Landscape

Record companies seem to fear new formats cannibalizing existing sales.

Can the tide be changed? The music industry is struggling in the fourth and final stage of piracy progression — adaptation. Part of the problem is that record companies seem to be trying to find an online subscription model solution that will generate incremental revenues without cannibalizing traditional record sales. There is a better approach that has been proven successful historically. Record companies are starting to realize that, although new formats probably will cannibalize existing ones, the formats should be embraced rather than feared, and capitalizing on this shift can perhaps grow the market over time.

The new competitive landscape includes four key kinds of participants, each of which we will examine in further detail:

- traditional music companies with physical music sales;
- legitimate online distributors;
- illegal online distributors; and
- pirates of physical music content.

Traditional Sales — Efficiency in Current Operations

We believe companies will need to improve their margins on current operations.

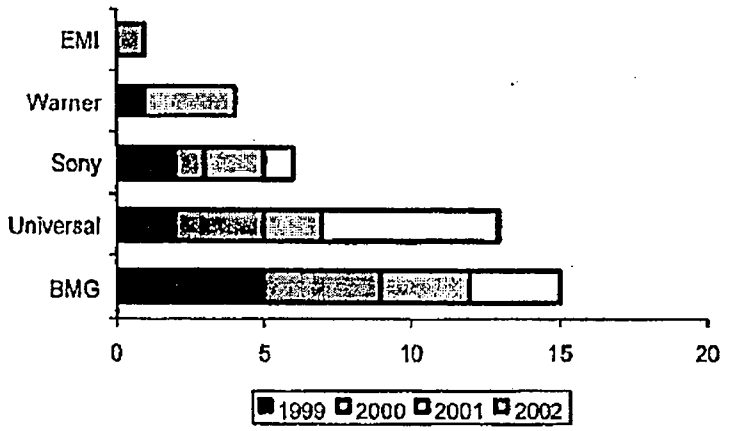
New business models often also mean new cost and revenue structures, and we feel that even companies that are able to capitalize on the new emerging channels will not be successful if they are unable to adjust their margins on current operations. In order to see valuations improve, there are a few measures we feel music companies must show they are undertaking, including margin improvements and efficiencies in distribution and production. As sales continue to decline, the necessity to focus on improving margins becomes more evident as economies of scale cannot be relied upon for profitability growth. Higher market share no longer translates directly into higher profitability largely because there is less upside benefit from hits than there was in the past, in our view. Historically, music sales have been hit-driven and the top few albums have swayed music division results. This is because there are efficiencies in marketing, producing, and distributing many units of a single album versus selling the same number of units on multiple albums.

Universal and BMG have relied most heavily on hits in the past.

However, hit albums have lost their impact over the past couple of years and their contribution to revenues and unit sales is declining. Of the 30,000 CD titles released in the U.S. last year, only about 400 (1%) sold more than 100,000 copies, while 25,000 sold less than 1,000 copies. A significant reason for this trend is that best-selling albums are usually targets of piracy, decreasing the level of legal sales. Universal and BMG are likely going to be most affected, as they have relied more on hits to drive their revenues since 1999. During this four-year period, BMG and

Universal have released 15 and 13, respectively, of the total top ten albums in each year (for a total of 40 albums). The remaining three majors had a total of 11 of the top albums, with Sony releasing six, Warner four, and EMI one.

Figure 25. Number of Top Ten Hits, 1999–2002



Source: SoundScan

Music studios are taking necessary steps to improve their operating margins, in our view.

We believe the companies that will perform the best going forward are those that not only rely on cultivating and promoting hits that drive the top line, but also focus on improving their operating efficiencies. It appears the music studios agree; we can see the results of their efforts to improve operating margins, particularly at EMI and BMG. Their ability to reduce the cost of sales — such as distribution, marketing, and promotion spend — in line with the decline in turnover is a key. During 2002, EMI and BMG each significantly improved their operating margins, Warner did to a lesser extent, and Sony has recently implemented some cost-cutting measures but has not yet seen the benefits. Online distribution, which is much cheaper than physical production and distribution, may be a key element of continuing to improve profitability.

Figure 26. Operating Margins, 2001–02

$ in million

	2001		2002		
	Revenue ($M)	Operating Margin	Revenue ($M)	Operating Margin	Margin Improvement
Universal	$7,073	11.0%	$6,790	8.9%	(220)bp
Sony	4,818	3.2	5,300	NM[a]	NM
Warner	4,038	9.5	4,200	11.5	190bp
EMI	3,978	7.8	3,540	11.7	390bp
BMG	3,220	1.1	2,930	4.6	350bp

(a) Operating margin was negative.

Source: *Music & Copyright*, company reports, and Smith Barney

Online Music Ventures — The Battle of Good vs. Evil

The industry's challenge lies in converting freeloaders to paying online customers.

We believe online music distribution is both an enormous new revenue opportunity for a declining industry and the potential source of its downfall. According to the International Federation of the Phonographic Industry (IFPI), in 2001 there were approximately 3 million users and 500 million files available at any one time on all existing peer-to-peer services. The IFPI does not have a more recent estimate, but with an increase in households going online, combined with consumer awareness of the ability to download music, we believe the number of users has grown by several hundred percent since 2001. We recognize there are many files consumers download for free but would not be willing to pay for. However, the industry's challenge — and its opportunity — lies in converting those users to legitimate paying customers. Music came online for free in line with general sentiment at the time that everything on the Internet should be free. Now the industry needs to convince people to pay for what they were getting for free. Some companies have been successful in generating online revenues, such as the *Wall Street Journal Online's* conversion to a paid subscription model, and music is striving to apply the lessons.

Legitimate online alternatives are available, but most have not provided a compelling offering.

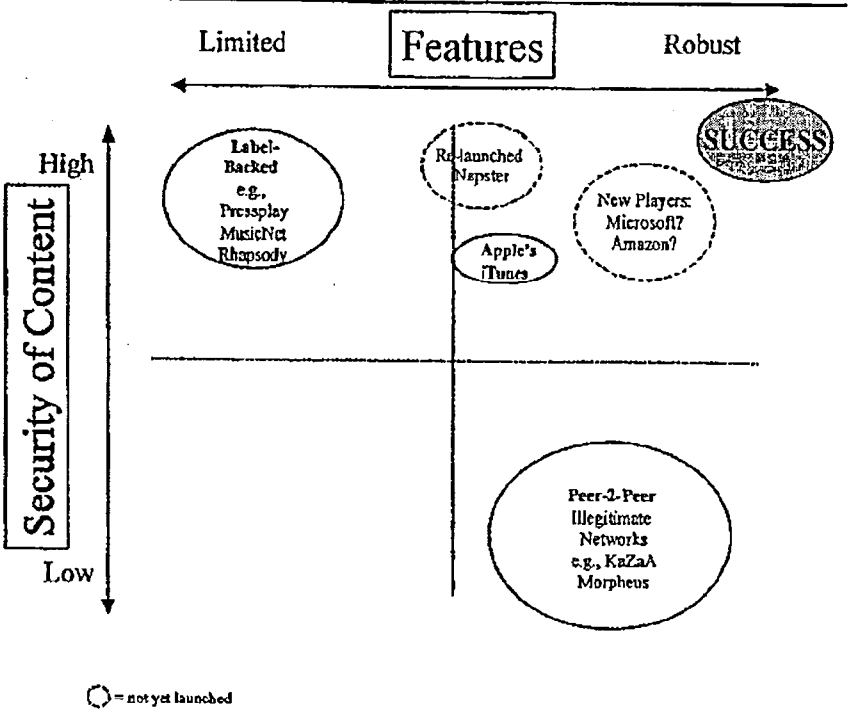
Most parties agree that music will always be available for free somewhere on the Internet, despite costly court battles to shut down illegal sites, but the aim is to bring the proliferation of sites under control. More than a dozen music subscription platforms have arisen over the past year, and the ultimate success of legitimate online music services depends on their ability to provide a compelling consumer proposition that offers music and flexibility with ease of download while protecting themselves from unlimited sharing. Having to compete with free services, these pay-for propositions might win popularity with consumers if they are able to provide the same degree of flexibility and music ownership. Therein lies the challenge.

Tug of War: Features vs. Security

Legitimate services are playing a delicate balancing act between security of content and appeal of service.

Digital music distribution services, both legitimate and non-industry supported file sharing, all fall at a crossection of two continuums (see Figure 27). On one side is the features they offer and on the other is the security of the content they provide. In essence, it is a tug of war between what consumers want and what record labels are willing to provide, i.e. features versus security of content. The one thing that is clear is that record labels need to do more to wean people away from file sharing services. Whether we like it or not, the availability of the file-trading networks has given music consumers a taste of what it means to have near-instant access to their favorite music for free, to listen to on their computers, to burn onto CDs, and to share with friends and others on the network. Piracy is a behavior issue as much as a pricing one. We believe that this newly created consumption channel will not disappear and that the successful players will recognize and capitalize on it. Finding the right price point that will lure people into paying while still giving record companies a profit is key. Apple's new iTunes service has come closest to the desired upper right-hand corner of the matrix. It combines a relatively large song library and flexibility to listen to and burn songs on CDs and portable players with measures to prevent wide-scale illegitimate sharing. But it still falls short of the ideal due to its limited song availability and some technical limitations on usage.

Figure 27. Landscape of Online Distribution Players



Source: Smith Barney

Music companies seem to be closing in on a viable solution.

The industry needs to aggressively move forward to enable legitimate online models. The past three-plus years have been evolutionary as record labels and online music services have been trying to figure out how to best convert users of free online services into paying customers. The music companies and some technology players tried different business models once they recognized the current model did not work, and we believe they are closing in on a solution. (See Figure 28 for a full description of the current label-backed online services.)

Pirates Are Still Out In Full Force: Peer-to-Peer Networks

There are numerous peer-to-peer networks that facilitate illegal file sharing.

The music industry is in a drawn-out battle with online file sharing networks. The innovator Napster operated through central servers through which all searches were conducted. The benefit to the music industry of this configuration was that it was easily shut down by removing the central servers. With Napster's demise, a number of decentralized replacement peer-to-peer networks arose (i.e., sharing is done directly among end users), which makes it more difficult to control and track users.

Peer-to-peer service KaZaA has an estimated 250 million users.

It is hard to estimate the actual number of unauthorized private downloads. To utilize most of the file sharing services, users have to download the proprietary software. The number of users who have downloaded the software is a key indicator to help us gauge the level of illegal file sharing. According to CNET.com, KaZaA is the most popular service with almost 250 million users worldwide. CNET tracks

downloads of all types of software and KaZaA has been on its top ten downloads chart for more than a year. Two other services, Morpheus and iMesh, have had 117 million and 61 million downloads, respectively.

Label-Backed Endeavors Are Plugging Along

The music companies have launched online offerings, none of which has been successful.

The first significant challenge to the free peer-to-peer (P2P) services kicked in during December 2001, when the major labels launched MusicNet and Pressplay. Pressplay was a joint venture between Sony and Universal and MusicNet was the brainchild of Warner Music Group, BMG, EMI, and Real Networks. In their attempt to lure more customers with a wider choice of songs, the labels owning MusicNet have made their catalogs available to Pressplay and vice versa. However, when the services were originally introduced they only allowed users to essentially rent music for a limited time. Downloaded files expired over a set period and consumer flexibility in usage of the music was extremely limited, particularly relating to file portability.

We believe that if a subscription model offers desirable proprietary content, then perhaps it will be more successful.

These early platforms followed a strict subscription business model, but it has become evident that there are a number of problems with that framework. The first is a behavioral issue. Historically, consumers have not paid a monthly fee to have access to music, and it appears that this is not appealing to them. In the past, there was a similar argument in the TV sector when skeptics doubted viewers would pay for cable when network access was available for free. The cable subscription model took hold because people were willing to pay for additional content. We believe that if a subscription model offers desirable propriety content, such as concerts or prerelease songs, then perhaps it will be more successful. The second problem is the confusion around the pricing and features of the subscription offerings. It did not seem to be clear to consumers what they would actually get for their monthly subscription. Many of the services had a tiered pricing structure, making them even more complicated.

Intellectual Property Distribution Is Tricky

We believe allowing flexible ownership of music purchased online will be key.

Finally, the ownership of the music is an issue for subscription services. Most services offer predominantly temporary or tethered downloads, access to which expires when the user's subscription finishes. Consumers do not find the prospect of losing their music once they stop paying the monthly fee appealing. That would be like buying a CD and throwing it away after a month. Instead, buyers want to become full owners of music — they want to download it, burn it onto CDs, and listen to it on the computer and on portable players. PressPlay was the only service with which subscribers could take music off a desktop computer and burn CDs. However, even that feature was a bit misleading because PressPlay's CD recording had severe restrictions, with only a select number of tracks deemed burnable and a very limited number of burns allowed per month. The reason for all these restrictions was that the leap from streamed content to downloadable content gets trickier when negotiating with labels.

The Industry Is Learning

Legitimate services are beginning to provide more flexibility.

Increasingly challenged by the new and re-launched entrants to the free online music market, the legitimate services now provide more flexibility. They offer tracks for download to a CD-R or hard drive, but they still place varying restrictions on further

uses of the music and have complex pricing plans. Also, many of them lack chart hits or a full repertoire of major artists. Legitimate services, however, are highlighting features they do offer that the unauthorized websites do not, such as a lack of advertisements and viruses and the availability of liner notes and editorial content.

The availability of individual songs may encourage purchases by customers who do not want to buy an entire CD.

There is evidence that consumers would be willing to pay for online music that offers a good value proposition, with music that is easy to find and download and is probably priced a la carte. The most important part of the value proposition is that consumers have control over the music they buy. Furthermore, we think the ease of buying singles online might actually grow the music market over time. Often music customers seem interested in buying one or two songs, but may not want to spend $11.99–$18.99 for an entire CD or even a few dollars to buy a CD or cassette single. However, they might purchase an online single for the current rate of $0.79–$0.99. To this end, both the labels and the paid music services are experimenting with pricing to best gauge consumer demand. This move is encouraging because it shows the labels are actually interested in developing a market.

Figure 28 illustrates the current legitimate online music services landscape.

Figure 28. Legitimate Online Music Distribution Services

SERVICE	iTunes	PressPlay / Roxio (Napster)	MusicNow	Rhapsody / Real Networks	VeriAudio
Developed by	Apple	Sony Music Entertainment (50%) and Universal Music Group (50%)	AOL Time Warner (20%), BMG (20%), EMI (20%) & Real Networks (40%)	Listen.com	Venture capital firms
Current ownership / plans	Same as developers	Sold to Roxio, which manufactures CD-burning software;	Same as developers	RealNetworks, streaming software company, bought Listen.com in April 2003. Created a joint music service called RealOne Rhapsody.	Same as developers
Launch date	Apr-03	Dec-01	Dec-01	Dec-01	Apr-99
Availability	Available to Mac and Windows users.	Pressplay website and various distribution partners where it is private-labeled. Also available at www.napster.com	Distributed through AOL (only to AOL subscribers) and RealNetworks	Listen.com website and various distribution partners where it is private-labeled.	MusicNow website and various distribution partners
Pricing	$0.99 / song a la carte	$10 / month for streaming music and downloads (which expire when subscription ends). About $5 per 5 songs to download and burn to CD or portable device.	$3.95 / month for 20 streams and 20 downloads; $8.95/month for unlimited streaming downloads; $17.95 for unlimited streaming and 10 CD burns.	$9.95/month subscription for unlimited streaming. Additional $0.79 / song for download/CD burn.	$4.95 a month for unlimited audio streaming only; $9.95 per month for unlimited streaming and to download individual tracks to listen to offline; In addition, $0.99 cents per individual track to download it to a portable device or burn it to a CD
Model	A la carte	Subscription	Subscription	Subscription	Subscription
Streaming	No (just song previews)	Yes	Yes	Yes	Yes
Downloads	Up to 3 computers	One computer	One computer	One computer	One computer
CD burning	Unlimited individual songs; up to 10 burns per playlist	Yes, bought in packages	Yes, limited per month	Yes	Yes
Portable Downloads	Yes, orto iPod	Yes		No	Yes
Peer to peer sharing	Limited, with Rendezvous feature	No	No	No	No
Strategy / Plans	Launched service for Windows users in October 2003; expand into Europe in mid-2004. Uses music service to help build interest in Macs and iPod devices	Relaunched under Napster name in October 2003. Plans to expand in Europe in mid-2004	Potential to be phased-out since RealNetworks, one of its owners, bought Listen.com		Target 30 - 50 year olds

Source: Smith Barney

Taking Steps in the Right Direction

Adapting to this new reality, music companies have made a three-fold change in their approach. They have:

1 begun to be more flexible in licensing the music;

2 decided to leave the distribution to others; and

3 become more aggressive about pursuing pirates.

EMI has become more flexible in licensing its music for online distribution.

Flexibility in Releasing the Content

Online services have spent the last couple of years trying to persuade consumers to pay for music subscription services instead of downloading them from peer-to-peer services. But to win licenses from the major labels, these services have imposed strict limitations on what consumers can do with their music, which heavily undermines their appeal. EMI has been at the forefront of trying to work within a new framework. In December 2002, EMI implemented a more lenient digital distribution program under which customers are allowed to download tracks permanently and may burn a limited number of personal copies. In addition, EMI provided the flexibility to import recordings to portable devices made available through a number of distributors, including ISPs such as AOL, EarthLink, Verizon, and MSN and music sites like MTV.com, MP3.com, and Listen.com. This marked a momentous change in the attitude of the labels. Another recent notable change has been with Pressplay, backed by Sony and Universal. Under the current pricing scheme, along with the unlimited downloads and streams consumers are able to burn 120 songs a year to CDs after paying an annual fee. Packages that allow more songs to be burned are available for individual purchase.

Even with this new openness, labels still limit music availability. We feel that one way to make the legitimate online distribution systems more viable would be to offer exclusive content, with artists making new or unreleased material available as part of these subscription services.

Most of the record labels seem to be opening up their catalogs to third party online distributors.

Leaving the Distribution to Others

In addition to investing in their own online stores, the labels are opening up their catalogs to third parties that value music and want to generate revenues in the digital domain for copyright owners. For example, EMI Recorded Music has signed more than 60 licensing agreements with numerous U.S. and European online retailers to sell its current hits, old classics, and classical music. Most significant has been the music labels' licensing agreements with Apple's iTunes. Apple negotiated relatively lenient terms for how customers can download the music by convincing the labels that its software would prevent wholesale copying and sharing of the music. We feel these negotiated terms are what gives iTunes its potential success, as it is a download service that gives buyers flexibility in how they use and share their music. There was a breach that Apple quickly fixed when consumers were sharing music without limits soon after the launch, and this may have made the labels somewhat hesitant. However, with iTunes' very rapid success, the labels will likely become more intrigued by the possibility of profitable online distribution that Apple may have pioneered.

In our opinion, the re-launched legitimate Napster may be successful.

In our opinion, signing up for services like iTunes is the most significant move the labels have made. We have not seen the upside from it yet, but we are in the midst of a transformation among the digital distribution players. A few recent moves have indicated a repositioning of the players, with the major record companies getting out of the digital distribution business, focusing on producing and licensing the content, and leaving the distribution more to the technology companies. For example, Sony and Universal sold their service Pressplay to Roxio. Roxio plans to re-launch its music service by early 2004 under the Napster name, which is arguably the most recognized name among customers for digital downloading.

Apple's iTunes is showing great promise with consumers.

Apple's iTunes may very well be one of the key models for selling music online. The service debuted on April 28, 2003 and sold 1 million tracks the first week and averages about 500,000 download sales per week. In July 2003, Apple reported that 6.5 million tracks had been sold and it was close to breakeven. A October 21, 2003 update from the company said the total had reached 14 million after a Windows version of iTunes debuted, and this is expected to accelerate online sales further. The key elements of iTunes' model are the pay-per-song option and the digital rights. Apple's early success suggests that fans prefer systems that allow purchases of songs a la carte. Customers can definitely use the music more flexibly than they have before, but the service still has restrictions — songs cannot be transferred to more than two computers and the same group of songs cannot be recorded to a CD more than ten times.

Technology companies may be the future of online music distribution.

Perhaps iTunes has worked thus far because of its limited exposure risk. It was until just recently available only to Mac users with the latest version of its software in the United States. Macs are 3% of the installed base of computer users, and those with software advanced enough to access iTunes is a subgroup of that total. There are still some obstacles to overcome, primarily technology-related issues, getting big artists to sign up, and settling the licensing terms. Nevertheless, Apple is planning to launch a Windows-based service by the end of 2003. In August 2003, Microsoft announced a pact with Europe's largest digital music site, OD2, to form Europe's first major a la carte online download service. If successful, other players such as Yahoo! or Amazon.com may consider launching competing services.

Industry group RIAA has taken the legal road to action, with some early encouraging results.

Becoming More Aggressive About Pursuing and Prosecuting Pirates

The most recent example of the legal/punishment trend is the RIAA's September 2003 moves to sue 261 individuals for distributing or copying songs illegally over the Internet. With penalties of up to $150,000 per copyrighted piece of material, the potential punishment may be enough to deter the casual downloader of music or persuade him to pay somewhere around $1 for a song. These suits are meant to deter others from illegally sharing music and the RIAA simultaneously instituted an amnesty program, promising not to sue individuals who erase all copyrighted music they have downloaded and who promise to abstain from similar activity in the future. The early results have been encouraging. An NPD survey of 40,000 panelists shows that music files acquired (swapped illegally, downloaded from paid sites, or ripped from CDs) declined from a high of 852 million in April 2003 to 655 million in June 2003, while the number of U.S. households acquiring music files hit a high of 14.5 million in April 2003 before falling to 12.7 million in May and then to 10.4

million in June. More recently, about 2.1 million copies of KaZaA were downloaded off CNET.com in the week ended November 9, down from 4.8 million in the week ended August 17and 6.5 million seven weeks previously.

Physical Piracy Is a Bigger Problem in Emerging Markets

With excess capacity, some disc production plants are believed to engage in illegal replication.

Piracy through CD replication in plants has grown for a couple of reasons. First, there has been increasing competition and overcapacity in the legitimate disc production business, fueled primarily by falling legitimate disc demand and earlier overinvestment in capacity. There has been a steady increase in the number of optical disc plants in recent years, and in 2001 there were an estimated 730 plants in operation around the world, versus 700 a year earlier and 660 in 1999. With the supply outstripping legitimate demand, rather than sitting idle many of these plants are believed to engage in illegal replication.

Figure 29. Excess Capacity in CD Replication Plants, 2001

Units in millions

Country	Estimated Capacity	Total Legitimate Demand	Excess Capacity	% Excess Capacity
Taiwan	8,000	200	7,800	98%
Hong Kong	3,000	140	2,860	95
China	1,800	700	1,100	61
India	750	120	630	84
Singapore	700	70	630	90
Malaysia	500	60	440	88
Indonesia	200	15	185	93
Russia	185	60	125	68
Poland	180	100	80	44
Macau	150	1	149	99
TOTAL	15,465	1,466	13,999	91%

Source: IFPI

Limited legitimate acquisition options may be a contributor to emerging market piracy.

A second reason for the proliferation of physical piracy is the rising demand for music in emerging markets. Many of the replication plants are in countries such as Malaysia that have inadequate legislation and enforcement of copyright laws and have not historically been big markets for the record companies. However, pirates have used the excess capacity opportunity to locally distribute, as well as export the pirated content, and have thus helped develop their own local markets.

The IFPI is active in closing factories engaging in illegal behavior

The IFPI, which acts as one of the industry's prime enforcement agencies, has been at the forefront of the anti-disc piracy efforts through a team of investigators working with governments, police forces, and customs departments. Since 2001, the IFPI has launched an unprecedented number of enforcement actions. Almost 30 million pirated and blank CD-Rs headed for illegal labs and more than 70 pirate CD lines were decommissioned in 2001 and 2002, primarily in Asia. CD-R piracy, in which discs are burned on CD recorders rather than in large plants, is becoming more of a problem in Latin America, primarily in Brazil and Mexico, where piracy used to be driven by imports from Southeast Asia but now are producing mass quantities in small private laboratories. A few countries are beginning to see more

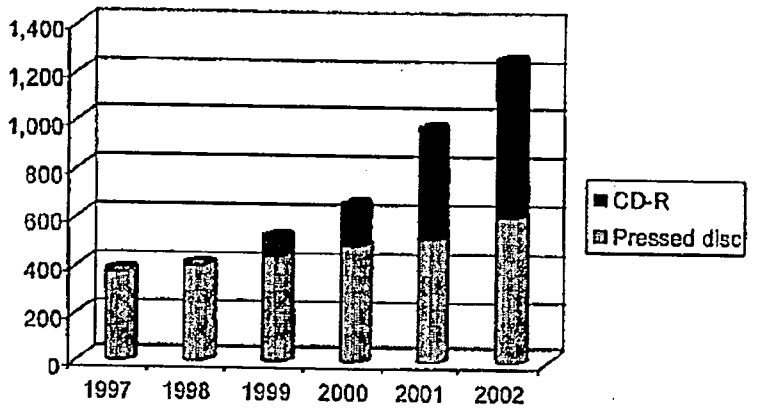
notable improvements in enforcement actions by local police and the introduction of some CD plant regulations. Nevertheless, there are still plenty of countries that are poorly regulated, such as Vietnam, Cambodia, and Russia, where we believe pirating plants are still rampant and growing.

More than 1 billion pirated discs are believed to have been sold worldwide in 2002.

The IFPI estimates that in 2002, 1.2 billion in pirated discs were sold worldwide, split almost evenly between pressed discs and CD-Rs. This is more than a 200% increase from 1997. We estimate these discs are worth almost $15 billion in lost revenues.

Figure 30. Worldwide Estimated Growth in Disc Piracy, 1997–2002

Units in millions



Source: IFPI

The Light at the End of the Tunnel

We believe the music industry is beginning to stabilize.

We performed a scenario analysis to gauge the likely impact of a number of possible outcomes of music piracy to 2005. This analysis forecasts likely physical sales (CDs), physical piracy (counterfeit CDs), legitimate online sales, and online illegal downloads. Our base case assumes that the music industry is finally taking steps in the right direction to curb piracy. Through efforts such as more aggressive legal actions and industry-backed alternatives to illegal downloading, which have shown some early indications of consumer acceptance (e.g., Apple's iTunes), we believe the music industry will begin to stabilize unit sales but will face revenue declines due to falling prices and a shift to downloads from physical sales. (See Appendix A for the details of these assumptions.) We made a few forecasts based on our analysis.

- Overall unit demand for music (including that filled by legitimate sales and piracy) should grow at close to a historical rate, or about 3%. We believe legitimate music unit sales should stay about flat between 2002 and 2005, such that by 2005, piracy will take over 45% of unit demand versus the estimated 41% in 2002 and 20% in 1999.

- Physical disc piracy will probably continue to be a problem, primarily in emerging markets where copyright laws are weak or nonexistent. We expect worldwide unit disc piracy to continue to grow at about 3% per year through 2005.
- In the online arena, we believe that as viable business models such as iTunes and Napster take hold, legitimate music sites should begin to gain some traction but that sales through this channel will likely remain below 1% of the industry total. Due to both the difficulty in shutting down online peer-to-peer networks that facilitate illegal file sharing and already-established consumer behavior in using these networks, we believe illegal music downloads will continue. However, we forecast that their growth will begin to slow and illegal downloads may account for about 25% of units acquired in 2005, up from an estimated 21% in 2002.
- OIBDA margins should improve as more sales are made through online channels, which have much smaller production and distribution costs.

Even a viable business solution might mean a haircut to industry revenue growth forecasts.

These conclusions assume that the music industry continues to invest in artists and repertoire (A&R, which funds the discovery and promotion of new talent) and that music companies continue to produce music consumers want to purchase. It is possible that, with continued decreases in sales, these budgets will be further cut and consumer demand for music will decrease as interest in what is being released declines. It is also possible that even a viable business solution means a haircut to industry revenue growth forecasts. Consumers may purchase fewer full-price CDs and instead pay only for the songs they want through an online service. We are not sure they will buy enough individual songs to make up for the lost sale of the full-price CD. This potential decrease may be slightly offset as consumers who previously chose to forgo buying an entire CD for a few songs they liked might now purchase those songs individually. We plan to carefully watch how these two possibilities evolve.

Will It Be the Best of Times or the Worst of Times? Sensitivities

For the industry analysis, there are three primary unknown inputs that we varied:

1. Overall demand for music;
2. The level of consumer acceptance of legitimate online distribution; and
3. The ability of the industry to curb physical disc piracy.

Overall music demand is expected to grow at 3% annually.

Overall Demand for Music

Our base case assumes that the total demand for music remains at a 3% historical growth rate. This includes all consumption, including that which is obtained without payment. We realize measured demand seems to have been decreasing over the past few years and will likely continue to decline for the next few years, but, as previously discussed, we believe this trend is indicative not of an actual decrease in demand, but rather of a shift in how music is obtained. In the scenario analysis we looked at the outcome given consistent total unit demand growth of about 3.2%, but varying the inroads that both physical and online piracy, as well as legal online sales, can make into total demand.

We estimate a modest level of growth in legitimate online services.

Online Distribution Channels

There are two variables in this analysis: 1) the level of saturation of legitimate online distribution models, and 2) the level of continued illegal proliferation of music. In the base case we assume a moderate level of legitimate distribution (less than 1% of total demand) and continued usage of illegal online channels growing at almost 10% annually between 2002 and 2005. In the bull case we assume that illegal downloads stabilize and grow only 1.4% annually, while legitimate online sites capture almost all of the demand growth. In the bear case we assume that illegal downloads continue to grow sales at almost 10% annually, while legitimate downloads capture only a small percentage of sales.

An estimated one counterfeit disc is sold for every three or four legitimate discs.

Physical Piracy

The base case assumes that one pirated disc was sold in 2002 for every three legitimate discs and that counterfeits grow at a moderate rate. The two scenarios here are: 1) physical disc piracy is curbed and remains at current levels, or 2) it continues to grow.

By 2005, revenues for Warner Music Group may approach the pre-1999 level.

Warner Music Should Eventually Begin to Sing Again

Looking to Time Warner's Warner Music Group as an example, we can see how our expectations are likely to affect the division. We expect Warner Music Group to generate roughly $3.3 billion in revenues (pro forma for the sale of the CD/DVD manufacturing operations) in 2003 and about $252 million in OIBDA. Sales and total OIBDA should see modest improvements as online sales begin to make up for lost physical sales and as illegal piracy growth slows. We expect year-over-year revenue growth to rebound slowly, from a decrease of 4.3% in 2002 to flat in 2005.

Figure 31. Warner Music Group Base Case OIBDA, 1999–2005E

$ in millions

	1999	2000	2001	2002	2003E	2004E	2005E	CAGR '99-'05E
TOTAL REVENUES	$3,615	$3,602	$3,266	$3,124	$3,262	$3,267	$3,267	(1.7%)
Physical Sales	$3,615	$3,602	$3,265	$3,122	$3,229	$3,201	$3,166	(2%)
Online Sales	$0	$0	$1	$2	$33	$66	$100	NM
Total Y/Y Growth		-0.4%	-9.3%	-4.3%	4.4%	0.1%	0.0%	
TOTAL OIBDA	$422	$382	$208	$226	$252	$253	$258	(7.9%)
OIBDA Margin	11.7%	10.6%	6.4%	7.2%	7.7%	7.8%	7.9%	
Physical OIBDA	$ 422	$ 382	$ 207	$ 225	$ 242	$ 234	$ 228	(9.7%)
EBITDA Margin	11.7%	10.6%	6.4%	7.2%	7.5%	7.3%	7.2%	
Online OIBDA	$0	$0	$0	$1	$10	$20	$30	NM
EBITDA Margin	NM	NM	30.0%	30.0%	30.0%	30.0%	30.0%	
Total OIBDA	$422	$382	$208	$226	$252	$253	$258	(7.9%)

Source: Company reports and Smith Barney

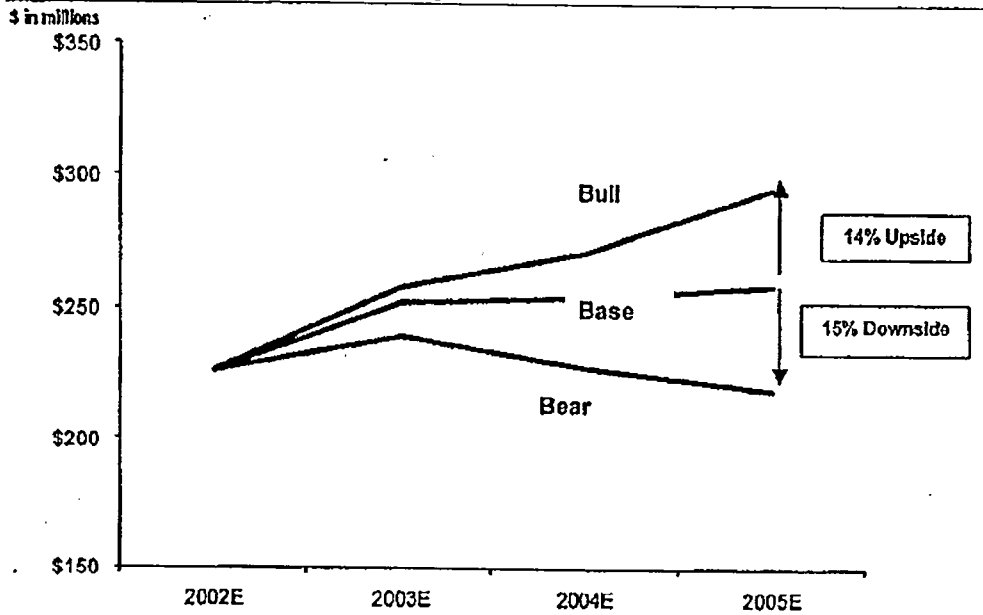
We could see 14% upside or 15% downside in OIBDA, depending on the piracy endgame.

It's a Sensitive Issue...but with Positive Indications

Depending on how this game plays out, we think there could be a substantial swing in Warner Music Group's earnings, with as much as 14% upside potential in 2005 from our base case to our best-case scenario, under which unit demand growth stays unaffected at 3%, legitimate online distribution takes hold to grow nearly 350% per year versus nearly 250%, illegal online unit sales decline by nearly 24% on an annual basis versus the base case of a 13% decline, and physical disc piracy is curbed from 8% growth to 7%. In our worst-case scenario — under which overall

music demand again is unchanged, illegal online distribution flourishes without the legitimate channel going anywhere, and physical disc piracy continues to grow — we forecast 15% OIBDA downside from the base case in 2005. We have seen some positive indications, such as the early success of Apple's iTunes, increasing legal activity, and more effective raids on illegal CD plants, and we believe there could definitely be upside from the base-case scenario.

Figure 32. Warner Music Group OIBDA Scenario Analysis, 2002–05E



Source: Smith Barney

Figure 33. Warner Music Group OIBDA Scenario Analysis, 2002–05E

$ in millions

	2002	2003E	2004E	2005E	CAGR
Bull	$226	$257	$271	$294	9.3%
Base	226	252	253	258	4.6%
Bear	226	239	227	218	-1.1%

Note: Figures are pro forma for the CD/DVD manufacturing operations sale, which is expected to occur at the end of 2003.
Source: Smith Barney

Film...Take Two and Action!

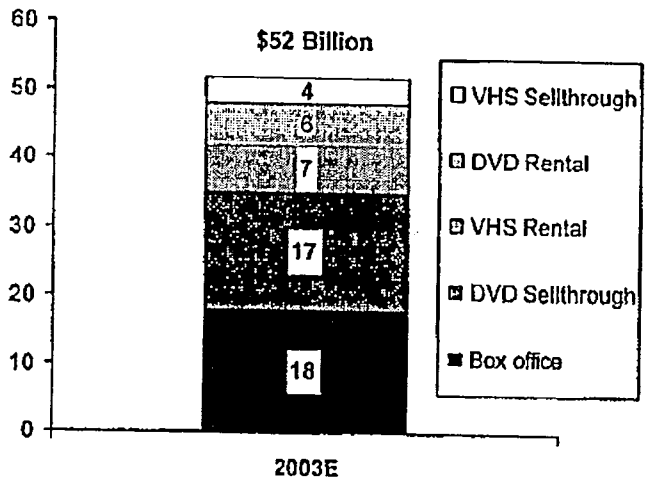
- We believe piracy is an increasing but controllable threat to the global film industry that may steal 6% ($3.5 billion) in film demand in 2003 and 9% ($5.4 billion) in 2005. Technology protection (e.g. DVD encryption and large file sizes) has been key to limiting film piracy to date, and long-term industry prospects remain strong.
- International markets have seen the most devastation due to weak or nonexistent anti-piracy laws. In some countries, up to 90% of film demand is estimated to be met by pirated products.
- DVDs are the fastest-growing segment for the film industry and the most susceptible to piracy. A contributor to the problem is overcapacity at Asian disc manufacturers.
- We do not think the box office window — which contributes 30%-40% of film entertainment revenues — will be negatively impacted by piracy due in part to the social element of film-going. Therefore, we expect that film exhibitors AMC and Regal are not likely to see significant revenue losses related to piracy.
- Instead, we believe MGM has the most piracy risk of any of the studio companies, based on its higher-percentage contribution from film, followed by Fox Entertainment and Disney. Viacom and Time Warner are more diversified and less exposed to film piracy. Based on our sensitivity analysis, 2005 company value at risk due to piracy ranges from 0%–24% upside in the best case to 0%–40% downside in the worst case. Finally, as a video retailer, we think Blockbuster's value at risk is highest of all of the companies we cover, at more than 40% on the downside.

Defining the Market

The film industry is expected to generate $52 billion in legal revenues in 2003.

When we speak of the worldwide film market we include two primary elements — box office and home video, with home video including sales and rentals of DVDs and CDs. In 2003, we estimate consumers will spend approximately $52 billion in legal revenues on these movie outlets combined. This total will be captured as revenues by film production and distribution companies (Time Warner, Fox Entertainment, Walt Disney, MGM, and Viacom), box office exhibitors (AMC Entertainment and Regal Entertainment), and home video retailers (Blockbuster). For the purposes of this report, we look solely at revenues recognized by content owners and disregard revenues that accrue to theater exhibitors, as we do not expect any meaningful impact from piracy on box office revenues.

Figure 34. Worldwide Film Market, 2003E



Source: Company reports and Smith Barney

What Is the Threat to Film?

Advances in reproduction, transmission, and storage technology are transforming the film industry.

It is clear that the film industry is at a juncture, where the inevitable growth of technology is coming into conflict with the traditional strategies of copyright owners (i.e., film studios). There is no doubt that the rapid shift to digital is changing the rules of the game. Reproduction, transmission, and storage technology are all progressing exponentially, resulting in an unprecedented power to copy, save, and distribute all types of media. Reproduction technology is becoming inexpensive and its quality is high. Transmission technology, including satellite, cable, broadcast, and broadband Internet, has linked consumers around the world at ever-increasing speeds and with competitive pricing. Storage technologies have also quickly expanded in capacity as total storage media costs have plummeted so entire movies can easily fit on a single disc.

Theater as a social institution has limited the piracy impact on exhibitors, in our view.

This all means that the film industry is going to be increasingly susceptible to piracy, just as the music industry was. However, due to current technological limitations (particularly the large size of film files and the limited penetration of broadband) and the nature of movies (the appeal of the theater-going experience for consumers), we are optimistic about the outcome of this battle. There are two primary areas that we think will be essential in securing a positive future for the movie industry. First is the necessity to influence consumer behavior to adopt new legal channels rather than allowing them to become comfortable with illegal ones from the outset. Second is the prospect for new revenue opportunities, for which there are two possible outcomes. The film content companies may become frozen with fear over new technology that could facilitate piracy, or they may use this opportunity to find new revenue streams. We believe there are indications that they are taking the second path. It could be a while until we see the results, but we think they are on the right track.

Most Likely Scenario

DVDs are the primary growth engine of film and the most vulnerable to piracy.

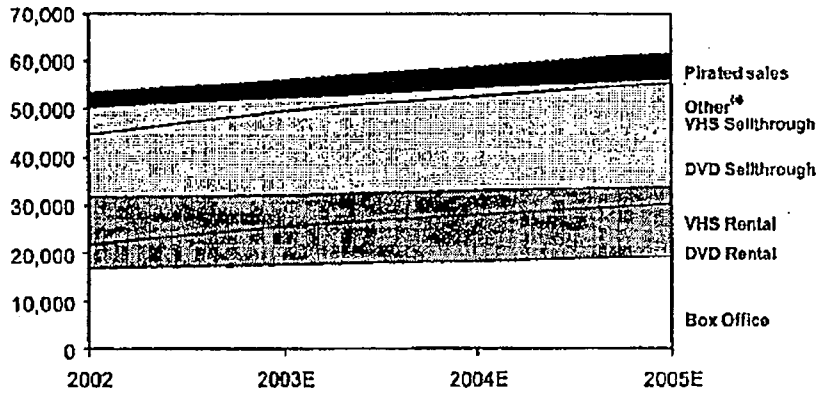
Film is a fairly mature but growing industry, with DVD as a big growth driver. Worldwide box office revenues of roughly $18 billion in 2002 are growing at a relatively steady state of about 5% per year, with ticket price increases at times making up for slower admissions growth. The post-box office window, particularly DVDs, is the primary growth engine, with DVD rentals and sell-through (which accounted for $12 billion in revenues in 2002) expected to grow at an average rate of 18.5% per year from 2002 to 2005. We believe the box office window will remain relatively untouched by piracy, but the faster-growing DVD category will feel the most pain.

In 2003 we believe pirated downloads and bootlegs will take $3.5 billion from the industry, representing 6.3% of total movie demand.

We estimate that 70% of pirated movies are directly taking money from the film entertainment industry. This is because we believe roughly 30% of bootleg purchases or movie downloads would probably not have ended up as box office tickets or video purchases as the consumer would not have wanted them at full price. In 2003, we believe that this 70% of pirated downloads and bootlegs will take $3.5 billion from the industry, representing about 6.3% of total film and home video demand. We predict that this impact will increase about 30% annually through 2005, becoming a $5.4 billion problem and taking 9.0% of film/home video demand. While this may sound like a looming problem, it is still a far cry from the 40% share that pirates have stolen from the music industry.

Figure 35. Film Consumer Expenditures — Base Case, 2002-05E

$ in millions



(a) Other legal revenues include a variety of emerging channels including online and video on demand.
Source: MPAA, *Video Store Magazine*, and Smith Barney

The Three Faces of Piracy

We believe film will not be as hurt by piracy as much as music was.

Nevertheless, film piracy is a real threat and we think it will become a bigger problem in the short term before the situation improves. But due to better prevention (i.e., DVD encryption), earlier and more aggressive enforcement, and offering legal alternatives to pirated mediums we believe film will not be as damaged by piracy as much as music was. There are three primary forms of piracy in the film industry.

Some pirated films are made by recording movies off of theater screens.

Copies of Theatrical First-Run Films

Bootlegging of films that have just opened or not yet officially opened in the theater can take one of several forms. The most common is a pirate using a hand-held video camera to record films off of theater screens and then copy them onto blank videocassettes and optical discs. Illegal copies are also sometimes made from legitimate advance copies used for screening or marketing purposes, or a theatrical print might be stolen and copied. These copies are then distributed in the U.S. and often shipped overseas for sale before the film's international theatrical release.

Counterfeit copied discs are quick to replicate and are of high quality.

Commercial Disc Piracy

We see disc piracy as the greatest immediate threat to the film industry, particularly with the dramatic increase in DVD player penetration over the past couple of years and the improvement in DVD recorders. Pirated discs, which consist of lower-quality video compact discs (VCDs — similar to DVDs but without some of the audio and video enhancements) and higher-quality DVDs are relatively inexpensive to manufacture and easy to distribute. These discs are usually made from an original DVD, so the quality is very high. Unlike traditional analog piracy (i.e., VHS format), a digital production facility can churn out a huge volume of illegal discs in a relatively short time. To illustrate this, a facility with disc pressing equipment can produce about ten times more VCDs or DVDs than can an average illegal videocassette duplication facility.

Online sharing will probably increase as file sizes compress and connection speeds improve.

Illegal Online Downloads

With the advent of the Internet, pirates can offer film files to millions of people using online communication avenues such as chat rooms, newsgroups, websites, and peer-to-peer sites. These files consist of both high-quality films taken directly from original or commercially pirated DVDs and poorer-quality files uploaded from bootlegged films. Online piracy for films is a relatively new phenomenon that is, unfortunately, growing as connection speeds get faster and file sizes compress.

The form that currently causes the most damage is commercial disc piracy. However, we believe that just as the music industry was blindsided, the film industry, if online downloading is left unchecked, could suffer much damage long term.

Film's New Reality

Film companies seem to be actively searching for legitimate alternatives.

The film industry is waking up to the digital reality. Studios have realized they cannot assume digital delivery of film content might cannibalize sales and therefore stay uninvolved with the new technology. By not providing a legal digital alternative, they almost encourage illegal downloads by failing to offer something for which demand has been amply demonstrated. The key is to get customers habituated. New and emerging trends on the Internet provide consumers with control and empowerment, giving people a sense they can have what they want when they want it. So unless a legal marketplace is available, consumers will find other ways to pursue their desired ends. The good news is that the film industry has begun to try to create a legitimate marketplace that serves this tech-savvy consumer group.

The biggest threat comes from the ability to share with millions of people and make many high-quality copies.

With the emergence of each new technology, the fears of the motion picture industry have grown, and perhaps rightfully so. When television and the VCR were invented, studios feared the end of theatrical movie releases as well as the supposed harm from one-at-a-time copies. Today's technologies make these perceived threats seem naive and relatively harmless. With high-speed connectivity and the Internet, the threat comes not from renting a cassette or ordering a movie on pay-per-view and making a copy for a friend, but from the ability to download from a stranger, making available millions of copies with the touch of a keystroke, or making thousands of high-quality copies off of a single DVD. However, the increased profitability of new formats like VHS and now DVD has helped to inject new life into the film industry, making the initial fears about new technology seem overblown in hindsight.

A Growing but Controllable Threat

Film is at an advantage over music in the fight against piracy.

Compared to the experience of the music industry, film has a few things on its side when it comes to piracy. First, film has some technological advantages that have limited the amount of online downloading thus far. Downloading a full-length film (typically 800 MB taking several hours) is not as easy as downloading a song (4–5 MB taking several minutes). However, film downloads will likely increase as online connection speeds get faster, file compression technology improves and broadband penetration increases. Second, the film "experience" is different from the music experience. During the theatrical release window, film going is often a social activity and we believe it is unlikely to be damaged too much by entertainment piracy. However, the post-box office window, which is becoming an increasingly important revenue stream, is more susceptible, in our opinion. Piracy is still a problem for home video, threatened by both counterfeit DVDs and illegal downloads. Finally, the studios have the benefit of observation and analysis, and in some cases (e.g., Time Warner) they have their own experience in music piracy. As discussed in the music section, the music industry had the unfortunate role of leading the way through the entertainment industry piracy jungle. Other content industries have learned from that experience and are even piggybacking off of some of the precedents music has set.

Importantly, the film industry has been a good student. Besides constantly introducing new creative features that enhance the current DVD product (such as directors' cuts, behind-the-scenes footage, etc), the studios are also working hard on the next generation format: high-definition DVD. With television signals being forced to be broadcast only in digital beginning in 2006, the transition to high-definition television viewing could represent another new opportunity for the creative entertainment studios to tap the households that may not have switched to DVD players, and galvanize sales of their library as well as current release products.

If Film Followed Music's Path...

We believe piracy damage will double from $2 billion in 2002 to $4 billion in 2005.

We analyzed the industry's sensitivity to various piracy scenarios. Our current models and company valuations assume the most likely scenario of moderate but controlled piracy growth, as shown in Figure 35. While we believe this scenario would not cause a decline in total industry dollars, we think with lessened piracy, industry growth (particularly in DVDs) would be greater. We believe the picture in

the film industry will get a little darker before it improves. However, given the industry's aggressive approach to piracy, we feel upside from the base case with stronger revenue growth (6.3% versus 3.4%, led by DVD revenue growth of 23.4% versus 18.5%) is not an unreasonable outcome. In this situation, the pirated portion of demand would only be about 1% by 2005, representing less than $500 million in sales. We assume that the box office receipts remain relatively unchanged, while home video sees most of the upside. This best case also assumes that piracy is reversed in both illegal downloads and physical counterfeits and bootlegs, declining at about 36% annually from 2002 to 2005 versus approximately 30% annual growth in the base case. This more positive outcome rests primarily on consumer acceptance of legitimate online channels and industry efficacy at stemming physical piracy, particularly in Asia and Latin America, where it is a more significant problem.

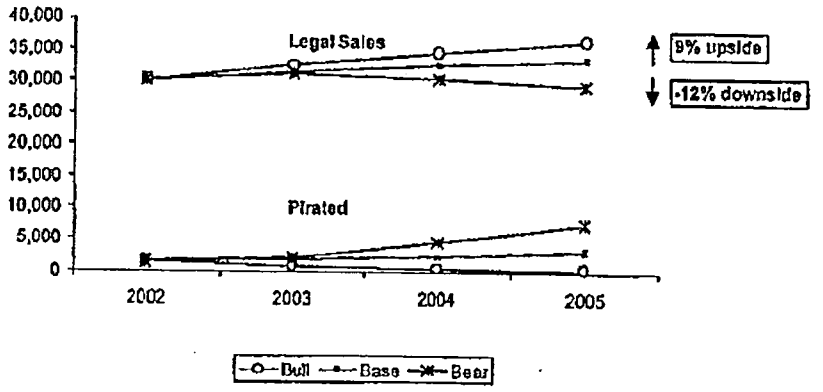
In our worst-case scenario, piracy would take $15 billion in revenues from the film industry.

The worst-case scenario would be one in which the film industry followed the music industry's path. In this scenario we estimate that the illegal share of sales could grow to more than 13% of demand by 2004 and more than 20% by 2005, representing more than $7 billion in sales in 2005. With these assumptions, total legal sales would decrease by 1% per year through 2005, despite a 10.6% annual increase in legal DVD sales/rentals (versus the 18.5% annual increase we forecast in our base case.)

Figure 36 shows our consumer expenditure expectations for the industry — base, worst-, and best-case scenarios. It includes all retail revenues to the industry (not just the studios) from domestic and international box office receipts and home video rentals and sales. In the bull case we estimate that consumers will spend 9% more than in the base case through legitimate channels in 2005, and in the bear case about 12% less.

Figure 36. Film Customer Expenditure Scenario Analysis, 2002–05E

$ in millions



Source: MPAA, *Video Store Magazine*, and Smith Barney

Figure 37. Film Industry Consumer Expenditure Scenarios, 2005E

$ in millions

	Bear Case	Base Case	Bull Case
Legal Sales	$29,322	$33,455	$36,357
Pirated Sales	7,422	3,290	387
TOTAL	36,744	36,744	36,744
% of Market Pirated	20%	9%	1%

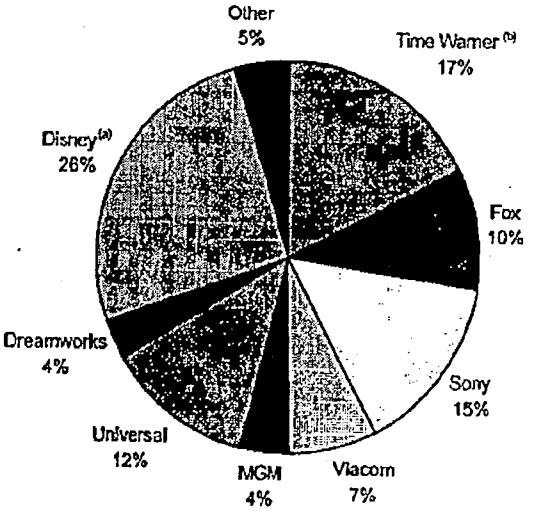
Source: MPAA, *Video Store Magazine*, and Smith Barney

A Few Studios Have the Most to Lose

The top five studios account for 80% of annual box office revenues.

In 2002, consumers spent $50 billion in legitimate sales on movies, with contributions from domestic box office receipts ($9 billion), international box office receipts ($8 billion), and worldwide home video rentals and sales ($33 billion). Historically, box office revenues have grown at a 6% compound annual growth rate, while the home video market has increased at a compound annual growth rate of about 5%. Based on revenues, the top five studios account for 80% of box office revenues, with more than a 10% share each. These five companies are the ones that have the most at stake and that we will want to watch most closely.

Figure 38. Market Share — Domestic Box Office as of September 30, 2003



(a) Disney includes Disney, Buena Vista, Miramax and Touchstone. (b) Time Warner includes Warner Bros. and New Line.
Source: Nielson EDI and Smith Barney

Moviemaking is a hit-driven business and OIBDA growth varies for each company.

Revenues for the film divisions of these companies have grown relatively steadily over the past several years, with expected average growth rates ranging from 2% to roughly 12% from 2000 to 2004. Operating income, on the other hand, is not very stable due to the risky hit-driven nature of moviemaking. For the most part, earnings have generally been increasing year over year for the major studios, but these growth — and sometimes decline — rates have varied more significantly.

From 2000 to 2004, for the companies under our coverage universe, we estimate compound annual growth rates for OIBDA range from a 7% decrease (MGM) to a 55% increase (Disney).

Figure 39. Filmed Entertainment Revenues, 2000-04E

$ in millions

Company	2000A	2001A	2002A	2003E	2004E	CAGR
Disney	$6,011	$6,009	$6,691	$7,643	$7,926	7.2%
Fox	3,953	3,676	4,048	4,498	4,685	4.3
MGM	1,054	1,218	1,417	1,550	1,661	12.0
Sony	5,069	5,605	7,329	6,865	7,127	8.9
Time Warner	8,119	8,759	10,040	10,561	11,222	6.4
Universal	4,063	4,370	4,516	4,287	4,398	2.0
Viacom	2,376	2,565	2,591	2,651	2,812	4.3
	$30,646	$32,401	$36,632	$37,556	$39,831	6.8%

Note: US$1=109.54JPY; (b) US$1=0.87EUR
Sony is covered by Smith Barney analyst Kiyotaka Teranishi and Vivendi Universal is covered by Smith Barney analyst Patrick Wellington.

Source: Company reports and Smith Barney

Figure 40. Filmed Entertainment OIBDA, 2000-04E

$ in millions

Company	2000A	2001A	2002A	2003E	2004E	CAGR
Disney	$141	$307	$319	$658	$820	55.2%
Fox	158	345	544	717	691	42.4
MGM	200	102	(40)	90	151	(6.9)
Sony	39	285	538	183	274	62.4
Time Warner	796	1,017	1,232	1,379	1,500	17.2
Universal	49	673	768	345	480	75.4
Viacom	215	220	258	267	288	8.5
	$1,609	$2,949	$3,620	$3,639	$4,193	27.1%

Note: US$1=109.54JPY; (b) US$1=0.87EUR
Sony is covered by Smith Barney analyst Kiyotaka Teranishi and Vivendi Universal is covered by Smith Barney analyst Patrick Wellington.

Source: Company reports and Smith Barney

Risk Factors

In order to determine which studios will be the most affected by piracy, we analyzed the sources of their revenue streams and the magnitude of what is at risk.

Our analysis weighed four factors:

1. The percentage contribution filmed entertainment makes to the parent company;
2. The percentage of revenues generated by box office versus home video;
3. The total dollar amount filmed entertainment generates; and
4. The studios' reliance on blockbusters.

In our view, MGM, Fox, and Disney have the most piracy risk exposure.

We ranked these factors according to how susceptible we feel they make a company to the risk of piracy. The most significant factor is the percentage contribution (in revenues and OIBDA) the filmed entertainment division makes to the parent company because this indicates how much of the entire company is exposed. Next in importance is the percentage of revenue the division generates from home entertainment because we feel the box office faces a much smaller threat from piracy, while DVDs are the fastest-growing segment and the most vulnerable. The next factor we consider is the total dollar amount a company generates from filmed entertainment, as this represents the total dollars at risk. Finally, we evaluate the reliance of a company on its hit movies since blockbuster movies tend to be pirated the most. Of the companies in our universe, we found that MGM has the most exposure, followed by Fox. From this quantitative analysis, Warner and Disney have similar levels of exposure. However, Time Warner is a more diversified company than Disney. Therefore, we feel Disney has more indirect risk associated with film piracy, where a number of streams of revenues (e.g., box office, video, consumer products, and live theater) can come from a single asset. Finally Viacom's exposure through its Paramount film division will probably be limited. (See the following sections for the analysis behind these risk conclusions.)

Figure 41. Company Risk Exposure to Film Piracy

STUDIO	RISK FACTOR [a] Contribution of filmed entertainment to parent company	Percent of revenue from home theater (DVDs)	Total dollar exposure	Reliance on blockbusters	TOTAL RISK EXPOSURE
MGM	High	High	Low	Medium	High
Fox	Medium	High	Medium	Medium	Medium - High
Disney	Low	Medium	High	Medium	Medium - High
AOL Time Warner	Low	Medium	High	High	Medium
Viacom	Low	High	Low	Low	Low

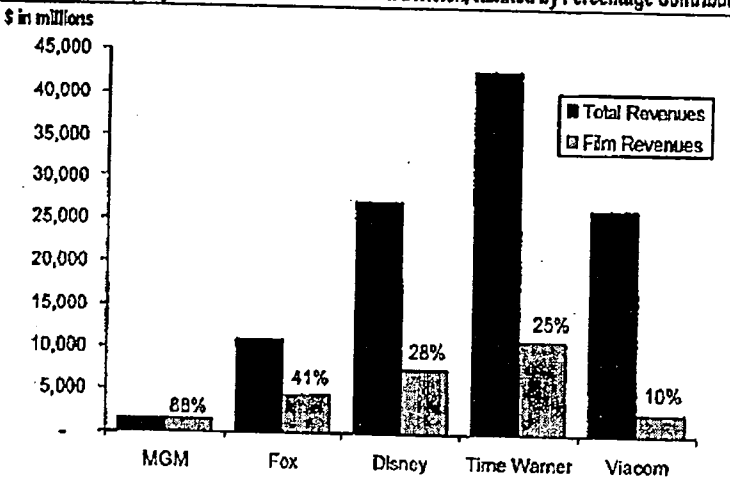
(a) Risk factors are listed in order of importance, with the most significant on the left going to the least important on the right.
Source: Smith Barney

AOL has the most exposure from a dollar perspective, but MGM has a greater percentage of OIBDA at risk.

Film Contribution to Parent Company

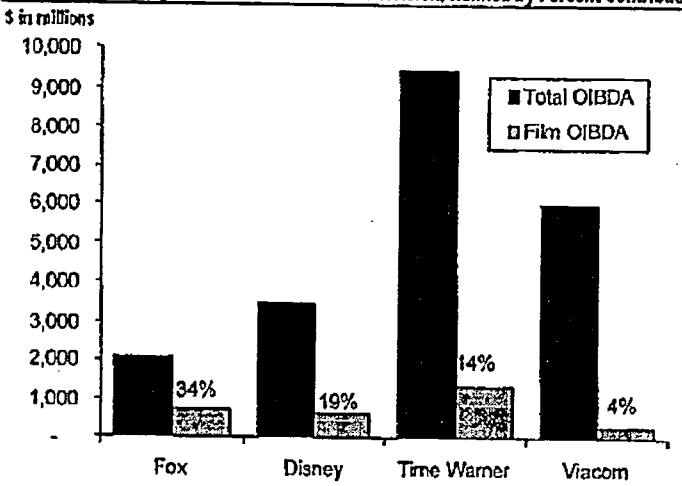
In absolute terms, Time Warner's film division (including Warner Bros. and New Line) has the most at stake with regards to film piracy since it is the biggest player in the industry. However, given the size of the company, its exposure is relatively smaller than that of Fox, Disney, and MGM. We expect it to contribute an estimated 25% of the company's revenues and only 14% of OIBDA in 2003. Disney has the second-largest contribution in dollar terms from the film division, accounting for an estimated 28% of revenues and 19% of OIBDA. Due to the hit-driven nature of films, these percentages can vary based on what films are released in the year. For example, Disney's filmed entertainment division contributed 4% of OIBDA in 1999 and 10% in 2001. At the high end of the pack in percentage terms (excluding MGM) is Fox Motion Picture Group, which we expect to account for 41% of Fox Entertainment Group's revenues and 34% of OIBDA in 2003. MGM has the most film exposure, with almost 90% of its revenues from filmed entertainment. On the other end of the spectrum, Paramount Studios only contributes about 10% and 4% of revenues and OIBDA, respectively, to Viacom, so its direct exposure is relatively limited. However, if Viacom's exposure to Blockbuster is incorporated, then exposure to filmed entertainment would be closer to 33% of revenues and 16% of OIBDA in 2003.

Figure 42. Company Revenues and Share of Film Division, Ranked by Percentage Contribution, 2003E



Source: Company reports and Smith Barney estimates

Figure 43. Company OIBDA and Share of Film Division, Ranked by Percent Contribution, 2003E



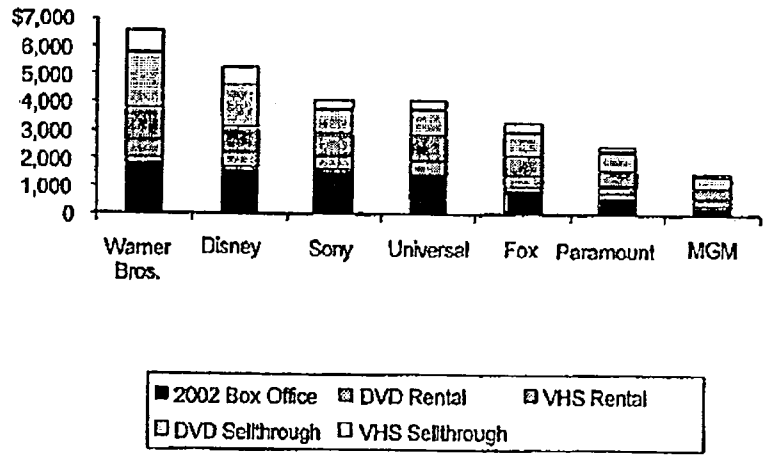
Source: Company reports and Smith Barney

Companies with more revenues coming from home video are likely to feel greater effects from piracy.

Revenues from Box Office vs. Home Video

As is discussed in greater detail in later sections ("The Silver Screen Is Still Golden...for Now" and "Pirates Invade the Home"), we feel the home video window is much more susceptible to loss from piracy than the box office window. Therefore, companies that generate a greater share of their revenues from post-box office sources have more at risk, in our view. When we speak of consumer spending in this context, we are not talking about the revenue dollars that go to the studios, but rather the total consumer spending on box office, rentals, and video purchases. Those revenues are recognized by the studios, the rental stores, and video retailers. From an absolute dollar perspective, Warner Bros. generates the most from home video, while MGM generates the least.

Figure 44. Consumer Spending on Movies by Medium, Ranked by Spending, 2002



Source: *Video Store Magazine*, Internet Movie Database, and Smith Barney

Figure 45. Consumer Spending on Movies by Medium, Ranked by Spending, 2002

$ in millions

Studio	2002 Box Office	DVD Rental	VHS Rental	DVD Sellthrough	VHS Sellthrough
Warner Bros.	$2,000	$640	$1,135	$2,025	$800
Disney	1,600	500	900	1,575	620
Sony	1,500	450	815	900	350
Universal	1,350	500	900	950	375
Fox	925	400	700	900	350
Paramount	680	325	560	650	250
MGM	360	200	350	430	170

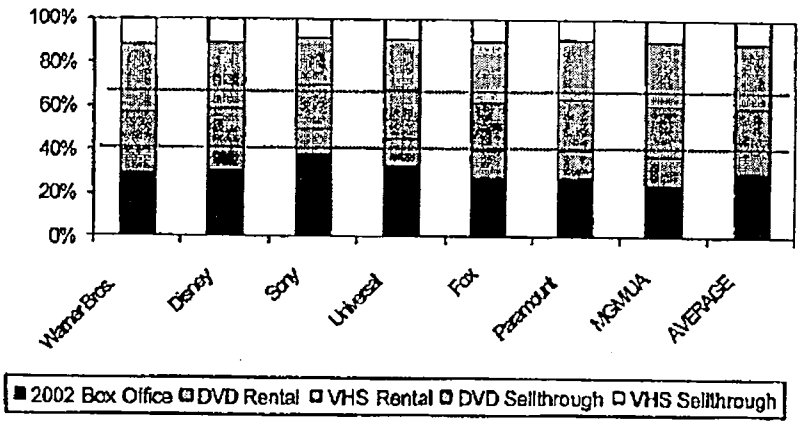
Source: *Video Store Magazine*, Internet Movie Database and Smith Barney

Viacom's Paramount is the studio with the greatest percentage of revenues coming from home video.

However, as shown in Figure 46, MGM, Fox, and Paramount had the highest share of consumer spending going towards home video (more than 70%). Since we believe the home video window is more susceptible to piracy than the box office window, we feel these companies are more at risk for being negatively affected by piracy than their peers.

Figure 46. Percent of Consumer Spending by Type, 2002

Percent



Studio	2002 Box Office	DVD Rental	VHS Rental	DVD Sellthrough	VHS Sellthrough
Warner Bros.	30%	10%	17%	31%	12%
Disney	31%	10%	17%	30%	12%
Sony	38%	11%	20%	22%	9%
Universal	33%	12%	22%	23%	9%
Fox	28%	12%	22%	27%	11%
Paramount	28%	13%	23%	26%	10%
MGM	24%	13%	23%	28%	11%

Source: *Video Store Magazine*, Internet Movie Database, and Smith Barney

Reliance on Blockbusters

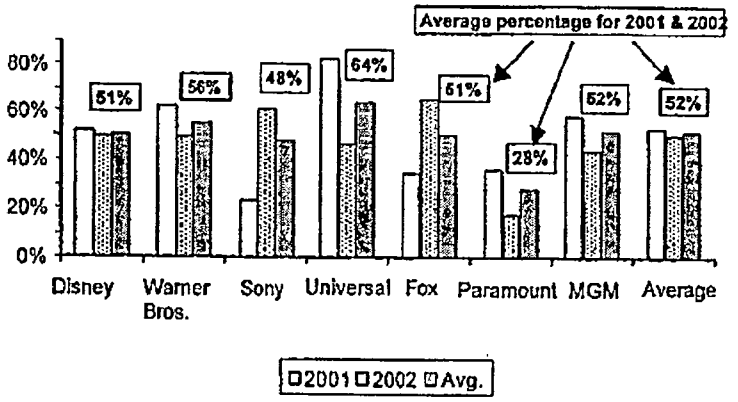
Most studios generate about 50% of annual box office revenues from blockbusters.

Based on results in 2001 and 2002, on average major studios generate just more than 50% of the total box office from blockbusters, which we are defining as the top 25 grossing movies for the year at the box office. As is clearly shown in Figure 47 and Figure 48, these percentages can fluctuate significantly from year to year, but over the past two years Universal and Warner Bros. relied more heavily on their hit movies than average, while only 28% of Paramount's box office receipts came from industry-wide top 25 movies.

Blockbuster movies are more likely than others to be pirated.

Blockbusters are more likely than other movies to be pirated because more people want to see them and they have been heavily marketed. Pirates do not tend to spend their own marketing dollars, but rely on studio efforts. Blockbusters are typically more expensive to produce, which translates into even greater costs. Consequently, they require higher box office attendance and DVD sales to achieve profitability, which is jeopardized by piracy.

Figure 47. Percentage of Domestic Box Office Receipts that Comes from Top 25 Grossing Movies



Source: Internet Movie Database and Smith Barney

Figure 48. Amount of Domestic Box Office Receipts that Comes from Top 25 Grossing Movies

$ in millions, percent

	2001 Blockbusters	2001 Box Office	Percent	2002 Blockbusters	2002 Box Office	Percent
Universal	$1,111	$1,356	82%	$637	$1,359	47%
Warner Bros.	1,134	1,801	63	968	1,953	50
Disney	772	1,495	52	810	1,621	50
Fox	293	856	34	611	931	66
MGM	262	448	58	161	365	44
Sony	202	869	23	959	1,562	61
Paramount	323	892	36	119	687	17
AVERAGE	$4,097	$7,717	53%	$4,264	$8,478	50%

Source: Internet Movie Database and Smith Barney

Our base case assumes piracy dampens home video growth and the box office feels only minimal damage.

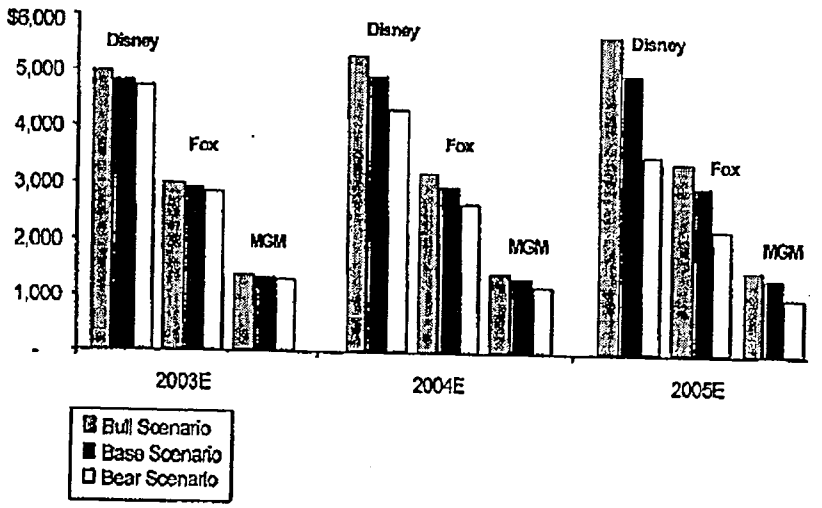
Company Impact

As we just explained, we feel Disney, Fox, and MGM have the most exposure and are the most susceptible to the dangers of piracy. What follows is a scenario analysis showing how film piracy could affect each of them. Our base cases assume minimal damage to the theatrical box office and a dampening of growth in DVD home video due to piracy, which we estimate is roughly 10% versus the industry demand expectation of closer to 18% from 2002 to 2005.

Figure 49 and Figure 50 show the potential effects on each of the companies, with around 8% possible revenue upside (versus our current forecasts) for each by 2005, but a 25%–30% potential downside in a less-favorable outcome.

Figure 49. Revenue Sensitivity to Piracy, 2003E-05E

$ in millions



Source: Company reports and Smith Barney

Figure 50. Revenue Sensitivity to Piracy, 2005E

$ in millions

	Time Warner	Disney	Fox	MGM	Viacom	Blockbuster
BULL CASE						
CAGR (2002 - 2005E)	8.5%	10.1%	9.8%	11.1%	7.5%	7.6%
Revenue	12,422	6,423	5,421	1,915	3,061	6,867
% Upside from Base	5.5%	1.7%	10.0%	6.9%	3.7%	7.7%
BASE CASE						
CAGR (2002 - 2005E)	5.5%	7.1%	6.8%	8.1%	4.5%	4.6%
Revenue	11,774	6,317	4,929	1,792	2,953	6,378
BEAR CASE						
CAGR (2002 - 2005E)	1.5%	3.1%	2.8%	4.1%	0.5%	(0.9%)
Revenue	10,870	5,632	4,752	1,661	2,675	5,825
% Downside from Base	(7.7%)	(10.8%)	(3.6%)	(6.2%)	(9.4%)	(8.7%)

Source: Company reports and Smith Barney

Value at Risk

We believe Blockbuster has the most value at risk from piracy.

Based on this upside and downside potential depending on the extent to which film piracy is kept under control, we determined how much of the value of the parent companies are at risk. In other words, we calculated the impact of piracy on our target valuations in a best- and worst-case scenario, using the same multiples on OIBDA or earnings found in our sum-of-the parts calculations for each of the companies. Finally, we calculated the percentage impact a best-case or worst-case value for the filmed entertainment division would have on total company value. As expected, Blockbuster and MGM are the most sensitive. Blockbuster has a potential of 16% to the upside and 26% to the downside, and MGM has an impact to valuation of 13%-(19)%.

Figure 51. Film Piracy "Risk" on Company Value, 2005E

$ in millions

	2005E Total Company OIBDA	OIBDA Piracy Risk		Value at Risk / Share			Potential % Impact on Target Price	
		Upside	Downside	Upside	Downside	Target Price	Upside	Downside
Time Warner	11,438	104	(226)	$0.30	($0.65)	$17.00	1.8%	(3.9%)
Disney	4,833	13	(171)	0.08	(1.13)	$26.00	0.3%	(4.4%)
Fox	2,638	98	(48)	1.41	(0.69)	$34.00	4.2%	(2.0%)
Viacom	7,360	17	(67)	0.13	(0.52)	$54.00	0.2%	(1.0%)
Blockbuster	766	73	(122)	3.17	(5.25)	$20.00	15.8%	(26.3%)
MGM	110	18	(28)	1.91	(2.85)	$15.00	12.7%	(19.0%)

Source: Company reports and Smith Barney

The Economics of a Movie

Filmed entertainment is a hit-driven business, making it somewhat volatile and an unpredictable element of income. To estimate how piracy might affect the film industry, we first need to understand how movie studios make money.

The Windows of a Film

A total of 95% of a film's revenues are generated within three years of its release.

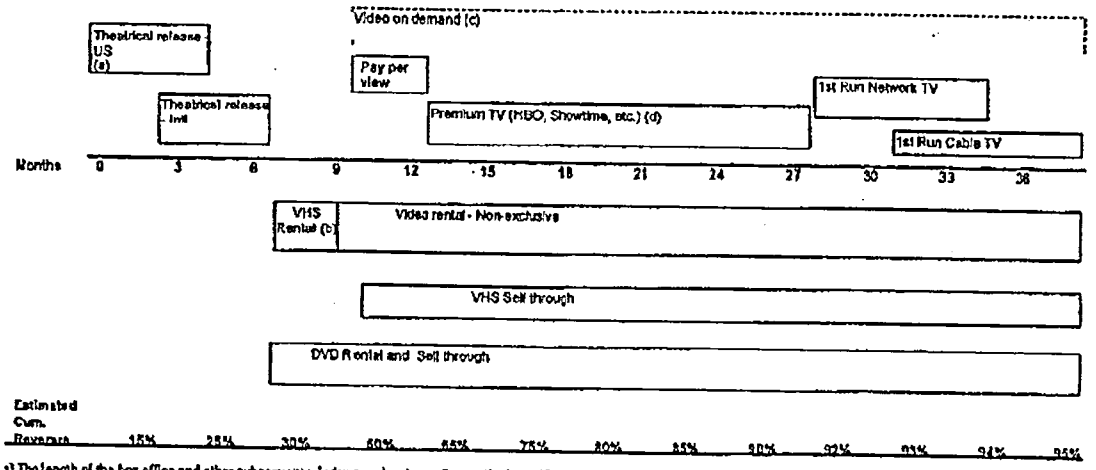
Figure 52 shows the typical "windows" of a film. A film is generally released first to the U.S. box office, then internationally. Four to six months after a film's box office opening, it is released to home video (DVD and VHS). After the home video run, a film typically moves through the pay-per-view, pay television, and free television syndication windows. We estimate that about 95% of a film's revenues are generated in the first three to four years via all of these windows. Each film is unique, but as a rule of thumb, 30% of a film's revenues come from the domestic and international box office run and the rest post-box office, including home video and syndication. Increasingly, the post-box office period is becoming a more important contributor.

The exclusive home video window following the box office release is an important revenue generator.

Previously, after a film had finished its run in domestic and international theaters, it was released for a period exclusively to the video rental window. More recently, with the proliferation of DVDs, movies are also available for sale on DVD at the same time that they are released for rental. Timing and pricing issues depend on box office results and marketing strategies, but with momentum from the box office trickling into the early home video window, we estimate that 30%-50% of a film's total revenues are generated through the first nine months of its life. After this period, a movie will continue to be available to rent and buy on VHS and DVD, but

it may also be available on pay-per-view for several months. About a year or two after a film's release, it is typically aired on a pay television service like HBO or Showtime. Finally, after a 15- to 18-month run on pay television, airing rights for a film are usually sold to cable or broadcast networks.

Figure 52. The Windows of a Film, 2003



a) The length of the box office and other subsequent windows varies depending on the box office revenues and marketing decisions. b) Typically, a 45- to 60-day exclusive window. c) Video on demand is now available only in select markets. The actual timing of the VOD window is unclear. d) Agreements are typically for an exclusive 15 to 18-month window a year after a film's box office debut & after the video rental and pay-per-view windows.
Source: Company reports and Smith Barney

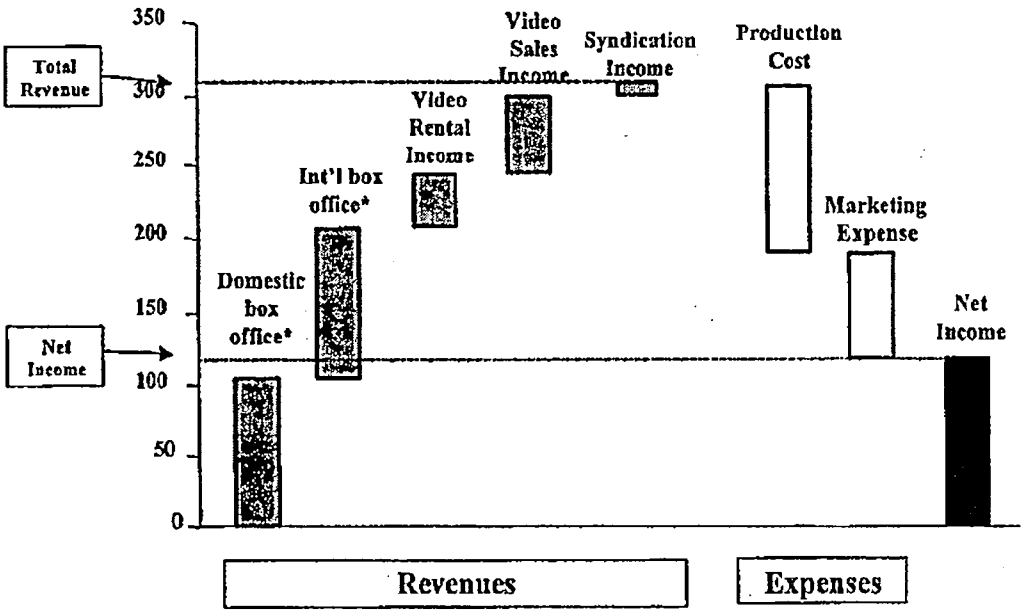
Video Pulls Up the Bottom Line...a Little

To analyze film window profitability, amortize production and marketing costs across the life of the movie.

To illustrate the sources of contribution to film profits, we provide an example. Using data from the results of six blockbuster films released between 1999 and 2002 that grossed between $250 million and almost $900 million in worldwide box office revenues, we created the graph in Figure 53. It illustrates the average contribution of each window (box office and home theater) for these movies. In identifying the sources of earnings for a film, we looked at film economics in a unique way. Most of the time production and marketing costs are taken against the box office, limiting what we view as box office profitability. However, we assumed production and marketing expenses would be incurred no matter how the movie was released (i.e., box office or home video), which would be like amortizing the costs across each window rather than just the box office. This leaves us with box office revenues (domestic and international net of distribution fees) and post-box office income net of disc and cassette manufacturing and distribution expenses.

Figure 53. Economics of an Average Film, 1999–2002

$ in millions



* Net of distribution expenses

Source: Smith Barney

Home theater contributes more revenues than the box office.

Based on this analysis, the box office contributes 46% of a movie's earnings, while home theater contributes 54%. For these movies, production and marketing expenses ran about 40% of net revenues. In this current film model, the box office and home theater windows are roughly equally important, and a film may not be profitable if either were significantly diminished.

Figure 54. Film Economics — Sources of Revenues

Source	Percent of Income
Box Office Income	
Net Domestic Box Office	24%
Net International Box Office	22%
Total Box Office Income	46%
Post-Box Office Income	
Video Rental	21%
Video Sales	24%
Syndication	9%
Total Post-Box Office Income	54%
Total Income, Excl. Prod & Mktg Costs	100%
Production cost as % of Income	26%
Marketing expense as % of Income	14%
Net Margin	60%

(a) Box office income equals net receipts (box office — distribution fees, which are approximately 50% of net receipts and go to the film exhibitors) but excludes production and marketing costs (b) Post-box office income equals revenues less operating expenses but does not deduct film production and marketing costs.
Source: Company reports and Smith Barney

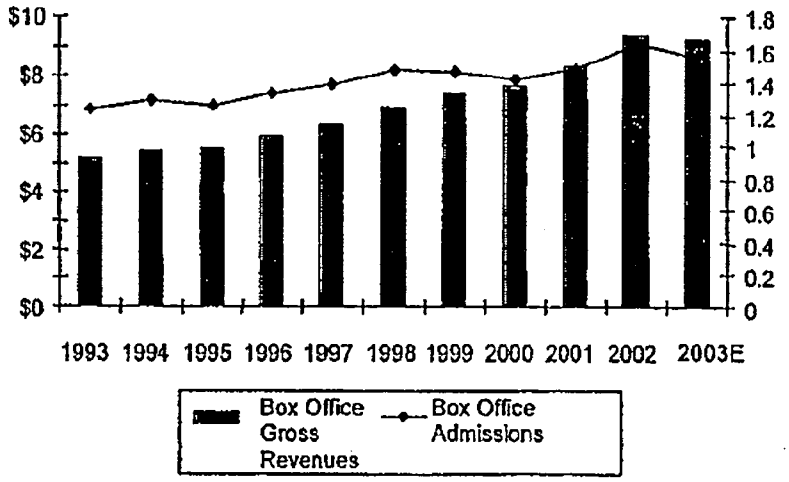
The Silver Screen Is Still Golden...for Now

Box office gross receipts have been steadily increasing.

Gross box office revenues in the U.S., which account for more than 50% of worldwide box office, have been steadily increasing, with an estimated 6% average annual growth rate between 1993 and 2003, although we expect growth to be flat to slightly up in 2003. Admissions, too, have been increasing, although at a slower rate (2% CAGR for the same period). Box office gross receipt growth has remained higher due to increases in ticket prices (4% annually on average) over the years. In our view, the slight ups and downs in admissions reflect the hit-driven nature of the business rather than an overall trend in either spending habits or other factors such as piracy.

Figure 55. U.S. Box Office Gross Receipts and Admissions, 1993-2003E

In billions



Source: National Association of Theater Owners

In our opinion, movie watchers enjoy the in-theater experience and will not abandon this window in favor of piracy for two primary reasons:

1 The unique film-going experience of a theatrical viewing, and

2 The poor quality of most pirated movies.

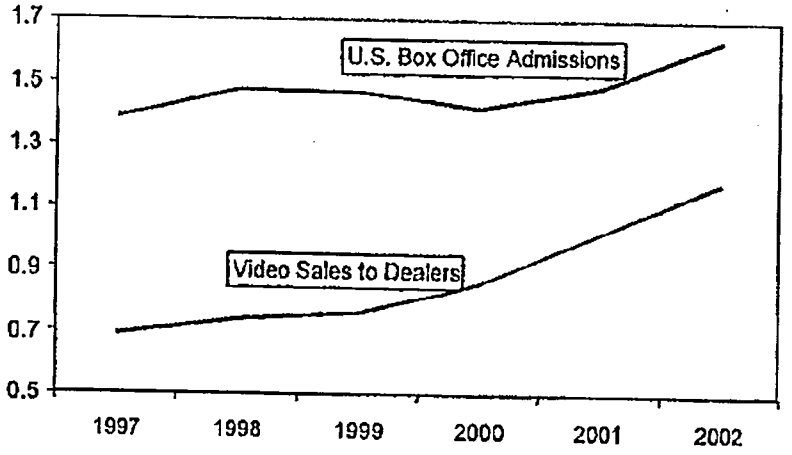
Even with the growing popularity of home video, people continue to go to movie theaters.

The Film-Going Experience

As illustrated in Figure 56, even as home video unit sales rose 11.6% annually from 1997 to 2002, box office admissions grew at the compound annual growth rate of 3.4%. This compares to lower annual average box office admissions growth of 2.5% from 1987 to 1997. This indicates to us, contrary to the initial fears of the studios, that home video did not cannibalize the theater and people continue to go to the movies. The one element we will continue to watch, however, is the growth and improvement in home theater equipment. We feel that, as the quality of home theaters improve, systems become more affordable, and the rental and sell-through windows continue to merge, we could potentially foresee a minor portion of the home video market eating into the box office.

Figure 58. Box Office Admissions and Home Video Units, 1997–2002

Millions



Source: MPAA and Smith Barney

Bootleg copies of first-run movies are usually of poor quality.

Poor Quality of Most Pirated Movies

Most of the versions of first-run movies that are available online or on bootleg discs are of very poor quality for two reasons. First, most of these movies are made by taking a video camera into a movie theater. These types of copies, called screeners, are often shaky, with a lot of background noise from surrounding theater attendees. Second, when the films are put online for download, the file size is often shrunk so they can be downloaded in a shorter amount of time, and that usually results in a grainy picture.

Bootleg copies can circulate around the world within a week.

Spider-Man and Luke Skywalker vs. the Pirates

Bootlegs have been around for a long time, but the Internet has quickly changed their reach and their potential damage has grown exponentially. Fortunately for the studios, as described earlier, most of the bootlegged copies are still of poor quality. Two recent examples of this were *Star Wars: Episode I* and *Spider-Man*. A camcorder copy of *Star Wars* was floating around the Internet one week before the release date, having been made from a private screening. Even with the free copies available online, the film still grossed $900 million at the box office worldwide. Similarly, *Spider-Man* was available online the day before its release. At a minimum, within a day or two of a movie being released bootleg videos based on camcorder recordings of showings are available on certain streets in New York and other big cities. And within a week, there is widespread availability of pirated discs and cassettes around the world (most having been copied in Asia) and online.

The film industry is developing screen technology to combat bootlegs.

To combat these screener copies, industry groups have engaged technology companies to develop a system to modulate the light cast on a movie screen to create a flicker or other patterns that would be picked up by recording devices, but would be unseen by the human eye in the movie theater, making the resulting images impossible to watch. To date we do not know of any implementations of this technology.

Piracy incidents create headline risk for media stocks.

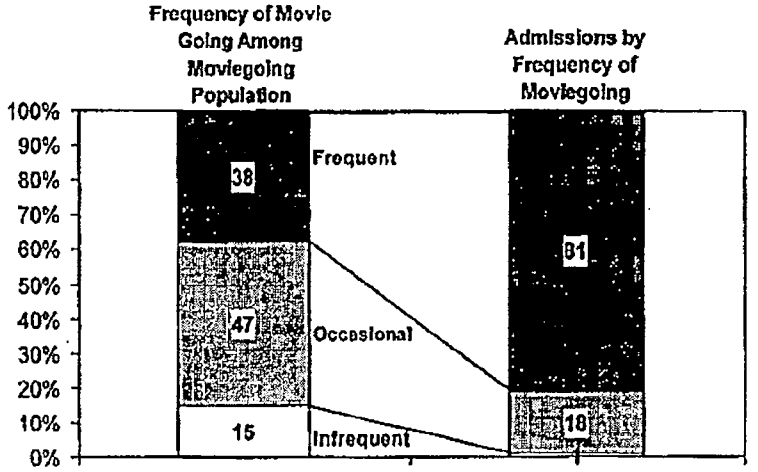
Another way these films are obtained is by stealing a prerelease screening copy. This scenario is much more disturbing as the quality is virtually the same as that of a legitimate video purchase. In June 2003, an unfinished version of *The Hulk* found its way onto the Internet two weeks before its official release, but it was an unfinished version with some of the special effects incomplete. Speculation over the poor quality of the film got out and shares of Marvel (Not Rated), which created *The Hulk*, traded down about 10% on the day this speculation spread. We feel that as digital filmmaking and distribution escalates, it will be critical to be vigilant to preempt the illegal interception of films. Filmmakers and producers need to make sure that they build a secure digital media supply chain. With so many touch points, from filming to storage and distribution to theater projection systems, there are many places where encryption can be broken. As an early countermeasure, film industry players developed a "forensic watermark," which identifies the source of a bootleg film to try to track possible cracks in the system.

Rough Waters Ahead? Beware the Typical Moviegoer

In 2002, 38% of moviegoers accounted for 81% of admissions.

The data in Figure 57 come from a survey on U.S. movie attendance conducted for the Motion Picture Association. In this survey, respondents reported how frequently they go to the theater to see movies (frequent, occasional, or infrequent). Box office attendance roughly follows the well-known 80-20 rule (although in this case it is closer to an 80–35 rule), with 38% of moviegoers — those that go frequently — accounting for 81% of movie theater admissions.

Figure 57. U.S. Movie Admissions by Frequency of Movie-Going, 2002

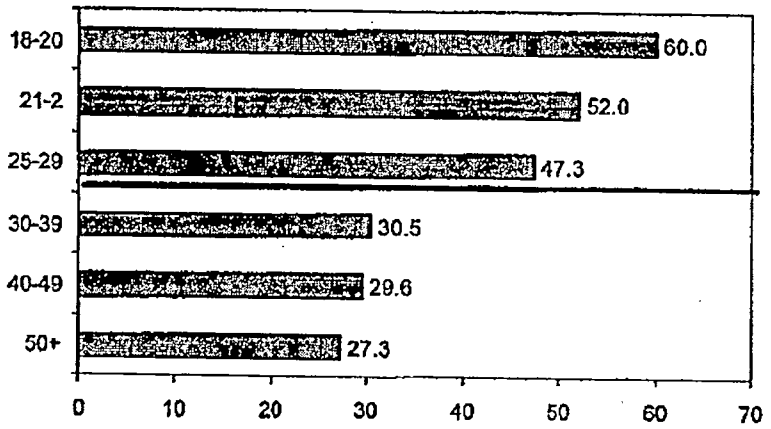


Note: Frequent moviegoers are defined as going to a movie at least once per month; occasional as going at least once in six months (two to 11 times a year); and infrequent as going less than once in six months.
Source: Motion Picture Association and Smith Barney

Most frequent moviegoers are young, as are those who acquire pirated content.

What we found more interesting is who makes up that 80% of admissions. Half of frequent moviegoers (those going to the movies at least 12 times per year) are under the age of 25, while less than 30% of people above the age of 30 go frequently. This customer mix is potentially problematic when viewed against the profile of a customer who is most likely to acquire pirated content — both groups are young. Also potentially troubling is that younger viewers have indicated they tend to see a movie during the opening weekend since they want to be among the first to see it. This could make them more susceptible to purchase early, pre-released pirated copies. On the other hand, going to the movies is a social activity, so even if this younger audience does acquire a pirated movie, they still might go to see the movie at the theater because of the social aspect.

Figure 58. Percentage of Frequent Moviegoers by Age Group



Source: Motion Picture Association and Smith Barney

Pirates Invade the Home

The post-box office windows have become increasingly important.

This section examines the home video window, including its progression, size, and vulnerability. The post-box office window is becoming increasingly important, contributing more revenues for the studios. At the same time, with advances in technology, it is also becoming more susceptible to piracy. When the VCR was first launched, film studios were afraid the new technology would destroy the industry. Studios sued VCR manufacturers in an attempt to require copying mechanisms to be disabled or limited and they resisted releasing films in the new medium. Yet, their worst fears did not materialize — consumers continued to go to movie theaters and the industry added an important new revenue source.

Most studios were hesitant to release their movies on DVDs.

Similarly, when DVD players were first introduced, they did not have across-the-board support from all the studios. Warner Bros. and Sony were the only major studios to promote the format, believing that by replacing VHS with DVD they would provide a high-quality, competitively priced product, inducing consumers to buy videos instead of renting. They believed, not incorrectly, that the introduction of DVDs would enable them to resell their back catalog of titles and sidestep the

rental stores, giving studios 100% of the home video profits. All the studios are finally releasing their new content on DVD and now they are also all re-releasing catalog titles on the newer format.

Entering the Reign of the DVD

DVDs experience less wear and tear than videotapes.

DVD stands for digital versatile disc, which is a high-capacity multimedia storage medium. It can accommodate a complete movie on a single disc and has a far greater resolution than a laser disc and almost twice the resolution of a standard VHS videotape. One more advantage is that a DVD is not physically touched while it spins in the player, and although they can get scratched, there is less wear and tear and loss of fidelity over time. In contrast, videotapes touch a playback mechanism, degrading the quality of the picture over time.

DVDs were developed primarily as sell-through product, while VHS products were meant for rental.

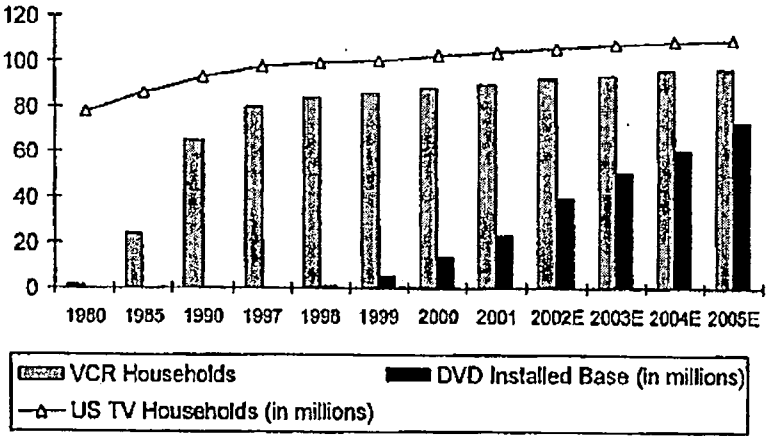
DVDs were made to be sold. When DVD was first introduced, the format was initially intended to be a sell-through format, meaning that consumers would buy them, not rent them. VHS has been, until somewhat recently, mainly a rental format, with titles priced much higher and intended for purchase by rental stores rather than by consumers. Many consumers had been taken aback when they inquired about purchasing a new VHS title only to find it priced between $59.95 and $89.95 or higher. Studios knew video stores had to order all the new films, so they could charge higher prices during the initial rental period, and then after the rental rush cooled off, they could reduce the price for sell-through for consumers who were still interested enough in the film to own it. The rationale behind this rental release strategy is that retailers would rent films multiple times, generating multiple revenue opportunities, but the studios did not get a cut of all these turnover revenues. This model is currently undergoing another transformation as sell-through DVDs, which are released at the same time as the initial rentals, are becoming more popular.

DVD penetration has grown quickly.

The market for DVD has grown faster than music CDs or video VHS did in their first two years in the U.S., Europe, and Asia, and many predict DVD will become the standard home video format, replacing videocassettes within the next five years. In 2003 an estimated 47% of all households that own a television are expected to also have a DVD player. This compares to roughly a 15% penetration of VCRs at a similar point after their introduction around 1980.

Figure 59. U.S. Home Video Penetration

Households in millions



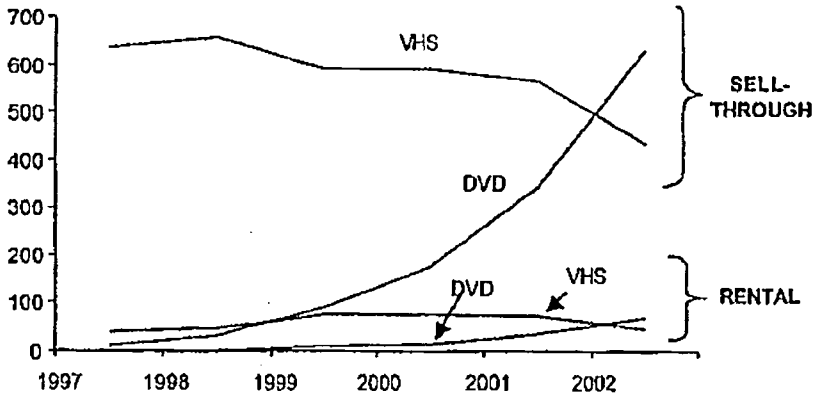
Source: MPAA, Nielsen Media Research, CEA, Kagan Media, and Smith Barney

DVDs now account for more sales and rentals than VHS tapes.

Since the advent of video rental 25 years ago, videocassettes have been the dominant format for video rental. Now, just more than six years since its launch, DVD has supplanted that pioneering technology. In the sell-through market, DVDs overtook VHS in 2002 and in rentals they exceeded VHS videocassettes rentals for the first time in June 2003, according to the Video Software Dealers Association. While DVDs do have encryption technology, pirates have been able to break that protection. Due to the greater ease of mass, quality copying with DVDs than cassettes, this shift could also open the door to more piracy problems.

Figure 60. U.S. Sales of Home Entertainment to Dealers, 1997–2002

Units in millions



Source: Motion Picture Association and Smith Barney

The Little Silver Discs Are Golden

Approximately 35% of U.S. homes have DVD players.

The home video market is experiencing strong momentum from DVD sales and the flow-through of more theatrical content to the DVD format. We expect DVDs to continue to fuel growth in the home video arena over the next two to three years as the installed base of DVD players increases.

DVD players are now priced for the mass market and the adoption of this home video format remains on a fast track. The average selling price of a DVD player has dropped from almost $500 in 1997, when the format was introduced, to $150 in 2000, with some players now available for less than $75. DVD players maintain their march as the fastest-growing technology of all time, now in 35% of U.S. homes. Unit sales totaled 17.6 million in 2002, up 39% on the back of new combination DVD/VCR players, and, according to the Consumer Electronics Association (CEA), sales will climb an additional 14% in 2003, reaching 20.1 million units on dollar sales of $2.6 billion.

DVDs: On the Road to Must-Have Home Media Status

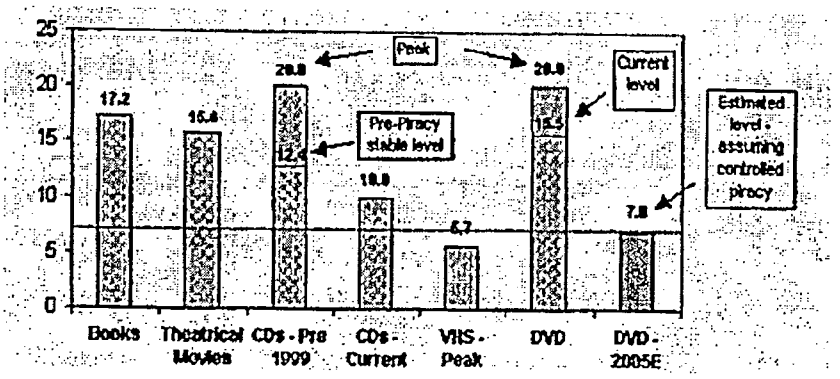
Studios are trying to create a "gotta have it" mentality with DVDs, which might promote piracy.

We believe DVDs have become a pirate's best friend. This is partially for all the reasons that we have already discussed and that are generally mentioned during our discussion on piracy, including the proliferation of the format, the quality of the content, and the ease and speed of copying. Studios have attempted to create strong demand for this new product with their marketing campaigns and with the content, the "extras" included on DVDs such as cut scenes, outtakes, director's commentary, and multiple language versions. We are not convinced the average consumer will see the value in these extras, but we think the studios have been effective in convincing consumers to at least consider the benefits of owning rather than renting. Since a movie, even at the $15–$25 price of a legal DVD, is still an investment, commercial pirates hope — and we believe some consumers agree — that viewers will spend $5–$10 for a pirated disc of comparable quality.

We believe consumers will purchase seven DVDs per year, assuming piracy is kept in check.

DVD sales volumes have grown relatively quickly because the tie ratio of discs to players is high, with consumers buying 14–16 in the first year after buying a DVD player, versus six for VCR/VHS in the mid-1990s. One of the prime reasons for this differential is the previously detailed pricing difference (DVD priced to sell and VHS priced to rent). Figure 61 illustrates the buying rates for certain types of home media. During the library build-up phase, CDs and DVDs hit peak levels of about 20 per year, while VHS has always been on the low end with less than six per year due to its high price point. Books have successfully been able to maintain their high level of 17 per year. CDs seem to have leveled off at about ten per year and we believe DVDs will settle at about seven per year, assuming piracy is kept in check.

Figure 61. Consumer Annual Legal Buy Rates per Household on Media and Entertainment



Source: Adams Media Research and Smith Barney

Consumers will probably build their DVD libraries in the first few years after buying a player.

We expect DVD tie ratios to follow a pattern much like that of CDs, very strong at first and then trailing off. In the two years after launch, the average DVD home bought more than 20 discs each, as did the average CD home until 1985. CD buying then trailed downward to about ten per year per home. There are a number of reasons for the decline, not the least of which is piracy. However, another contributing factor is that in the initial period following adoption, many purchases were made to convert personal libraries from analog cassette to digital CD. Once that conversion was complete, individuals started buying fewer CDs per year and tended to buy primarily new music. We expect a similar pattern to occur with DVDs. The other pattern we saw with CDs was the huge decline in volume starting in 2001, spurred in large part by online file swapping.

In our opinion, the next 12–18 months will continue the library-building phase that began a few years ago as mass market consumers with recently purchased DVD players continue to look to build out their DVD libraries. After this build-out begins to taper off, we expect the rental home video business to resume a low single-digit growth trend.

Home Video Keeping Up with Technology

Protecting content in a digital world is a serious challenge.

Advances in both analog and digital technology offer content owners new opportunities for distributing their works and offer consumers new means for receiving and enjoying these works. Such advances, however, also pose a serious challenge of protecting works in a world where: 1) duplication is easy and inexpensive; 2) every copy made, whether from the original or another copy, is exactly the same as the original; and 3) distribution to users around the world can be accomplished virtually cost-free and immediately over the Internet. This challenge is particularly acute in today's world, where an individual not only simply receives works, but also sends and redistributes such works to others.

Copy Protection from Day One

DVD was originally introduced with a layer of copy protection.

The introduction of DVD video was a multi-industry combined effort and it set the stage for some of the current approaches to implementing copyright control technologies. The DVD was developed and designed to be playable by both consumer electronics devices and personal computers, and both industries were eager for the introduction of this new format for motion pictures. On the consumer electronics side, the analog VCR market was fairly mature and DVD offered a new generation of players that could gain wide popularity with consumers and generate substantial equipment sales. On the computer side, DVD represented an opportunity for the personal computer to get into the home entertainment market as a playback device for movies. Film studios, however, were not prepared to release their movies on this new digital format without protections against unauthorized copying and distribution — particularly digital copying and distribution. Because DVD was a new format, it provided the ideal opportunity to build in copy protection technology. Since there was no existing installed base of DVD players or DVD drives for personal computers, copy protection could be designed and built into these new devices from the outset.

Developments in technology have definite pros and cons.

Developments in technology often prove to be a double-edged sword to creators and content owners. On the one hand, they provide more sophisticated tools for the creation and legitimate dissemination of works. On the other hand, these same technologies often facilitate unauthorized reproduction and distribution of works in violation of content owners' rights. However, some counterpoints to this are the enhanced content initiatives, such as director's cuts, behind-the-scenes footage, and now high-definition DVDs. In addition, digital distribution and required online registration of users with high-quality networked television sets may help to further prevent piracy. This tug-of-war dilemma is not new, dating all the way back to the introduction of the printing press, but in recent years certain advances in technology have added a dramatic new dimension. These advances focus on digital copying, compression, bandwidth, and networking.

Digital Copying

Analog copies of audio and video works degrade in quality with each generation. Thus, if a person makes a copy of an analog videocassette and gives it to a friend, that copy will not be as good as the original. A copy made from that copy would be of even poorer quality. Analog technology thus contains an inherent barrier against multi-generation copying that serves as an obstacle to massive unauthorized consumer copying. Digital copying, however, involves bit-for-bit replication. This means that every copy is perfect and that perfect copies can be made from other copies through endless generations. Moreover, digital copying can be done at very high speeds with no loss of quality. The threat of unauthorized copying is therefore much more dangerous with the advent of digital copying. Currently, the ease with which an analog signal can be converted into digital format and then disseminated rapidly means that analog delivery also presents challenges and must be taken into account in copy protection efforts.

Compression

Audio and video content, when converted to full-resolution digital form, result in large files. Prior to digital compression technology, such works required substantial bandwidth or very long periods of time to deliver across a network. Compression technologies have altered this situation whereby perfect "lossless" copies can be created that are less than 25% of the original digital size. This means that these copies can be delivered in one quarter of the time it took to deliver the uncompressed originals. New compression techniques are predicted to allow for nearly lossless copies at 5% of the original size. These vast advances in compression technology mean that it will become easier, faster, and more convenient to transmit full-length high-quality audio and video works over networks such as the Internet.

Bandwidth

Increases in bandwidth mean greater capacity for delivering more data more quickly. Cable modem and high-speed DSL phone lines are now available to consumers for their Internet connections. Some predict that bandwidth capacity will eventually increase to the point of providing speeds that are several hundred times greater than today's common 56-K modem. These advances in bandwidth will make it vastly easier to distribute high-quality works to many people quickly and inexpensively.

Networking

As more and more people get connected to the Internet, they experience two-way links from the external world to the home and out again. Networking of personal devices in the home (such as personal computers, televisions, recorders, and music systems) is increasing, as users demand more interactivity in the devices that they purchase. This allows users to both receive and send works from home as well as move works among the different devices in their home (e.g., from a personal computer to a digital recorder). Such networking makes it easy for non-professionals to make and distribute multiple high-quality copies of audio and video works. Indeed, every consumer who is hooked up to the Internet can become an unauthorized re-publisher.

The requirements for pirating content have become easier and cheaper.

These advances in technology mean that content piracy no longer requires dedicated pirates using expensive equipment to reproduce works or physical distribution channels to distribute such unauthorized copies. Today an individual with a few thousand dollars of home equipment can make and distribute an unlimited number of high-quality unauthorized copies of works.

Illegal Online Sites

A few sites facilitating illegal movie file sharing have been shut down.

Movie88.com, one of the first online movie sites, and a handful of other sites and services popping up around the world offer growing proof the movie industry cannot count on immunity from digital forces. Like Napster before it, Movie88 was more than just an everyday pirate website: It was a commercial video-on-demand service that was comprehensive and easy to use and cost only $1 per movie. With the studios' digital film services still in development, that is a dangerous combination of features. Like Napster, Taiwan-based Movie88 was shut down in February 2002, but was quickly replaced by Iran-based Film88 and U.S.-based Scour.com. These too were shut down, but it is representative of a disturbing new trend. Along with

U.S. sites, illegal commercial download sites have begun operating from various parts of the world, where copyright laws are not the same as in the U.S. and shutting them down can be more difficult.

Technology barriers to sharing movies online are quickly falling.

Sharing movies on the Internet used to be confined to small circles of people with enough computer knowledge on how to access the files. Film studios had been insulated partly by the enormous size of high-quality digital video files, which made it relatively difficult to trade movie files over the Internet. But that barrier has been progressively falling thanks to improvements in digital video formats and streaming technology. The growth of P2P networking and the rise in popularity of DVDs has changed the climate of movie sharing, allowing movie files to be shared instantaneously with millions of users. Software called "DVD rippers" extracts the large files off of a DVD and automatically encodes them to relatively small 600-to 700-MB high-quality files. This has made movie distribution as simple as "point and click." Along with P2P networks KaZaA and Morpheus, which are better known for music but now also have an array of films, two of the most popular networks are FastTrack, which claims more than 4 million simultaneous users logged in at any time, and eDonkey2000, which claims more than 500,000 users.

DVD Burners and Encryption

DVD burners are becoming less expensive, likely increasing illegitimate copying.

DVD burners have been slower to develop and come down in price than CD burners. One of the main issues has been an assortment of standards: DVD-R, DVD-RAM, DVD-RW, and DVD+RW. While one format is not necessarily better than the next, compatibility can be a major issue. Some formats are incompatible with one another, and they also offer varying compatibility with devices such as home DVD players and DVD-ROM drives. Nevertheless, prices are beginning to come down, and the more they do the more the price spread between a high-quality pirated disk and a legitimate one grows, as does the differential in the convenience of burning one's own movies versus having buying or renting. Both of these factors will likely increase the spread of illegitimate movies.

A number of cases have challenged the legality of DVD copy protection.

With the benefit of seeing what was happening to music CDs, DVDs were originally introduced with anti-piracy measures, a layer of copy protection that was intended to be an effective shield against proliferation. While this protection has since been broken, the issue of protection has been at the forefront since their introduction, and the struggle by the studios is active. From a legal perspective, according to 1998's Digital Millennium Copyright Act, it is illegal for anyone to use software to break or bypass digital encryption codes. So far this law has not held up, and the concept of "fair use" (where consumers are allowed to copy legally obtained content for personal use) has prevailed. As we mentioned earlier, in January 2003, DVD Jon, a Norwegian teenager, was cleared of piracy charges after he developed a computer program called DeCSS to crack the code and allow the copying of DVD movies. The court ruled that it is not illegal to use the DeCSS code to watch DVD films obtained by legal means. The problem is that DeCSS also facilitates illegal copying, so the studios are appealing the ruling. Using this code-breaking technology, there are a number of companies selling software to allow DVD copying. The studios are now in a legal battle with one such technology company 321 Studios, which

commercially produces products similar to what DVD Jon developed. The studios, rightfully, fear that 321's technology could lead to rampant unauthorized copying of high-quality replicas of DVDs.

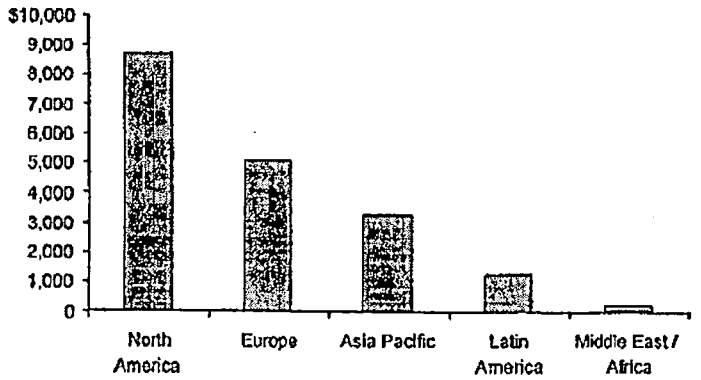
Piracy Across Borders

International releases usually follow the U.S. release, but screener copies often beat the official openings.

There is a huge audience for Hollywood movies in the international market, with approximately 45% of box office receipts coming from outside the United States. We expect international receipts to continue to grow in importance, particularly as Hollywood studios incorporate global tastes in their movies rather than catering exclusively to the domestic market. Traditionally, the international release schedule begins one week to one month after the U.S. release and continues to roll out into more countries over the following year. This strategy of staggered releases is primarily because of the time and resources necessary to conduct a coordinated release. However, it also seems to be contributing to international piracy. A screener copy from the U.S. usually hits the streets abroad soon after the U.S. opening, after which the prospects for local box office success diminish greatly.

Figure 62. International Box Office Admissions, 2002

$ in millions



Source: InformaMedia and Smith Barney estimates

All of the major studios have international exposure.

All of the major studios have international exposure. Historically, Fox, Viacom (Paramount), and Disney (Buena Vista and Miramax) movies have performed well at the international box office. Fox lays claim to seven movies out of the top 25 highest-grossing movies worldwide between 1989 and 2002, while Disney and Viacom have five each. Time Warner only recently made the top 25 international list, in 2001 with *Harry Potter and the Chamber of Secrets* and *The Lord of the Rings*; in the first half of 2002 it led the international box office on the popularity of these movies.

Fox successfully attempted same-day international openings to preempt international piracy.

Due primarily to the fear of piracy, international release strategies are being reconsidered. Now, worldwide "day-and-date" releases — in which a title opens simultaneously in as many markets as possible — are increasing, eliminating the period during which pirated copies are in high demand. For example, on May 2, 2002, Fox rolled out *X-Men 2* in 58 countries, the most ambitious simultaneous release to date. Its international opening-weekend tally was a record $155.2 million.

We believe this strategy was successful since there is no evidence that a pirated copy beat the official release overseas. Warner Bros. also followed this strategy by doing a day and date and same-hour international release of Matrix Revolutions on November 5, 2003, in 80 countries on close to 20,000 screens. We believe we could see such a strategy for some of the expected blockbusters going forward.

China Is the Worst Offender

Piracy is a huge issue in Southeast Asia.

Southeast Asian countries have long been known for the illegal copying of goods developed in the West, from handbags to books to movies. The Video and Film Industry Association estimates the U.S. film industry loses more than $150 million every year to piracy in China. We think this number is higher, particularly since it does not take into account potential lost revenues from films that are never released in China or released only on a very limited basis due to fear of piracy.

Legitimate film distribution in China is seriously challenged by the black market.

Since widespread distribution of foreign films began under a revenue-sharing agreement in 1994, imported films have captured roughly 70% of China's box office revenues. This growth shows the country's interest in American films, which we believe have a majority of the 70% share of imports. With a population of more than 1.2 billion people, China is a huge potential market. In our view, this opportunity has been greatly limited by piracy, which emerged as one of the film industry's greatest challenges in the 1990s. With the advent of VCD and DVD technology, film piracy became rampant. Not only are pirated VCDs and DVDs considerably cheaper than movie tickets in China, films are often available in these formats weeks (if not months) before their official theater releases. Further challenges to China's film industry include historically weak marketing and distribution systems. Legitimate film distribution in China is challenged by piracy, so the studios and distributors have not wanted to invest in marketing and distribution, but without investment there is little hope to capture the potential. The DVD version of the *Harry Potter* movie was reportedly available in China's major cities weeks before the movie's U.S. theater release (let alone its release in Chinese theaters). Foreign films are not the only targets of piracy either, as Chinese films are often available far in advance of theater releases as well.

The Chinese government is occasionally but not consistently aggressive about fighting piracy.

Periodically the government has been cracking down on piracy since the mid-1990s, but these efforts have tended to lose steam after a few weeks. However, since China's admission to the WTO in 2001, the Chinese government has launched a massive crackdown on piracy as part of its promise to boost protection for intellectual property. For example, in 2002 the government destroyed in a single sweep more than 27.5 million illegal audio and video discs from Chinese plants, equal to about 4% of the demand for pressed discs.

Malaysia Rivals China

Malaysia is another country with rampant piracy, but we think the situation could improve.

Another country that appears to have taken a leadership role in the tainted industry is Malaysia, with an estimated $40 million in annual losses, according to the International Intellectual Property Alliance. The group claims Malaysia is one of the primary sources for pirated optical media products that are exported all over the world. The Malaysian government is seeking to address the problem through a new Optical Disc law, and as evidence of its commitment a special task force has been set up with the goal of getting rid of the piracy in two years. We have some

confidence in Malaysia's commitment to fighting piracy due to a somewhat related pursuit. Malaysia is trying to establish itself as a "high-tech corridor." Its success in accomplishing this ambitious goal and attracting high-tech companies to the area hinges on its ability to protect intellectual property.

They Are Not Going to Take It Anymore

There has been increased activity on the legal front as the studios step up their combined commitment to fighting the problem internationally. Four of the world's biggest film studios, Disney, Warner Bros, Universal, and Fox took their first open legal action against video pirates in China.

The studios are fighting back in the courts, and winning.

Two actions in Beijing have already been settled, while verdicts on another series of suits in Shanghai are still pending. Warner and Universal settled their Beijing-based complaints against one retailer and two factories, whereby the defendants paid a collective 250,000 Yuan ($30,200) in damages, apologized, and agreed to destroy all their stock of the illegally copied materials. They also agreed not to copy illegally any Motion Picture Association (MPA, the international counterpart of the Motion Picture Association of America) member titles in the future and were required to give the MPA the names of the parties that placed the illegal replication orders. The cases in Shanghai are still pending and involve actions by Disney, Universal, and Fox against three local retailers.

Has Film Piracy Reached Proliferation Yet?

Having learned from music's experience, film is compressing its path to adaptation.

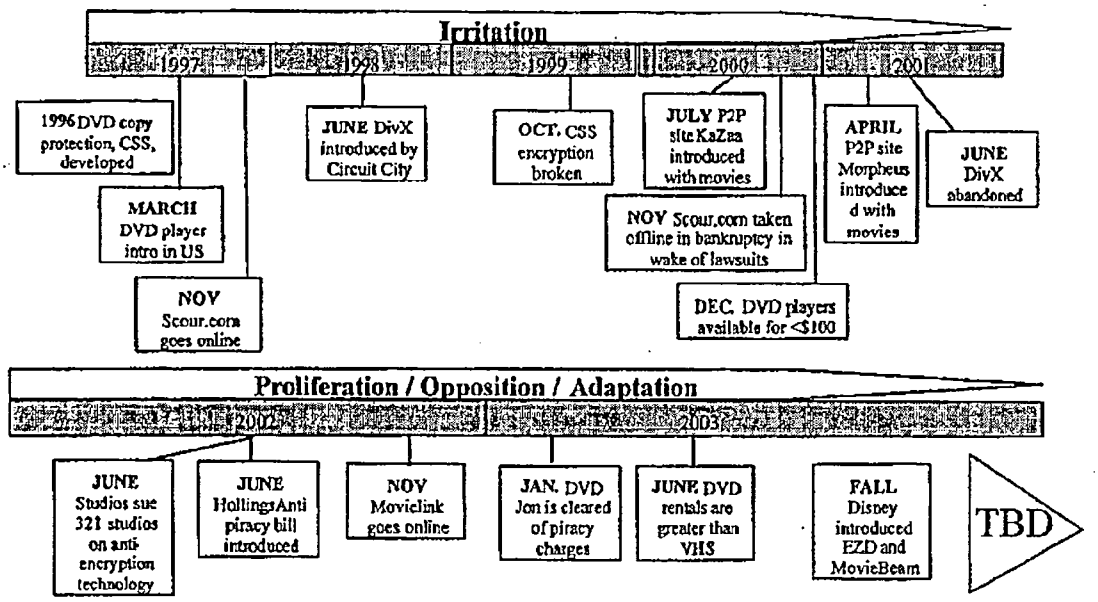
In a broad sense, film is following the path of phases we outlined for the music industry. Technological constraints have certainly limited the extent of proliferation, but the industry wants to make sure piracy it is not inevitable. Therefore, this course is being compressed and elements of the later phases of opposition and adaptation are being observed earlier.

Film's online piracy damage is less than 2% of what music is experiencing.

Clearly the film industry is through the irritation phase, but the impact is significantly smaller than music experienced in its proliferation. Whereas we estimate that about 5 billion music album-equivalents are downloaded annually, we estimate that the number of films downloaded is less than 2% of that amount. In the physical world we estimate there is one pirated music CD sold for every three or four legitimate ones sold, but for movies we believe that number is closer to one in 14 in the U.S. and one in five internationally (where film piracy has definitely proliferated). It seems to us that film is in the early stages of proliferation.

However, at the same time, we can see elements of opposition and adaptation. By engaging in both types of behavior, the film industry is hoping to stop piracy proliferation and continue its history of sales growth.

Figure 63. Film's Piracy Timeline, 1997–2003



Source: Smith Barney

Opposition: A Multi-Front Battle

The film industry is launching opposition, using the courts, technology, and public opinion.

The film industry has brought forward the opposition phase, hoping to halt proliferation in its tracks. The growth of reproduction, storage, and transmission technology has terrified copyright owners. To limit the threats, the content community has launched a multiple-front battle, using Congress, technology, the courts, education, and public opinion to restrict the capabilities of recording and peer-to-peer technologies and ensure movies do not suffer the same fate as music.

A piracy solution is going to require a coordinated effort.

The challenge of providing adequate protection for intellectual entertainment property is difficult and complex; similarly, the solutions are neither simple nor one-dimensional. As lawmakers, content owners, and consumer electronics and computer manufacturers have struggled to meet this challenge, several issues have become clear:

- Neither technology alone nor legal measures alone can provide a viable solution;
- The development and implementation of copy protection technologies and structures require cooperation and compromise among the content, consumer electronics, computer, and other relevant industries;
- The implementation of copy protection must take into account reasonable consumer expectations and cost considerations; and
- Copy protection technologies and structures must do their job but be flexible enough to adapt to new innovations.

Accomplishing these is certainly no easy task, and it is becoming increasingly evident that hardware and content companies have a mutual interest in working together so they can both sell more products.

Technological evolution may lead to future cross-industry cooperation in copyright protection.

Hollywood Always Reluctant...but Technology Can Be a Friend

With the convergence of computer and consumer electronic technology, digital content will move almost seamlessly from device to device. From the perspective of the film industry, the primary goal of the various copy protection solutions is to protect the content owner's rights. From the perspective of the hardware and storage media manufacturers, the goal is to develop a balance between creating what customers want and what implementation costs, and secondly protection effectiveness. With the dramatic growth in the development of digital content and global online distribution, cross-industry efforts are increasingly important. The resolution of this issue is not solely dependent on the film industry; it will also take the computer makers, chipmakers, and consumer electronic manufacturers. A key component of this evolution may be high-definition DVD, which could hasten cross-industry efforts, and online registration for networked devices may help in digital rights management.

There is a disconnect between the objectives of content developers and hardware manufactures.

There is a serious cultural gap that separates Silicon Valley from Hollywood — entertainment executives are accusing big technology companies of turning a blind eye to rampant online piracy and consumer electronics companies of purposely facilitating easy copying of content to sell more hardware units. The Consumer Electronics Association is accusing the studios of going on a "scorched earth campaign" and saying that their actions are stifling innovation.

We believe there will be some increased copy protection legislation.

The most blatant example of this rift is a bill that was introduced by Senator Ernest "Fritz" Hollings in mid-2002 that would require all digital media devices to have built-in technology to block unauthorized copying. While we do not expect the bill to pass, it has put technology companies on the defensive in Washington and has increased the likelihood that some form of government-endorsed copy protection may eventually be adopted.

Consumer electronics companies and the motion picture industries have a history of working together.

The search for technological safeguards has been going on for years with limited success thus far. While the Secure Digital Music Initiative, led by the record industry, collapsed after several years of feuding among record labels, technology companies, and consumer electronics manufacturers, cross-industry efforts have had better success in the video realm. Consumer electronics companies and the motion picture industries have a history of working together to meet the needs of both industries. The best examples are the anti-copying protection that is part of the DVD standard and the anti-fast forward technology designed to ensure that copyright warnings are shown. Although the Hollings bill is a sign that further efforts to bridge the gap are not going well, it has spurred a new wave of support, at least publicly, in support of copyright protection from the technology industry. In summer 2003, a group of CEOs from nine technology companies, including Microsoft, IBM, and Dell, sent a joint letter to the heads of the major media companies expressing their desire for more cross-industry cooperation. Intel and Time Warner also expressed their support for limited copy protection plans.

Cooperation Is Possible

A number of electronics manufacturers are working on an anti-piracy solution.

An example of electronics manufacturers cooperating with movie studios to create copy controls aimed at thwarting online video piracy is a group called 4C Entity. A coalition that includes Intel, IBM, Toshiba, and Panasonic, it is working to create broad hardware specifications. Another body known as the Video Watermarking Group, a group of consumer electronics companies that includes Hitachi, Macrovision, NEC, Philips Electronics, Pioneer, and Sony, is working to create a system that places a unique bit of code into a video file, making it difficult to copy or play without permission from copyright holders.

Microsoft has taken a positive step with regard to copy protection.

Microsoft has also gotten involved in the debate. In 2002, it added a personal video recorder (PVR) to its new Media Center PC design. It designed the PVR so that content could only be viewed on the PC that recorded it. That meant, for example, that one could not download or extract content, copy it onto a DVD, and view the disc on a consumer DVD player or another PC. Consumer reaction to this "feature" was so negative that Microsoft changed its course. The software has been changed so that now the copyright owner, not Microsoft, gets to decide whether a particular TV program will be encrypted to the hard drive, meaning it would not be possible to view the show on a different PC or DVD player. In effect, there is a switch that the content owner can leave on or off. If the switch is on, the content will be encrypted and limited to the single computer; if it is off, the show or movie may be copied. The implications of this move are that Microsoft has removed itself from the digital rights management controversy, making the technology available but leaving the decision up to the copyright owner. In May 2003, Microsoft and AOL also announced an anti-piracy alliance, whereby they will work together to create an environment that is secure across multiple platforms.

It appears cooperation in developing a viable solution is likely.

In June 2003, cable networks and consumer electronics companies agreed on rules to limit how much viewers could copy or distribute digital TV programs on a new generation of recording devices. Viewers using sophisticated new digital recorders that would make nearly perfect copies would be able to make unlimited duplicates of programs on broadcast TV channels but not distribute them over the Internet. From cable channels, viewers could make one copy, and from video-on-demand services they could not make any copies. This move indicates a willingness to strike a balance between shutting down copying all together and avoiding plunging the movie, programming, and cable TV industries into the world of Internet piracy, which could eventually choke off creation. We also believe high-definition DVD will afford a new opportunity for consumer electronics and content distributors to work together to further penetration of this new product. In addition, as future products (movies, television, connected personal video recorders, or set-top boxes) become more likely to be networked, online registration can provide an additional layer of protection for content owners/distributors. These are all indications that we are moving in the right direction.

On the Legal Front

Industry groups have become much more aggressive in seizing illegal discs.

Striking the balance between protecting copyrights and not frustrating consumers or limiting flexibility will likely require some legal intervention. In an effort to find and stop piracy, the MPAA and IFPI function much like law enforcement agencies,

and informants willing to name names are often the first source. The MPAA has created an informant program: DVD Rewards. The MPAA has been dealing with piracy since the popularity of the video cassette. But the speed at which DVD piracy has affected the movie industry came as a shock and the shift has been dramatic. In 1998, the MPAA seized no illegal DVDs anywhere in the world. Last year, it seized 7 million worldwide. In addition, the organization seized 26 million VCDs, a lower-quality optical disc video format popular in Asia. Although peer-to-peer programs have been receiving considerable press with regards to illegal file trading, the bulk of efforts by the MPAA have focused on illegal copying of DVDs to prevent the erosion of retail sales, where sales are being directly impacted.

They are also active on the legal front.

As discussed in previous sections, the industry has also been active in the courts in order to protect the anti-copying devices on DVDs (DVD Jon and 321 Studios cases) and take illegal file sharing networks offline (Film88 and Scour.com). The industry is taking legal steps earlier than music did to shut down the offenders before they become a problem.

A primary objective is to influence consumer attitude and behavior.

The Court of Public Opinion

The movie studios launched an ad campaign in July 2003 featuring the tagline "Movies. They're Worth It." The ads feature makeup artists, set painters, and other crafts people saying that piracy robs them of a living, and they are being shown on broadcast television and in theaters before a feature presentation. The purpose of the ads is to reinforce the ethical issues around piracy and to influence customer behavior before it is too engrained.

Adaptation — Will Alternatives Take Hold?

Some studios are experimenting with providing alternative to pirated movies.

In order to preempt pirates from dictating the endgame, some of the movie studios are proactively searching for solutions that capitalize on the benefits of digital delivery while countering the threat of piracy. However, they walk a fine line. The studios would not wish to damage the high-growth, high-margin sell-through DVD business.

These proposals are trying to do two things, which in our view make strategic sense:

1. Test the waters in expanding the legitimate home video (primarily DVD) market; and
2. Find ways to combat piracy by presenting a lower-cost, known, higher-quality alternative to illegal DVDs.

We are encouraged by the studios' actions.

We do not feel we have found the final answer yet, but we are very encouraged by what we see here. We think perhaps the biggest long-term risk to the industry is not pursuing new streams of revenues. These moves indicate that the studios are trying to influence customer behavior before the pirates do and that they are not so fearful of technology opening the door to more piracy that they are in essence paralyzed.

Downloads on the Up and Up

A group of movie studios formed to launch a legitimate online movie download service.

The film studios have been proactive about developing online models, but the amount of content has been limited until a "protectable" model is developed. In addition, because of the long download time of a movie, the online model is still somewhat cumbersome and that may limit its appeal. Nevertheless, a group of Hollywood studios

has banded together to launch its own online service called Movielink LLC. The hope is that consumers will get in the habit of paying for the movies they download from the Internet before swiping movies from peer-to-peer services becomes too entrenched. Movielink customers pay $2.95–$4.95, each studio independently setting pricing and content availability, for a movie that can be downloaded to a computer hard drive and stored for 30 days. Once the movie is activated, the customer has 24 hours to view it as many times as he or she wishes, but cannot burn it to a DVD. The service, launched in November 2002, is owned in equal shares by Sony Pictures Entertainment, Warner Bros., Universal Pictures, Paramount Pictures, and MGM; in July 2003 Disney also agreed to include some of its films. While the studios are only getting a fraction of the revenues they generate from selling an equivalent movie on VHS or DVD, with video-on-demand they incur no packaging and only minimal distribution costs. While Movielink can draw on this powerful list of backers, the fledgling service faces a significant challenge because it competes with online file sharing networks that let people download movies free, often well before they are released officially on Movielink. In addition, the inability to watch the movie on anything but a PC or a TV screen connected to a computer will probably limit the appeal of the service. Other legitimate networks available include CinemaNow.com and CinemaPop.com.

A few other services exist, but they have not gained much traction.

CinemaNow.com was launched in late 1999 and began as an online distribution for independent films. It has since expanded and has content from some of the majors including Fox, MGM, and Warner. The movies are available on a pay-per-view basis or for a subscription of $9.95 per month with unlimited access. Customers are able to burn a movie onto a disc, but in order to protect the content CinemaNow requires that they be connected to the Internet and acquire a license each time they play it. CinemaNow's investors include Microsoft, Blockbuster, and Lion's Gate Entertainment. Another provider of legally obtained online movie content is CinemaPop.com, owned by Kanakaris Wireless. Similar to CinemaNow, this model offers a subscription-based option for $4.59 per month or a pay-per-view option for $2.95, but some movies are only available through one option or the other. The movies are streamed to customers' computers so they do not have to wait for an entire movie to download before watching, but when traffic is high or a connection speed is slow, the movie can be disrupted. CinemaPop claims the quality to be near that of a DVD. This network is still small, and as of June 2003 CinemaPop had almost 7,500 paid subscribers and 3,000 historical pay-per-view transactions.

Disney Wants Customers to Throw Away Their DVDs

Disney is quite active in testing various alternative movie acquisition models.

Disney is taking the bet that customers want added convenience and new channels from which to get their movies. The company has teamed up with a DVD technology company, Flexplay Technologies, to develop disposable discs that are designed for sale in supermarkets, drugstores, convenience stores, and other nontraditional outlets. The self-destructing discs, called EZ-D, are playable for 48 hours from the time they are removed from their vacuum-sealed packaging, after which the bright red coloring on the backside turns to black and the disc becomes useless. Disney launched the product with a four-city test (Austin, Texas; Peoria/Bloomington, Illinois; Charleston, South Carolina; and Kansas City, Missouri) in September 2003 with eight titles: *Signs, The Recruit, The Hot Chick, 25th Hour, Frida, Equilibrium, Heaven,* and *Rabbit-Proof Fence.*

We are skeptical about the potential for EZ-Ds.

Disney hopes to sell the discs for a dollar or two above the price of a standard video rental (the suggested retail price in test markets is $6.99) by appealing to consumers who want convenience and hate having to return rentals or pay late fees. To limit the amount of full-priced sell-through cannibalization from the limited-play DVDs, there will be a delay in releasing the EZ-D after the initial home video market window begins. This type of technology is not meant to directly reduce piracy (the content protection technology on the EZ-D is no more difficult to break than that on a regular DVD), but to provide alternative, attractive legitimate solutions for customers so perhaps they will not turn to pirated products. We agree that this is exactly the approach studios should be taking, but we are not convinced EZ-D provides the final solution. EZ-D reminds us of DivX, an earlier failed attempt at a 48-hour DVD. DivX, a concept backed by Circuit City in the mid-1990s, was a short-lived experiment primarily due to a lack of widespread distribution points and confusion created by the requirement to play the disc on a different technology-based player, in our view.

Coming Soon to a TV Near You

Video-on-demand is an area we will want to watch.

Video-on-demand is the next-generation pay-per-view, and many feel it is the future of home video rental, but the move into video-on-demand has been an obstacle course of legal hurdles, licensing woes, industry infighting, and the threat of piracy. On-demand technologies are seeking to revolutionize TV by giving viewers much more control over what they watch. But there are many different ways to deliver an on-demand service and the industry is trying to figure out which ones will win public support. Most of the major studios, except Disney, have lined up behind the services on cable TV to provide video-on-demand.

Disney is testing its own VOD service.

Disney has decided to go it on its own and is developing its own service, called MovieBeam. It's a risky strategy, but if it succeeds, Disney will have cut out the biggest middlemen in home entertainment — cable operators and video rental stores. A profitable MovieBeam also would give Disney's local TV stations a new revenue stream. The MovieBeam service will rely on a dedicated set-top box with a huge hard drive that stores about 100 DVD-quality movies. The box will enable users to view as many of the movies as they wish and Disney will bill customers only for the ones they watch. Every week, MovieBeam will replace ten to 12 of the movies on the box wirelessly through local TV channels, using technology supplied by Dotcast of Mountain View, California, and it can load a movie in DVD quality onto a set-top box in about 40 minutes.

We feel Disney will need to get other studios on board to gain consumer appeal.

MovieBeam had its first public tryout this fall in Salt Lake City and two other cities. The service will transmit movies through ABC stations, ten of which Disney owns, and PBS outlets. We are encouraged that a studio is finally working with technology rather than fearing it would open the door to piracy, but what Disney is doing, unfortunately, is reminiscent of early music attempts: working on its own. The main problem with going alone on video-on-demand is the limited access to content. Movie consumers generally think of movies in terms of titles, not production studios. Therefore, in order for this alternative to work Disney will probably need other studios to join it on MovieBeam; the studios will most likely try to do so if Disney demonstrates some early success.

Video Games Should Play On

- Video game software is subject to piracy, but we believe the damage can be kept under control.
- Hardware (console) and game software manufacturers have a mutual interest in controlling piracy and have coordinated to develop anti-piracy copy control measures.
- Hackers have created mod chips to sidestep protection measures, but aggressive policing is working to stem their sales.
- The international marketplace is our biggest concern with piracy not only directly stealing sales, but also limiting international expansion in countries where black market sales have dampened chances at the development of legitimate markets.

Piracy Limits Expansion

Video game piracy has been limited in the U.S. but is more of a problem internationally.

The video game industry is another entertainment industry that is susceptible to piracy. Of the industries we analyzed (music, film, and video games), the video game industry has seen the least impact thus far. With aggressive industry efforts facilitated by the mutual interest hardware and software manufacturers have in controlling piracy, we believe the piracy problem can be kept to a mere irritation, at least in the United States. In our view, the bigger risk for the video games industry lies in international markets where piracy has started to take hold. This piracy has not directly taken sales from the game publishers because the console manufacturers have not marketed in these emerging markets. However, piracy has probably been a determining factor in the decision of the producers to not pursue those markets, and in limiting expansion opportunities piracy has had a detrimental effect. We believe short-term piracy risk to the video game industry is limited. However, we are going to watch its progression carefully, especially the ways in which the industry attempts to get ahead of the curve.

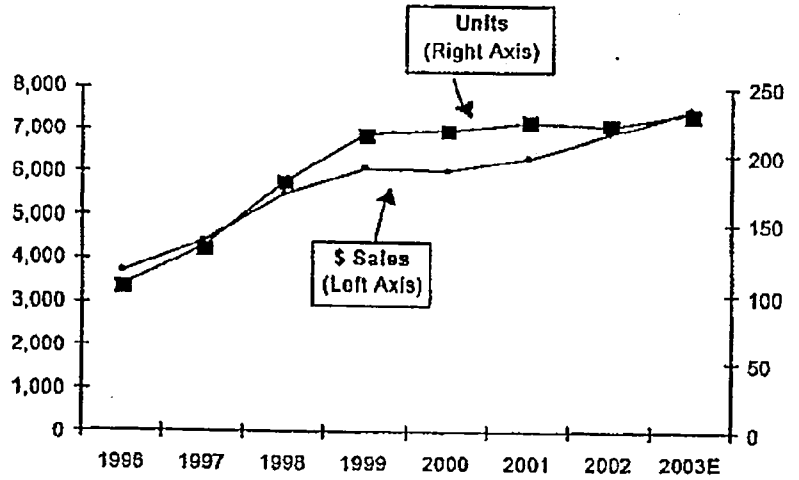
The Gamers Are Growing

The U.S. video game software industry is worth about $7.5 billion.

Building a better box (technological innovation) and improved content have been the key drivers behind growth in the video game business. Since arcade games were first introduced four decades ago, new technology has enabled increasingly complex and entertaining games that can be played on a variety of devices. The U.S. video game software industry has grown 10% annually since 1996, doubling in value from $3.7 billion in retail sales to an estimated $7.5 billion in 2003.

Figure 64. U.S. Video Game Software Retail Sales, 1996–2003E

Millions



Source: Entertainment Software Association and Smith Barney estimates

Software and Hardware Have a Mutual Interest

A successful platform launch will be followed by several years of software releases.

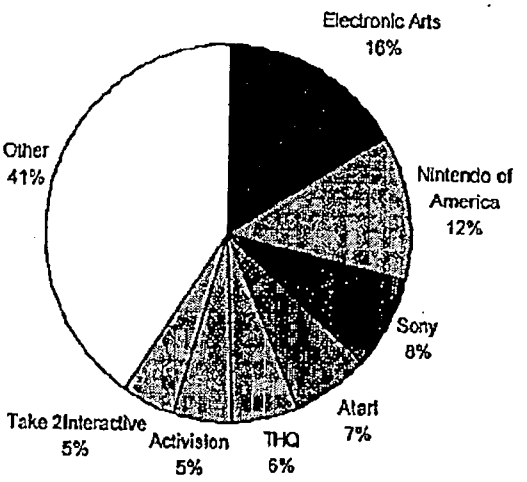
Hardware and software sales move in cycles with platform releases — new hardware introduction drives software sales and new game development in turn drives hardware sales. Typically, when a platform is launched hardware sales rise immediately. For several years after the launch, software titles based on that platform are released, driving growth in that segment. As a platform ages, its manufacturer's suggested retail price (MSRP) is lowered to spur more sales and grow the installed base for games.

Software Publishers

Electronic Arts is the market share leader in software dollar sales.

Within the video game industry, game publishing is a fragmented business, with the top six publishers controlling only about 60% of the market. Electronic Arts is the market share leader in terms of software dollar sales, with about 16% of North American software sales in the first half of 2003. The precise market share varies from mouth to month depending on the timing of releases, but in any given period, Electronic Arts leads by a meaningful margin.

Figure 65. Video Game Industry — Software Publishers U.S. Share by Dollar Sales, First Half 2003



Source: NPD and Smith Barney

Publishers are taking steps to manage the risk-reward profile of the business.

As with films, video games are a hit-driven business. Publishers are taking steps to help manage this risk, including diversifying title offerings and genres and using well-recognized brands and trademarks. In another shared characteristic with film, the most popular video games are also the most likely to be pirated. As a result, we believe this move to diversification will have a secondary benefit of mitigating piracy risk. Another way to spread exposure is to publish games on multiple platforms (e.g., release a Playstation2 title on XBox). "Porting" a game to a different platform typically takes three to six months and requires about 25%–50% of the original title's cost, a fraction of the 18 months to several years and the $2–$8 million it takes to develop a new game from scratch. By re-publishing games on different platforms, publishers can amortize development and marketing costs over a larger base, reach a broader installed base, and benefit from the games' existing reputations as proven hits, thus making this a fairly conservative strategy.

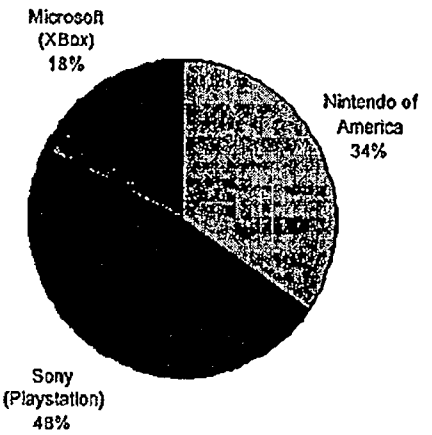
The switch to a digital format has advantages, but also makes games more open to piracy.

Another way the games industry has been similar to film and music is its transformation from analog (cartridges) to a digital (DVD) system. As with film and music, this switch has been beneficial to the industry, but it also opens the door to increased copying violations. For example, publishers must keep a close watch on inventories to maximize sales while protecting against obsolescence. Technology has worked to the publishers' advantage with new generation platforms. With the switch to DVD-based from cartridge-based platforms, order fulfillment time has fallen to less than a week from three to four weeks. This shift has enabled publishers to be more responsive to retailer demand while also lowering inventory carrying costs. However, this ease and speed in production also works in favor of pirates copying discs illegally.

Hardware and Software Have a Mutual Interest

In addition to the software manufacturers, the other major players in the video game industry are hardware (console) manufacturers: Sony (Playstation), Nintendo (Gamecube and GameBoy), and Microsoft (Xbox).

Figure 66. Video Game Industry — Hardware Share by Dollar Sales, First Half 2003



Source: NPD and Smith Barney

Video game consoles have anti-piracy protection built into them.

Video games are played on proprietary hardware, so the hardware and software makers have had a mutual interest in protecting each other, particularly since many of the hardware manufacturers are also game publishers. One key initiative is to give video game consoles built-in protection in the form of anti-piracy software. With this protection, piracy is not as easy as downloading a game off of the Internet or buying a copied game because these illegal copies will not play on the machines.

Hackers have developed mod chips to sidestep protection measures.

This does not mean that piracy is impossible. Gamers have found a way to outwit the protection by modifying their machines, known as "modding." Modding is a process whereby a console owner adds chips to game consoles to disable the security precautions the manufacturers build into their systems. In theory, only Microsoft-authorized discs will run on an Xbox and only Sony-authorized games will play on a PlayStation 2. By adding mod chips to these consoles, owners can play non-authorized games.

Protection reinforces to users that playing copied games is wrong.

Even though the capabilities are available to play pirated games, we believe the anti-piracy protection, which requires users to have to take an extra step of altering their machines, has been effective in the United States. First, most people do not know how to alter consoles or that it is even possible to do. Perhaps more important, the necessity of modding makes it blatantly obvious to the user that playing copied games is wrong. This differs from the music experience in that a major obstacle to eliminating illegal music downloading was that many users did not consider their activities to be illegal.

Some Players Are More Vigilant

Video game piracy will probably not affect each manufacturer equally.

One way that games industry differs from film and music is in the hardware platforms. Whereas all CD and DVD players are built on a single standard, each game hardware system is unique. This allows each manufacturer to make its own decision about its approach to piracy rather than adhering to an industry standard that inevitably falls to the lowest common denominator. Therefore, we cannot necessarily assume piracy will affect each manufacturer in a proportion equal to its market share, as was the case with film and music.

Microsoft and Nintendo have been active with anti-piracy measures.

For example, Nintendo is consumed with fighting piracy, driving its decision to use hard-to-copy mini-DVD discs on its latest platform, the GameCube. The non-standard DVD format disappointed consumers who hoped to also use the game machine to play movies, but so far, the GameCube has not been hacked. Microsoft has also been active in fighting piracy, and in late 2002 it altered the internal configuration of the Xbox slightly so that existing mod chips would no longer work. Of course, pirates have re-hacked the new system, but the ability to make hackers constantly play catch-up is an advantage. If nothing else, it frustrates an average user who decides to try a mod chip, only to find that it does not immediately work. We believe such moves are helping to limit video game piracy to only the very technologically savvy.

Legal Battles Are Effective

Sites selling mod chips have been declared illegal and shut down.

Since customers have to alter their machines to play copied discs and since most customers do not know how to do it on their own, the industry has been relatively successful in controlling the extent of piracy by cutting off the providers of the mod chips. In December 2002, one of the more popular sites selling mod chips, isonews.com, was closed down. The website had been used to market mod chips and it offered listings of available pirated games. It had more than 100,000 registered users and claimed to receive more than 140,000 hits each day. The owner of the site was charged with conspiring to import, market, and sell devices known as modification chips, which was declared illegal under the Digital Millennium Copyright Act of 1998 (explained in the Piracy Primer). His full sentence is five months in prison, five months of home detention, three years of probation, and a $28,500 fine. Microsoft has also been active in the court, and a Microsoft lawsuit temporarily shut down the Hong Kong-based company Lik-Sang. Lik-Sang offered a variety of mod chips for the Xbox and Sony's PlayStation 2, along with game consoles with mod chips already installed by Lik-Sang technicians. It is doubtful Lik-Sang will have the resources to effectively fight the suit.

Industry groups are working to remove all sites selling chips to allow the use of copied games.

The International Digital Software Association (IDSA), the trade group that represents the video game industry, is following a strategy called "notice and takedown" whereby it notifies ISPs that it has reason to believe particular sites are selling illegal games. The ISP will then typically notify the seller and ask it to either remove the chips or close down completely. According to the IDSA, the group has shut down some 30,000–40,000 websites this way. We believe this approach is sending the right message to offenders and is indicative of the industry's proactive

approach to software pirates, but if the problem continues to grow we do not think this will be sufficient. It is a logical approach, but filing so many lawsuits is simply not practical.

The International Marketplace Is Tough

Video game consoles are sold primarily in the U.S., Europe, and Japan.

Video game consumers are a global group, with 48% of 2001 console shipments going to the U.S., 24% to Europe, and 28% to Japan, by our estimate. The U.S. share was slightly higher than normal due to a disproportionate share (up to 50%) of new hardware consoles ordered in initial launches. Historically, the geographic distribution of software sales has been fairly steady, with the U.S. at 43%, Europe at 32%, and Japan at 25%.

In some countries a black market has diminished the chance of a legitimate market.

This geographic market share shows that video games have not reached a significant number of international markets. We believe one of the reasons for the lack of this expansion is that black market sales in certain countries have smothered any chance of a legitimate market. Sony, Microsoft, and Nintendo have not launched their systems in South America and parts of Asia. While none of these companies attributes this decision to piracy, we believe a lack of legitimate market control influenced the decision.

In an international court, mod chips were upheld as legal.

Unlike in the U.S., where console makers have won courtroom victories against mod chip distributors, in the international realm the legality of mod chips is not clear. For example, in Australia Sony sued a man supplying mod chips. Sony PlayStation consoles sold in Australia differ from those sold in the U.S. and Japan, and the defendant's claim was that the mod chips were being used to allow consumers to play legitimately bought overseas games. The court ruled that the chips do no violate copyright law because they can be used for legitimate reasons. This ruling opens a potential floodgate as modding not only allows people to play legitimately acquired games, but also pirated games.

Appendix A — Music Base Case Model

Music Industry Model and Assumptions

For this model we assumed total unit demand for music would continue to increase at a steady rate based on a pre-1999 industry average growth rate of about 3% (only since 1999 has that demand been divided between actual sales and illegal downloads and pirated discs).

We arrived at our estimates for illegal units sold and downloaded by consolidating information from a number of industry sources. For example, for illegal physical sales, the IIPA estimates that one pirated album is sold for every three to four legal sales. We assumed that for 2002 one illegal album is sold for every four legal sales. For illegal downloads, we took the mid-range of industry estimates of about 50 billion songs downloaded a year. We translated song downloads into album-equivalents by assuming ten downloaded songs equals an album. However, we realize that a lot of songs that are downloaded would have been purchased as an album or as a single if they had not been free. Since we are trying to estimate the lost sales to the music companies as a result of piracy, we assume that about 25% of songs downloaded results in lost sales. We calculated total pirated music on an industry level, and then for the Warner Music analysis we assumed that illegal sales affected the division based on its revenue market share. Other assumptions include:

- Share of demand, 2002

% Physical sales	60%
% Physical piracy	20%
% Illegal downloads	20%
% Legal downloads	<1

- Annual Growth, Units, 2002–05E

Net Demand Growth	3.2%
Legal physical sales growth	0.5%
Physical piracy growth	3.2%
Legal downloads growth	24.4%
Illegal downloads growth	9.8%

- Sales assumptions

Sales value on physical units	$12 declining to $10
Average gross margin on physical units	7.2%
Revenue on online sales/song	$0.65
Gross margin on online sales	30.0%

- Annual Growth, Dollar Value, 2002–05E

Net Demand Growth	(1.7)%
Total Legal Sales Growth	(4.3)%
Total Pirated Sales Growth	2.7%
Legal physical sales growth	(4.3)%
Physical piracy growth	(1.8)%
Legal downloads growth	24.4%
Illegal downloads growth	9.8%

Figure 67. Music Industry Base Case Scenario

$ in millions

MUSIC INDUSTRY	1999	2000	2001	2002	2003E	2004E	2005E	CAGR 1999-2005	CAGR 2002-2005
TOTAL UNITS	4,208	4,481	4,667	4,865	4,923	5,130	5,345	3.7%	3.2%
% Total Units - By Legitimacy									
Legal	3,440	3,370	3,111	2,865	2,654	2,782	2,915	-2.7%	0.6%
% of total units	80%	75%	67%	59%	54%	54%	55%		
Illegal	868	1,111	1,557	2,000	2,270	2,349	2,430	18.9%	6.7%
% of total units	20%	25%	33%	41%	46%	46%	45%		
TOTAL	4,308	4,481	4,668	4,865	4,923	5,130	5,345		3.2%
% Total Units - By Format									
Physical	4,284	4,213	3,988	3,834	3,633	3,831	3,977	-0.9%	1.2%
% of total units	98%	94%	85%	79%	74%	74%	74%		
Online	96	268	679	1,031	1,290	1,329	1,368	55.8%	9.8%
% of total units	2%	6%	15%	21%	26%	26%	25%		
TOTAL	4,308	4,481	4,667	4,865	4,923	5,130	5,345		
% Total Units									
Legal Physical Sales	3,440	3,370	3,110	2,861	2,619	2,775	2,908	-2.6%	0.5%
% of total units	80%	75%	67%	59%	54%	54%	54%		
Online Sales	-	-	1	4	9	6	7	NM	24.4%
% of total units	0%	0%	0%	0%	0%	0%	0%		
	20%	25%	33%	41%	46%	46%	45%		
Illegal Physical Piracy	764	843	878	973	985	1,056	1,069	6.7%	3.2%
% of total units	18%	19%	19%	20%	20%	20%	20%		
Online	96	268	679	1,027	1,285	1,323	1,361	55.7%	9.8%
% of total units	2%	6%	15%	21%	26%	26%	25%		
TOTAL REVENUES	$37,126	$37,744	$35,774	$34,788	$31,552	$30,755	$29,978	-3.5%	-4.3%
Physical Sales	$37,126	$37,744	$35,765	$34,782	$31,520	$30,715	$29,929	-3.5%	-4.3%
Implied Unit Price	$10.9	$11.2	$11.5	$11.55	$11.9	$11.1	$10.3		
Online Sales	$9	$0	$9	$25	$32	$40	$49	NM	24.4%
Implied Unit Price	$0.0	$0.0	$0.5	$5.5	$5.5	$6.6	$6.6		
TOTAL EBITDA	$4,328	$4,081	$2,774	$2,470	$2,374	$2,254	$2,170	-10.9%	-4.2%
Physical Sales	$4,328	4,001	2,771	2,463	2,364	2,242	2,155	-11.0%	-4.4%
EBITDA Margin	11.7%	10.6%	6.4%	7.2%	7.5%	7.3%	7.2%		
Online Sales	$0	$0	$3	$8	$10	$12	$15	NM	24.4%
EBITDA Margin	NM	NM	30.0%	30.0%	30.0%	30.0%	30.0%		
Total EBITDA	$4,328	$4,081	$2,774	$2,470	$2,374	$2,254	$2,170	-10.9%	-4.2%
EBITDA Margin	11.7%	10.6%	6.4%	7.2%	7.5%	7.3%	7.2%		

Source: Company reports and Smith Barney

citigroup
Smith Barney

Appendix B — Film Base Case Model

Film Industry Model and Assumptions

Our film industry base case assumes moderate but controlled piracy growth. We believe DVD growth will continue to take share from VHS as DVD player penetration grows. DVD growth should remain steady, but in our opinion it would be greater without piracy. We also assume the box office window remains relatively untouched by piracy.

Other assumptions include:

- Total Film Demand Growth 5%
- Box Office Growth 4%
- DVD Rental Growth 30%
- VHS Rental Growth (26)%
- DVD Sell-through Growth 18%
- VHS Sell-through Growth (46)%

Figure 68. Consumer Expenditures on Films, 2002–05E

$ in millions

Base Case	2002	2003	2004	2005	CAGR
Box Office	17,090	17,517	18,393	19,312	4.2%
DVD Rental	4,794	7,851	9,596	10,627	30.4%
VHS Rental	9,658	6,797	5,124	3,889	(26.2%)
DVD Sellthrough	13,050	17,313	19,753	21,485	18.1%
VHS Sellthrough	5,806	2,996	1,656	922	(45.8%)
Other	-	95	199	258	NM
Illegal	3,023	3,523	4,175	5,346	20.9%
Total Demand	53,420	56,091	58,896	61,840	5.0%
Share of Demand					
Box Office	32.0%	31.2%	31.2%	31.2%	
DVD Rental	9.0%	14.0%	16.3%	17.2%	
VHS Rental	18.1%	12.1%	8.7%	6.3%	
DVD Sellthrough	24.4%	30.9%	33.5%	34.7%	
VHS Sellthrough	10.9%	5.3%	2.8%	1.5%	
Other	0.0%	0.2%	0.3%	0.4%	
Illegal	5.7%	6.3%	7.1%	8.6%	
Total	100.0%	100.0%	100.0%	100.0%	

Source: Company reports and Smith Barney

Figure 69. Film Production Company Revenues, 2002–05E

$ in millions

Base Case	2002	2003	2004	2005	CAGR
Box office	$9,238	$9,469	$9,842	$10,439	4.2%
DVD Rental	3,196	4,921	5,984	6,550	27.0%
VHS Rental	5,681	4,261	3,196	2,397	(25.0%)
DVD Sellthrough	8,700	10,853	12,318	13,242	15.0%
VHS Sellthrough	3,415	1,878	1,033	568	(45.0%)
Other	-	95	199	258	NM
Illegal	1,512	1,851	2,322	3,290	29.6%
Total Demand	31,741	33,328	34,995	36,744	5.0%
Share of Demand					
Box office	29.1%	28.4%	28.4%	28.4%	
DVD Rental	10.1%	14.8%	17.1%	17.8%	
VHS Rental	17.9%	12.8%	9.1%	6.5%	
DVD Sellthrough	27.4%	32.6%	35.2%	36.0%	
VHS Sellthrough	10.8%	5.6%	3.0%	1.5%	
Other	0.0%	0.3%	0.6%	0.7%	
Illegal	4.8%	5.6%	6.6%	9.0%	
Total	100.0%	100.0%	100.0%	100.0%	

Source: Company reports and Smith Barney

Companies mentioned in this report: AMC Entertainment Inc. (AEN-$14.27; 2S), Apple Computer (AAPL-$20.38; 3H), Blockbuster Inc. (BBI-$17.14; 2H), Electronic Arts Inc. (ERTS-$44.25; 1M), EMI (EMI.L-$2.89; 2M), Fox Entertainment Group, Inc. (FOX-$27.71; 2H), Game Stop Corp. (GME-$16.22; 2H), Metro Goldwyn Mayer, Inc. (MGM-$16.00; 3H), Microsoft (MSFT-$25.10; 1M), News Corporation (NWS-$34.03; 2H), Regal Entertainment Group (RGC-$20.00; 2H), Sony (SNE-$33.65; 2H), Time Warner (TWX-$15.44; 2H), Viacom Inc. (VIAB-$37.82; 1M), Vivendi Universal (V-$22.10; 1H), Walt Disney Co. (DIS-$22.68; 1M).

Notes

Notes

ANALYST CERTIFICATION

Appendix A-1

We, Jill Krutick and Suk Han, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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EXHIBIT CO 0955

COLLINS STEWART

EMI

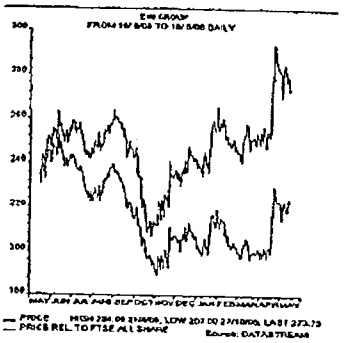
UK/ Europe | Media | Large Cap

17 May 2006

A deal would make sweet music

Recommendation:	Strong Buy
Target	400p
Price:	273p
Market cap:	£2.1bn

	1m	3m	12m
Absolute (%)	7	10	18
Relative to FT All Share (%)	11	10	-3



- **The combined valuation of EMI and Warner Music (WMG) is too low.** The current enterprise value of EMI and WMG is 8.5x EBITDA after cost savings. Assuming 1.5% nominal growth in music industry sales and flat underlying margins, 10.5x is justified. So the average "Hold" recommendation from brokers can't be right.

- **The cost savings from combining EMI and WMG are massive.** EMI's estimate of £160m pa understates the eventual savings from combining recorded music businesses. We estimate that only four-fifth of the combined workforce need be retained which would save around £230m pa. Consensus cost saving estimates seem far too low.

- **Selling Warner Chappell (WC) would avoid the only likely regulatory problem and reduce EMI's net acquisition cost.** We believe that WC would fetch £900m, or 13.2x EBITDA. This may seem a high valuation, but music publishing catalogues have stable cash flows that can be debt financed (eg Bowie bonds). The most elegant solution would be for WMG's private equity shareholders to retain WC. This way EMI reduces execution risk, pays an all cash offer for the stub and gives the consortium the opportunity to re-lever WC.

- **Financing is not a problem.** Assuming a $32.50 share offer for WMG, EMI would need £1.8bn of additional debt and £1.0bn of new equity. This would put EMI on 45:55 debt / equity capital structure within acceptable covenants (5.3x pre- and 4.0x post restructuring debt/EBITDA). A rights issue would be required to raise the equity. EMI's largest shareholders are supportive, with one exception (with a 2.3% stake). A 250p rights issue is possible (a 10% discount) that would create 390m new shares (50% of the current issue).

- **Both WMG and EMI shareholders make money.** EMI's main criterion is EPS accretion and based on £160m cost savings, accretion is 24% and 9% at US$30 and US$35/share. More importantly at the mid-point (US$32.50, 16% upside for WMG) post-restructuring ROIC is 8.0%. But if we are right that EMI is currently understating cost savings by £70m, EMI will have doubled its capital base and generated 9.5% ROIC, compared to 8.0% cost of capital.

- **A very favourable risk-reward profile on EMI.** EMI's share price would doubtless fall initially on an improved offer due to risk arbitrage flows. But once the market starts to count the EPS accretion, and more importantly value creation, the shares should be re-rated. There is little downside. In contrast with £160m savings (assuming $32.50 for WMG) our DCF valuation shows 16% upside to 325p for EMI. With the extra cost savings we forecast the valuation rises to 400p, or 43% upside. Strong Buy.

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The Combined Valuation of EMI and WMG is too low

The average broker recommendation on Warner Music Group (WMG) is "Hold". Likewise most brokers rate EMI a "Hold" too. Investors can argue that there will be a relative winner and loser if a bid goes ahead, but this misses the fact that EMI+WMG's combined enterprise value is only 8.8x EBITDA based on EMI's estimate of £160m costs savings. This is already low, but the valuation may prove even cheaper for two reasons: 1) If EMI manages an on-sale of Warner Chappell for £900m the implied valuation falls to 8.4x and 2) If EMI manages to achieve an additional £70m cost savings the implied valuation falls to 7.7x.

What kind of rating should the combined business trade on? As a rough guide you would expect a business growing free cash flow at 1.5% pa and with 8.25% cost of capital to trade on 10.5x EBITDA. Support to this view is provided by EMI's historical trading multiples: the combined business trades on a similar EV/Sales multiple (1.63x currently, verses 1.57x historic), but at a 25% discount to the historic EBITDA multiple (8.8x, verses 11.8x) even under the most pessimistic of assumptions.

So the market is either 1) Taking an unrealistically gloomy assessment of music businesses growth in free cash flow, 2) Under appreciating the extent of costs to come from the business or 3) Just being inconsistent. (We don't believe the market is putting a low probability of the chance of a deal as the valuations of EMI and WMG are so different... clearly risk arbitrage funds are already pushing the price of EMI down relative to WMG).

Table 1: EMI and Warner Music - Current Valuation Multiples

	EV / Sales	EV / EBITDA
Stand-alone valuations		
Warner Music Group	1.76	12.3
EMI	1.44	9.9
Combined business (without disposals)		
With £160m cost savings[1]	1.63	8.8
With £230m cost savings[1]	1.63	8.2
Combined after disposing Warner Chappell		
Warner Chappell disposal[2]	3.16	13.2
EMI+WMG (£160m cost savings)[1]	1.53	8.4
EMI+WMG (£230m cost savings)[1]	1.53	7.7
Fair value		
Historical EMI trading multiple	1.57	11.8
DCF suggested by 1.50% growth, 8.25% WACC	-	10.5

[1] We assume that the exceptional cost of achieving cost savings is equal to one year of savings. [2] We assume that Warner Chappell's EBITDA is reduced by $10m in order to support a headquarters function.
Source: Collins Stewart

Massive Cost Savings

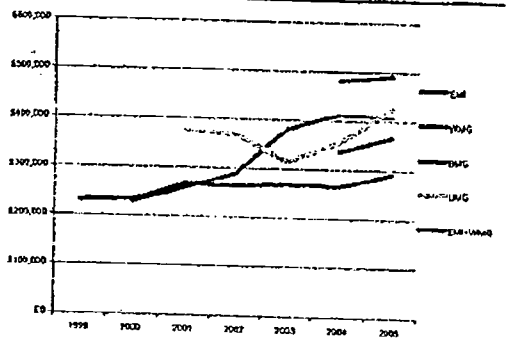
The most important factor to our argument is the extent of cost savings from combining EMI and Warner. EMI expects £160m of annual savings. However we believe this will prove over conservative. Certainly EMI has little incentive to admit the full extent of savings as already it can already demonstrate EPS accretion and a positive ROIC-WACC spread from an acquisition of WMG. Press reports suggest that savings could actually be a lot higher: sources close to Warner Music suggest savings up to £266m ($500m). UK sources say £215m ($400m) can be cut from the cost base.

We believe that EMI's estimate is a minimum. Ultimately we think that £230m can be saved. The sales-per-employee ratio of the music majors has increased since 1999. Bertelsmann-Sony (BMG) and Universal Music Group (UMG) have improved sales/employee to £415,000 from the low £200,000s. Employee data for WMG are not available before 2004, however the statistics since then indicate that it achieves £492,000 sales/employee. EMI has improved its sales/employee from £230,000 to £291,000 but still remains significantly behind BMG and UMG.

WMG's class-leading productivity results from determined cost cutting by its VC owners. Minor acts and associated staff were cut and investment was refocused into music categories popular in the Americas. Our industry sources warn that the cuts might limit WMG's stand-alone international growth, but if combined with EMI (strong internationally, weaker in the US) we doubt that these cuts will prove to be too close to the bone. Assuming comparable performance to BMG and UMG, EMI+WMG needs retain only 80% of their combined workforce. This would save £230m annually (£100,000 per position including overheads).

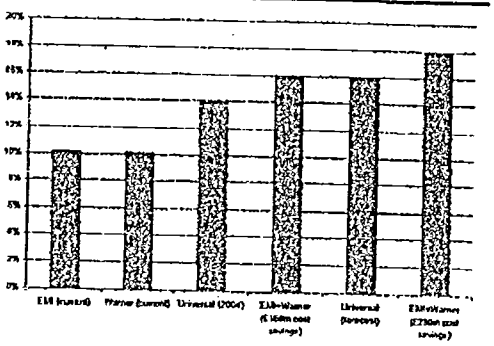
£160m cost savings would increase EMI's recorded music EBITDA margin from 10% to 16%. UMG achieved 14% EBITDA margin in 2004 and our Vivendi forecasts reflect this increasing to 15%. However, we would hardly call UMG the gold standard – as part of a conglomerate there is less pressure to perform. With our estimate of £230m of cost savings we believe that EMI should attain 18% recorded music EBITDA margin. The transition to digital music, with fewer physical distribution and inventory costs should help meet this target.

Figure 1: Sales Per Employee



Annual Reports and Collins Stewart

Figure 2: Recorded Music EBITDA Margins



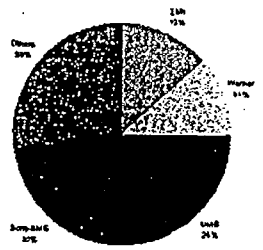
Annual Reports and Collins Stewart

An Immediate 'On-Sale' Of Warner Chappell

An immediate on-sale of WMG's music publishing division, Warner Chappell (WC), would address the only likely major regulatory problem and reduce EMI's net acquisition cost. We think it would fetch £900m–£990m.

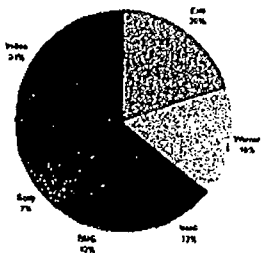
EMI tried merging with WMG in 2000 but staged a withdrawal when it became apparent that the EU Competition Commission would push for a combination of record label, music catalogue and distribution disposals. The scale of disposals required for a deal might be more acceptable to EMI this time. Collectively EMI and WMG account for 24% of the recorded music market. This puts them in second place after UMG and just before Sony-BMG. And independent music acts have easier route to market now that they can distribute on the Internet. This is unlikely to be a problem. However the combined 36% of the music publishing market is likely to be a problem. The simplest solution would be to sell-on WC.

Figure 3: Recorded Music Market Shares



Source: IFPI

Figure 4: Music Publishing Market Shares



Source: IFPI

Who could buy WC? Both Sony Music (who are underweight music publishing) and venture capital investors would probably be interested. VCs in particular would be willing to contribute only a small equity stake and use lots of debt to finance an offer. A highly leveraged capital structure would be suitable because music catalogues usually have stable cash flows that can be financed almost entirely with debt. David Bowie proved that there was demand for such an investment when he sold the rights to his first 25 albums for $55m cash up-front. (Rod Stewart and Iron Maiden have also sold asset backed debt too).

Bowie Bonds were priced at 128 bps above the 30 year T-bond in 1997. Although Moody's downgraded them from A3 to Baa3 (one notch above junk) in 2004, growth of legally distributed digital music has once again rekindled interest in music catalogues. WC has a more diversified catalogue to Bowie, and therefore deserves a lower risk spread. Balancing this against still weak recorded music sales we believe a 130 bps spread is reasonable now. This suggests a 13.2x EBITDA valuation for WC. Depending on the central overhead required to run WC, we think the business is worth £900m–£970m.

Table 2: Warner Chappell Valuation

	Downside	Upside
Revenue	$536m	$536m
EBITDA	138	138
Central costs	(10)	0
EBITDA (post central costs)	128	138
EV / EBITDA multiple	13.2x	13.2x
EV ($m)	1,696	1,822
EV (£m)	902	969

Source: Collins Stewart

The most elegant solution for WC would be for WMG's original VC backers (Thomas Lee, Bain Capital, Bronfman and Providence) to retain it. That way the net cost of EMI's acquisition would fall to £2.9bn from £3.8bn (under our base-case scenario of an $32.50 offer, and adding the cost achieving cost savings in the acquisition cost). This reduces EMI's risk and helps them to finance an all-cash offer. Also it provides WMG's shareholders with an interesting way to cash out the majority of their investment while re-levering a stub interest with just a sliver of equity. Press reports suggest that their initial $1.25bn equity stake has already been repaid in dividends. Their cash out from selling WMG and retaining WC would give them another $1.6bn.

Financing Is Not A Problem

Under our base case scenario EMI offers $32.50 for WMG, sells on WC for £902m and finances the balance of the business on 4.0x post-cost saving (5.3x pre-cost saving) Debt to EBITDA. This means that EMI raises £1.8bn of new debt and needs £984m of new equity.

Press reports say that most of EMI's largest investors would be supportive of another bid for WMG, and this would undoubtedly mean a rights issue. (There is one high profile dissenter, but the fund in question is listed as owning only a 2.3% stake, so unless they can convince others this would not be a show stopper). Our investment bankers say that a 10% discount would be appropriate to fund an acquisition that is substantially accretive. However, we think it likely that an offer up to $35 would also require a more deeply discounted rights issue.

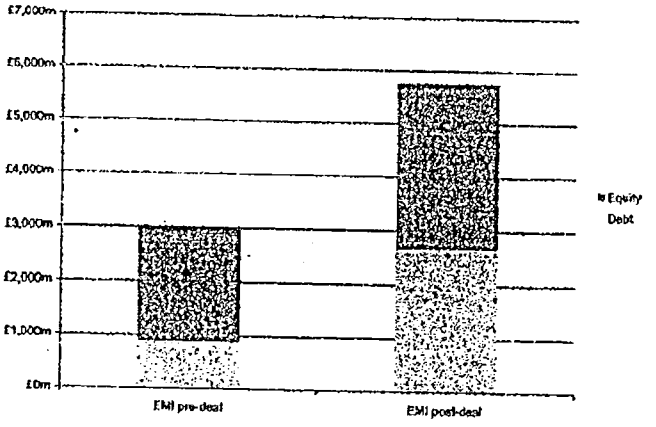
Our base case would cause EMI to issue 392m new EMI shares at 250p. (See the appendix for the detailed calculation). This would increase EMI's issued shares by 50% and result in a 45% debt to total capital ratio.

Table 3: Rights Issue – New Shares Required (% of current shares)

Offer price	$30.00	$32.50	$35.00
Rights Issue price			
250p	39%	50%	60%
225p	44%	55%	67%

Source: Collins Stewart

Figure 5: Pre- And Post Acquisition Capital Structure



Source: Collins Stewart

Value Creation

One of EMI's principal acquisition criteria is that of EPS accretion. (We are not wild about this metric due to accounting distortions, but we'll look briefly at this as EMI is using it). We've been relatively conservative in assuming the EMI's new debt costs an average of 8%. Our analysis suggests that acquiring WMG (ex-WC) is 9%–24% accretive to EMI. This assumes a 10% rights issue and £160m full year of cost savings. At our £230m cost saving estimate, EPS accretion increases to 33%–54% above EMI's stand-alone EPS.

Table 4: EMI EPS Accretion From WMG Acquisition And Restructuring (FY+1)

Offer price	$35.00	$32.50	$30.00
EPS Accretion - %			
£160m cost savings (EMI initial estimate)	9	16	24
£230m cost savings (Collins Stewart estimate)	33	43	54

Source: Collins Stewart

Doubling the capital base and achieving 9.5% ROIC is a corporate 'slam dunk'

More importantly from our point of view is the ROIC on the acquisition. The deal stacks up. At the mid point of our acquisition range ($32.50), and after £160m of cost savings post integration, ROIC is 8.0% (in-line with the cost of capital for a 45:55 debt to equity financed music company) If cost savings turn out to be £230m, post integration ROIC would be 9.4%. In anybody's terms that would be the corporate equivalent of a slam-dunk: *almost doubling the capital base and earning a 140 bps spread on your cost of capital.*

Table 5: EMI Value Creation From WMG Acquisition And Restructuring (FY+1)

Offer price ($)	35.00	32.50	30.00
Increase in Gross Capital (%)	99	92	85
Cost of capital (%)	8.0	8.0	8.0
ROIC (%)			
£160m cost savings (EMI initial estimate)	7.5	8.0	8.6
£230m cost savings (Collins Stewart estimate)	8.8	9.4	10.1

Note: We assume that an acquisition completes on March 31, 2007 and that the first full year of integration savings kicks in from 2008.

Source: Collins Stewart

Valuation

We believe that the risk reward trade-off from investing in EMI is excellent: there is minimal downside, while the upside is as much as 430p (58% upside).

No doubt risk arbitrage funds would take off the initial shine from an acquisition of WMG. Relative valuations between WMG and EMI already indicate that they are short EMI and long WMG. But this is why we actually believe that the risk-reward is better on EMI than on WMG. If a deal does not soon get agreed WMG's valuation is more vulnerable. In fact, if WMG buys EMI the risk arbitrage funds could be even more burned. (Press reports raise the possibility of this scenario, but we believe that WMG would prefer to sell to EMI for at least $30/share).

But once the market recognises the earnings accretion and value creation coming from a combination we believe EMI will be re-rated upwards. As a stand-alone business our DCF indicates 289p fair value for EMI. So there is about 6% upside. (Our financial forecasts actually pretty closely reflect consensus estimates). However, after acquiring WMG (at $32.50) our valuation moves to 325p (19% upside) based on £160m cost savings. If an additional £70m of costs is removed – we think they can be – the valuation moves to almost 400p (397p, 45% upside). This is a very attractive risk-reward profile.

Table 6: EMI Valuation – Risk Reward Matrix

WMG Offer price	$35.00	$32.50	$30.00
Target price			
£160m (EMI Initial estimate)	303	325	350
£230m (Collins Stewart estimate)	369	397	430
Upside / Downside			
£160m (EMI Initial estimate)	11%	19%	28%
£230m (Collins Stewart estimate)	35%	45%	58%

Source: Collins Stewart Quest™

Our DCF values are based on 8.0% cost of capital based on EMI's post acquisition capital structure (45% debt to total capital). And we estimate that terminal cash flow growth is 1.5%. We think that this is quite conservative as Informa/Global Music forecast 2.0% growth in 2007 and 3.0% in 2008 as digital sales more than compensate for still shrinking physical sales. (See the appendix).

EMI Stand Alone Financial Estimates

Table 7: Income Statement							
31 Mar y/e	2004	2005	2006E	2007E	2008E	2009E	2010E
Underlying	(1.4%)	(5.1%)	2.7%	2.5%	2.5%	2.0%	2.0%
Currency	(1.1%)	(3.3%)	1.1%	(1.5%)	0.0%	0.0%	0.0%
Scope	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Group - Change	(2.5%)	(8.4%)	3.8%	1.0%	2.5%	2.0%	2.0%
Recorded Music / EMI Music	1,723	1,600	1,640	1,656	1,697	1,731	1,765
EMI Music Publishing	398	401	438	442	453	462	471
Revenue	2,121	2,001	2,078	2,098	2,150	2,193	2,237
Recorded Music	147	126	137	154	163	182	183
Music Publishing	102	100	114	119	127	132	134
Operating profit	249	225	250	273	290	314	318
Recorded Music	8.6%	7.8%	8.3%	9.3%	9.6%	10.5%	10.4%
Music Publishing	25.6%	24.9%	26.0%	27.0%	28.0%	28.5%	28.5%
Operating margin	11.8%	11.2%	12.1%	13.0%	13.5%	14.3%	14.2%
Associates and JVs	(0)	1	1	1	1	1	1
Exceptionals / sub-total	(206)	(66)	(23)	0	0	0	0
Net finance costs	(96)	(62)	(59)	(70)	(65)	(62)	(58)
Pre-exceptional PBT	183	141	178	204	225	252	260
PBT	(53)	99	170	204	225	252	260
Tax	(20)	(24)	(54)	(61)	(67)	(76)	(78)
Effective tax rate	12.1%	16.9%	30.0%	30.0%	30.0%	30.0%	30.0%
Minorities	1	1	(2)	(3)	(3)	(4)	(4)
Pre exceptional net income	144	118	123	140	154	173	179
Net income - reported	(72)	76	114	140	154	173	179
Average diluted shares (mn)	827	873	877	877	877	877	877
Underlying Diluted EPS	15.5	13.1	15.0	17.0	18.6	20.8	21.4
Change	(0.6%)	(15.5%)	14.4%	13.6%	0.3%	11.5%	3.1%
DPS	8.0	8.0	8.0	8.4	9.2	10.2	11.2
Change	0.0%	0.0%	0.0%	5.0%	10.0%	10.0%	10.0%

Source: Collins Stewart

EMI Stand Alone Financial Estimates (Continued)

Table 8: Cash Flow Statement

31 Mar y/e	2004	2005	2006E	2007E	2008E	2009E	2010E
EBIT	249	232	250	273	290	314	318
Depreciation	35	25	31	31	32	33	34
EBITDA	284	257	282	305	322	347	351
Non cash items	2	2	0	0	0	0	0
Net provisions utilised	(35)	(63)	0	0	0	0	0
Working capital	58	25	0	0	0	0	0
Operating cash flow	309	221	282	305	322	347	351
Cash conversion	109%	86%	100%	100%	100%	100%	100%
Capex	(51)	(30)	(31)	(31)	(32)	(33)	(33)
Tax	(31)	(33)	(39)	(57)	(64)	(72)	(77)
Enterprise free cash flow	228	159	212	216	226	242	241
Interest	(95)	(100)	(73)	(70)	(66)	(62)	(58)
Equity free cash flow	132	59	139	146	160	180	183
Equity FCF / share (p)	16.8	7.4	17.6	18.5	20.2	22.8	23.1
Normalised Equity FCF / share (p)	21.3	15.5	17.6	18.5	20.2	22.8	23.1
Disposals	80	4	0	0	0	0	0
Acquisitions	(95)	(82)	0	0	0	0	0
Dividends	(66)	(64)	(63)	(64)	(68)	(75)	(82)
Exchange and other	60	4	0	0	0	0	0
Net change in cash	111	(81)	76	82	92	105	100
Net cash / (debt) - beginning	(860)	(749)	(830)	(754)	(672)	(580)	(475)
Net cash / (debt) - end	(749)	(830)	(754)	(672)	(580)	(475)	(375)
Net debt / EBITDA	2.6	3.2	2.7	2.2	1.8	1.4	1.1

Source: Collins Stewart

Income Statement – EMI Acquires Warner Music

Table 9: Income Statement

31 Mar y/e	2004	2005	2006E	2007E	2008E	2009E	2010E
Underlying	(1.4%)	(5.1%)	2.7%	2.5%	2.5%	2.0%	2.0%
Currency	(1.1%)	(3.3%)	1.1%	(1.5%)	0.0%	0.0%	0.0%
Scope	0.0%	0.0%	0.0%	76.7%	0.0%	0.0%	0.0%
Group - Change	(2.5%)	(8.4%)	3.8%	77.6%	2.5%	2.0%	2.0%
Recorded Music / EMI Music	1,723	1,600	1,640	3,248	3,329	3,396	3,464
EMI Music Publishing	398	401	438	442	453	462	471
Revenue	2,121	2,001	2,078	3,690	3,782	3,858	3,935
Recorded Music	147	125	141	314	484	491	498
Music Publishing	102	100	109	111	113	116	118
Operating profit	249	225	251	425	597	606	615
Recorded Music	8.6%	7.8%	8.6%	9.7%	14.5%	14.4%	14.4%
Music Publishing	25.6%	24.9%	25.0%	25.0%	25.0%	25.0%	25.0%
Operating margin	11.8%	11.2%	12.1%	11.5%	15.8%	15.7%	15.6%
Associates and JVs	(0)	1	1	1	1	1	1
Exceptionals / sub-total	(206)	(66)	(23)	(160)	0	0	0
Net finance costs	(96)	(62)	(59)	(215)	(210)	(203)	(197)
Pre-exceptional PBT	163	141	178	211	388	404	419
PBT	(53)	99	170	51	388	404	419
Tax	(20)	(24)	(54)	(63)	(116)	(121)	(126)
Effective tax rate	12.1%	16.9%	30.0%	30.0%	30.0%	30.0%	30.0%
Minorities	1	1	(2)	0	(5)	(6)	(6)
Pre exceptional net income	144	118	123	148	265	277	288
Net income - reported	(72)	76	114	(12)	265	277	288
Average diluted shares (mn)	827	873	877	1,271	1,271	1,271	1,271
Underlying Diluted EPS	15.5	13.1	15.0	12.3	21.6	22.5	23.4
Change	(0.6%)	(15.5%)	14.5%	(17.7%)	75.3%	4.0%	3.8%
DPS	8.0	8.0	8.0	8.4	9.2	10.2	11.2
Change	0.0%	0.0%	0.0%	5.0%	10.0%	10.0%	10.0%

Source: Collins Stewart

Cash Flow Statement – EMI Acquires Warner Music

Table 10: Cash Flow Statement

31 Mar y/e	2004	2005	2006E	2007E	2008E	2009E	2010E
EBIT	249	232	251	425	597	606	615
Depreciation	35	25	26	46	47	48	49
EBITDA	284	257	277	471	644	654	665
Non cash items	2	2	0	0	0	0	0
Net provisions utilised	(35)	(63)	0	0	0	0	0
Working capital	58	25	0	0	0	0	0
Operating cash flow	309	221	277	471	644	654	665
Cash conversion	109%	86%	100%	100%	100%	100%	100%
Capex	(51)	(30)	0	0	0	0	0
Tax	(31)	(33)	(31)	(55)	(57)	(58)	(59)
Enterprise free cash flow	228	159	(39)	(58)	(90)	(119)	(123)
Interest	(95)	(100)	(73)	(215)	(210)	(203)	(197)
Equity free cash flow	132	59	134	142	288	275	286
Equity FCF / share (p)	16.8	7.4	16.9	18.0	36.4	34.8	36.2
Normalised Equity FCF / share (p)	21.3	15.5	16.9	18.0	36.4	34.8	36.2
Disposals	80	4	0	0	0	0	0
Acquisitions	(95)	(82)	0	0	0	0	0
Dividends	(66)	(64)	(2,783)	0	0	0	0
Exchange and other	60	4	984	0	0	0	0
Net change in cash	111	(81)	(1,737)	47	186	163	162
Net cash / (debt) - beginning	(860)	(749)	(830)	(2,566)	(2,520)	(2,334)	(2,171)
Net cash / (debt) - end	(749)	(830)	(2,566)	(2,520)	(2,334)	(2,171)	(2,009)
Net debt / EBITDA	2.6	3.2	2.8	5.3	3.6	3.3	3.0

Source: Collins Stewart

Appendix – Valuation Multiples at Current Share Prices

Table 11: Detailed Enterprise Value Calculations

	WMG US (current).	WMG LN (current)	EMI LN	Combined	Warner Chappell Disposal	Combined after disposal	Cost savings	Combined after cost savings
Valuation								
Share price	$27.96		£2.73					
# shares	155		790					
Equity value	4,334	2,305	2,157	4,462		2,486		2,716
Net debt	(1,886)	(1,003)	(860)	(1,863)		(2,939)		(2,939)
Enterprise value	6,220	3,308	3,017	6,325	899	5,426	230	5,656
Revenues								
Recorded Music	2,994	1,593	1,656	3,248		3,248		3,248
Music Publishing	536	285	442	727	285	442		442
Total	$3,530m	£1,877m	£2,098m	£3,975m	£285m	£3,690m		£3,690m
EV / Sales	1.76	1.76	1.44	1.59	3.16	1.47		1.53
EBITDA								
Recorded Music	16.0%	16.0%	10.8%	13.3%		13.3%		18.6%
Music Publishing	25.8%	25.8%	28.5%	27.4%		28.5%		28.5%
Total EBITDA Margin	14.3%	14.3%	14.5%	14.4%		13.7%		19.9%
Recorded Music	478	254	179	433		433	170	603
Music Publishing	138	73	126	199	73	126		126
Central Costs	(112)	(60)		(60)	(5)	(54)	60	6
Total	$504m	£268m	£305m	£573m	£68m	£505m	£230m	£735m
Cost of achieving cost savings								1.0
Net debt / EBITDA ratio								4.0
EV / EBITDA (before savings)	12.3	12.3	9.9	11.0	13.2	10.7		7.7

Source: Collins Stewart

Appendix – Valuation Multiples at an $32.50 Acquisition Offer For WMG

Table 12: Enterprise Value Calculations – On Acquisition

	WMG US	WMG LN	EMI LN	Combined	Warner Chappell Disposal	Combined after disposal	Cost savings	Combined after cost savings
Valuation								
Share price	$32.50		£2.73					
# shares	155		790					
Equity value	5,038	2,680	2,157	4,836		3,141		3,301
Net debt	(1,886)	(1,003)	(860)	(1,863)		(2,659)		(2,659)
Enterprise value	6,924	3,683	3,017	6,699	899	5,800	160	5,960
Revenues								
Recorded Music	2,994	1,593	1,656	3,248		3,248		3,248
Music Publishing	536	285	442	727	285	442		442
Total	$3,530m	£1,877m	£2,098m	£3,975m	£285m	£3,690m		£3,690m
EV / Sales	1.96	1.96	1.44	1.69	3.16	1.57		1.62
EBITDA								
Recorded Music	16.0%	16.0%	10.8%	13.3%		13.3%		16.4%
Music Publishing	25.8%	25.8%	28.5%	27.4%		28.5%		28.5%
Total EBITDA Margin	14.3%	14.3%	14.5%	14.4%		13.7%		18.0%
Recorded Music	478	254	179	433		433	100	533
Music Publishing	138	73	126	199	73	126		126
Central Costs	(112)	(80)		(80)	(5)	(54)	60	6
Total	$504m	£268m	£305m	£573m	£68m	£505m	£160m	£665m
Cost of achieving cost savings							1.0	
Net debt / EBITDA ratio						5.3		4.0
EV / EBITDA (before savings)	13.7	13.7	9.9	11.7	13.2	11.5		9.0

Source: Collins Stewart

Appendix – Base Case Acquisition Financing

Table 13: Post Acquisition Financing Structure	
Acquisition price	$32.50
Diluted shares out	155
Buyout WMG equity value	$5,038m
WMG net debt	(1,886)
Buyout WMG enterprise value	$6,924m
Buyout WMG enterprise value	£3,683m
Financed by...	
Disposal of Warner Chappell	899
New Debt	£1,799m
Cost savings	£160m
Net debt / EBITDA (pre-savings)	5.3
Net debt / EBITDA (post-savings)	4.0
New Equity	984
Share issue...	
Discount to current share price	8%
Rights issue subscription price	£2.51
New shares issued (m)	392
Current shares out	790
New shares / Current issue	50%

Source: Collins Stewart

Appendix – Recorded Music Growth Forecasts

Table 14: Global Music Industry Sales

	2000	2001	2002	2003	2004	2005	2006E	2007E	2008E
Global Music Expenditure $bn									
Physical	40	39	36	36	33	32	31	29	29
Digital	0	0	0	1	1	2	3	6	7
Total	40	39	36	36	34	34	34	35	36
YoY Growth									
Physical	-	-	-	-	-	-	-4.5%	-3.5%	-2.2%
Digital	-	-	-	-	-	-	70.0%	60.0%	29.8%
Total	-	-3.0%	-6.0%	0.0%	-6.0%	-1.0%	2.0%	2.0%	3.0%

Source: Informa, Global Music Forecasts

Appendix – DCF Valuation Sensitivity

Table 15: Valuation Sensitivity – assuming £230m cost savings							
WACC \ Terminal growth	0.00%	0.50%	1.00%	1.50%	2.00%	2.50%	3.00%
Target price (p)							
7.50%	296	342	394	455	527	614	720
7.75%	277	320	368	425	492	571	667
8.00% (post acquisition capital structure)	260	299	345	397	459	531	619
8.25%	242	280	323	372	429	495	575
Upside / (Downside)							
7.50%	8%	25%	44%	64%	93%	125%	164%
7.75%	1%	17%	35%	56%	80%	109%	144%
8.00%	(5%)	10%	26%	46%	68%	95%	127%
8.25%	(11%)	3%	18%	36%	57%	81%	111%

Table 16: Valuation Sensitivity – assuming £160m cost savings							
WACC \ Terminal growth	0.00%	0.50%	1.00%	1.50%	2.00%	2.50%	3.00%
Target price (p)							
7.50%	242	279	322	372	430	501	587
7.75%	227	261	301	347	401	466	543
8.00%	212	245	282	325	375	434	504
8.25%	199	229	264	304	350	404	469
Upside / (Downside)							
7.50%	(11%)	2%	18%	36%	58%	83%	115%
7.75%	(17%)	(4%)	10%	27%	47%	71%	99%
8.00%	(22%)	(10%)	3%	19%	37%	59%	85%
8.25%	(27%)	(16%)	(3%)	11%	28%	48%	72%

Table 17: Valuation Sensitivity – EMI Stand-Alone Valuation							
WACC \ Terminal growth	0.00%	0.50%	1.00%	1.50%	2.00%	2.50%	3.00%
Target price (p)							
8.00%	2.44	2.62	2.81	3.04	3.31	3.62	4.00
8.25% (based on stand alone capital structure)	2.34	2.50	2.68	2.89	3.13	3.42	3.78
8.50%	2.24	2.39	2.56	2.75	2.98	3.24	3.55
Upside / (Downside)							
8.00%	(11%)	(6%)	3%	11%	21%	32%	46%
8.25%	(15%)	(9%)	(2%)	6%	14%	25%	37%
8.50%	(18%)	(13%)	(7%)	0%	9%	18%	29%

Source: Collins Stewart

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Research Recommendations issued by Collins Stewart Limited in Q1 2006

Recommendations	Buys	Sells	Hold/Neutral
Percentage of Total	56%	19%	25%
Percentage of which in Corporate Client stocks	21%	1%	14%

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EXHIBIT CO 0956

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INITIATION

19 June 2006
Global
Entertainment

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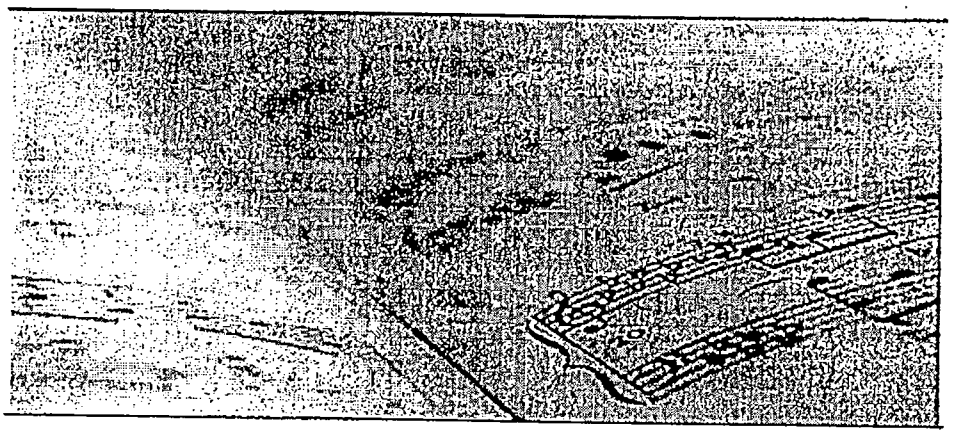
OVERWEIGHT

Global Music Industry

"Just the Two of Us"



- We initiate coverage on Warner Music Group with an Outperform rating and a target price $30. We also reiterate our Outperform rating on EMI, raising our target price from 300p to 310p. In this report, we analyze the strengths, weaknesses, and strategic positioning of all four music Majors: Sony (Sony BMG—joint venture), Vivendi (UMG or Universal—subsidiary) as well as publicly listed WMG and EMI Group. We also present our global music industry model, digital growth scenario, margin comparison analysis, and industry consolidation scenarios.
- The recorded music industry sales outlook is improving. After five years of decline, we believe that we are nearing the inflexion point, where sales growth may turn positive. Year to date, the world's two largest music markets, the United States and Japan, are experiencing positive growth.
- Industry margins are also picking up. In addition to the turnaround in sales growth, margins are improving, reflecting a concerted effort among all the Majors to cut costs and increase efficiency. In addition, we are seeing the benefit of higher digital margins.
- We envisage further upside from a possible EMI/WMG merger. We believe a deal is forthcoming given its compelling strategic logic and the fact that the synergies are so substantial and tangible.

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Executive Summary

We initiate coverage on Warner Music Group with an Outperform rating and a target price $30. We also reiterate our Outperform rating on EMI, raising our target price from 300p to 310p. In this report, we analyze the strengths, weaknesses, and strategic positioning of all four music Majors: Sony (Sony BMG—joint venture), Vivendi (UMG or Universal—subsidiary) as well as publicly listed WMG and EMI Group. We also present our global music industry model, digital growth scenario, margin comparison analysis, and industry consolidation scenarios.

The recorded music industry sales outlook is improving. After five years of decline, in which the global recorded music market has contracted from over $37 billion in 2000 to around $33 billion in 2005, we believe that we are nearing the inflexion point where sales growth may turn positive. Year to date, the world's two largest music markets, the United States and Japan, are experiencing positive growth. Piracy is being addressed and contained, digital sales are exploding, and new, incremental revenue streams are emerging.

Industry margins are also picking up. In addition to the turnaround in sales growth, margins are improving. We have witnessed a concerted effort among all the Majors to cut costs and increase efficiency, helping to protect and augment margins almost irrespective of industry outlook. We are also seeing the benefit of higher digital margins come through. Over the past three years, industry margins have expanded from 7.4% to an estimated 14.8% in 2006. We believe the industry has a two-to-three year window to exploit these higher digital margins before artists' contracts are renewed and artists begin to demand a share in the upside.

We envisage further upside from a possible EMI/WMG merger. We believe a deal will eventually be struck given its compelling strategic logic and the fact that the synergies are so substantial and tangible—possibly almost as much as the EBITDA generated by WMG alone—that both companies would materially benefit. The only issue is who will be the acquirer and how will the capitalized value of available synergies be split. We have modeled the potential acquisition assuming EMI is the likely acquirer, at a purchase price of $30 (higher than the initial $28.50), with £125 million p.a. in cost savings (about 4% of the combined cost base) and financing of net debt/EBITDA of 3 times. In this conservative scenario, the deal would be 16% accretive to EMI's earnings. Greater upside surprise could follow from a higher level of cost savings and from the sale of the Warner Chappell publishing business for a higher valuation than the 12.5 times EBITDA (£1 billion/$1.8 billion) we have assumed. The synergies are so substantial that the deal would also be significantly accretive if WMG were to be the acquirer.

Valuation—On a 2006 calendar-year-adjusted basis, EMI and WMG are trading on EBITDA multiples of 10.5 times and 11.2 times, respectively.

Warner Music

We initiate coverage of Warner Music with an Outperform rating and a $30 share price target. WMG is a global recorded music company and music publisher. Its recorded music market share is approximately 12% and its music publishing market share is approximately 16%.

Our share price target is based on an analysis of merger economics with EMI as well as a discounted cash flow valuation. EMI has recently made a $28.50 takeover offer for WMG. A $30 takeover price, a 5% premium to the previous offer, would still be highly EPS accretive to EMI.

Key risks

- Takeover premium? Arguably the market has awarded a valuation premium to WMG for a potential merger or takeover by EMI. There is, therefore, a risk of share price downside were this not to occur.
- Warner Music is not in compliance with Sarbanes-Oxley. The company needs to implement appropriate internal controls to achieve this. Two of three material weaknesses have been addressed. The remaining weakness relates to accounting for royalty payments.
- It is unclear whether WMG has been overly aggressive in reducing its A&R investment, which may affect its future release schedule. Since acquisition from Time Warner, the company has reduced its artist roster by approximately 30%.
- Risks of the music industry. The music industry revenue model is in the process of evolving, with downside risks associated with piracy and uncertainties over the upside opportunities of the emerging digital platforms.

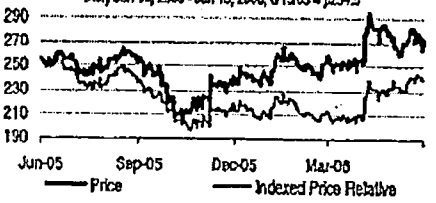
EMI Group plc EMI.L / EMI LN

OUTPERFORM*

Price (15 Jun 06)	273 (p)
52 week high - low	294.00 - 207.00
Target price (12 months)	(from 300.00) 310.00 (p)
Analyst's Coverage Universe	Media
Weighting (vs. broad market)	OVERWEIGHT

** Stock ratings are relative to the relevant country index.*

Price / Indexed Index - United Kingdom FTSE All Share, Jun 15, 2005 - Jun 15, 2006, 6/15/05 = p254.5

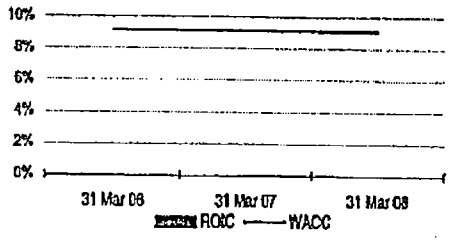


Year	3/06A	3/07E	3/08E
EPS (CS adj., p)	15.7	17.1	19.4
P/E (x)	17.4	15.9	14.1
P/E rel. (%)	130.0	129.7	121.2
Revenue (£ m)	2,079.9	2,115.5	2,151.7
EBITDA (£ m)	275.8	303.6	328.8
IC (£ m)	—	—	—
OCFPS (£)	—	—	—
ROIC	—	—	—
P/OCF (x)	—	—	—
EV/EBITDA (x)	11.5	10.3	9.3

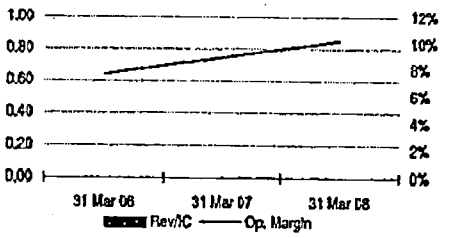
Number of shares (m)	790.07	Enterprise value (£m)	2,969.15
Net debt (3/06A, £ m)	879.5	Dividend (3/06A, £)	8.00
Net debt/Total cap. (3/06A)	48.4%	Dividend yield	2.93%

Year	Q1 EPS	Q2	Q3	Q4
3/06A				
3/07E				
3/08E				

ROIC / WACC



REV / IC Op. Margin



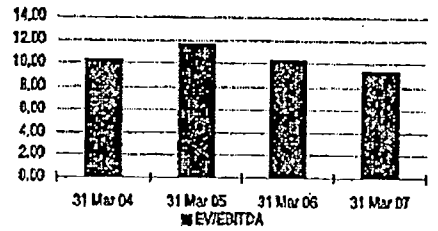
Historical valuation

Year	3/05A	3/06A	3/07E
Y/E closing price (p)	2.38	2.53	272.75
Market cap. (£ m)	2,061.93	2,154.93	2,154.93
End year net debt (£ m)	837.3	879.5	814.2
Enterprise value (£ m)	2,992.23	3,034.43	2,969.15

Key historical ratios

EV/EBITDA (x)	11.0	10.9	9.7
EV/IC (x)	—	—	—
P/E at closing price (x)	15.0	14.8	14.1

EV/EBITDA (at historical prices)



Strategic analysis

Existing strengths: Music industry turnaround; strong management; good cost control; high exposure to music publishing.

Existing weaknesses: Music sales still volatile; continued threat of piracy; artists' royalty demands; relatively low U.S. exposure.

Existing opportunities: Industry consolidation; controlling piracy; higher digital margins; mobile phone music opportunities; lower cost of debt.

Existing threats: Possible cannibalization effect of digital music, power of physical and digital retailers.

Company description

EMI is a leading global music company, with a 13% global market share in recorded music and the largest music publishing catalogue worldwide.

Source: Company data, Credit Suisse estimates
On 06/15/06 the Index - United Kingdom FTSE All Share Index closed at 2,860.89

Sony 6758 / 6758 JP

OUTPERFORM*

Price (15 Jun 06)	4720.00 (¥)
52 week high - low	6,150.00 - 3,670.00
Target price (12 months)	7500.00 - 64.00 (¥)
Analyst's Coverage Universe	Technology Hardware & Equipment
Weighting (vs. broad market)	MARKET WEIGHT

** Stock ratings are relative to the relevant country index.*

Year	3/06A	3/07E	3/08E
EPS (CS adj., ¥)	46.59	203.64	344.73
P/E (x)	101.3	23.2	13.7
P/E rel. (%)	484.7	129.2	83.1
Revenue (¥ m)	7,475.4	7,951.0	8,916.8
EBITDA (¥ m)	573.1	614.0	841.9
IC (¥ m)	7,353,500.0	—	7,924,618.2
OCFPS (¥)	535.26	587.21	805.08
ROIC	0.3%	1.1%	2.2%
P/OCF (x)	10.2	8.0	5.9
EV/EBITDA (x)	8.2	7.5	5.4

Number of shares (m)	1,001.90	Enterprise value (¥m)	4,625,008.51
Net debt (3/06A, ¥ m)	-101.7	Dividend (3/06A, ¥)	25.00
Net debt/Total cap. (3/06A)	-3.2%	Dividend yield	0.5%

Historical valuation

Year	3/05A	3/06A	3/07E
Y/E closing price (¥)	4,270.00	5,450.00	4,720.00
Market cap. (¥ m)	4,456,919.25	5,692,448.77	4,728,953.84
End year net debt (¥ m)	-307,692.0	-101.7	-103,945.3
Enterprise value (¥ m)	4,421,261.84	4,728,852.14	4,625,008.51

Key historical ratios

EV/EBITDA (x)	9.1	8.2	7.5
EV/IC (x)	0.7	0.8	—
P/E at closing price (x)	27.0	117.0	23.2

Strategic analysis

Existing strengths: Strong market shares in key product lines such as LCD televisions and PCs.

Existing weaknesses: Audio business is weak.

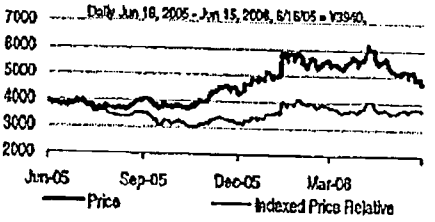
Existing opportunities: Margin recovery in electronics business.

Existing threats: Price erosion in key product lines.

Company description

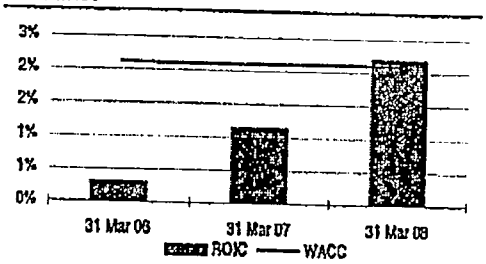
Sony is a prominent consumer electronics manufacturer, and top game equipment manufacturer. Sony is Japan's most famous brand.

Price / Indexed Japan TOPIX

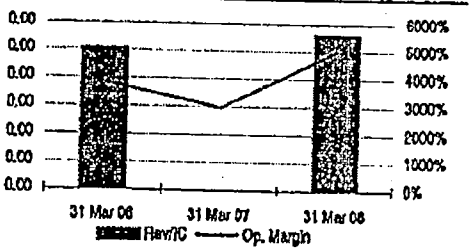


Year	3/06A	3/07E	3/08E
Q1 EPS	-8.53		
Q2	-43.13		
Q3	161.58		
Q4	-68.43		

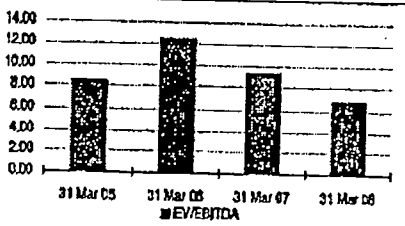
ROIC / WACC



REV / IC Op. Margin



EV/EBITDA (at historical prices)



Source: Company data, Credit Suisse estimates
On 06/15/06 the Japan TOPIX index closed at 1,468.14

Vivendi VIV.PA

NEUTRAL*

Price (15 Jun 06)	26.80 (eu)
52 week high - low	29.28 - 24.65
Target price (12 months)	24.00 (eu)
Analyst's Coverage Universe	Media
Weighting (vs. broad market)	OVERWEIGHT

** Stock ratings are relative to the coverage universe in each analyst's or each team's respective sector.*

Year	12/05A	12/06E	12/07E
EPS (CS adj., eu)	1.38		
P/E (x)	19.8	—	—
P/E rel. (%)	135.0	130.2	129.3
Revenue (eu m)	19,484.0	20,259.8	20,980.1
EBITDA (eu m)	5,331.0	5,860.5	6,163.8
IC (eu m)	—	—	—
OCFPS (eu)	—	—	—
ROIC	—	—	—
P/OCF (x)	—	—	—
EV/EBITDA (x)	5.1	4.8	4.2

Number of shares (m)	1,153.48	Enterprise value (eum)	26,968.67
Net debt (12/05A, eu m)	3,859.0	Dividend (12/05A, eu)	1.00
Net debt/Total cap. (12/05A)	20.5%	Dividend yield	3.7%

Valuation

Year	12/04A	12/05A	12/06E
Y/E closing price (eu)	23.49	26.45	26.80
Market cap. (eu m)	28,906.53	30,521.00	30,913.18
End year net debt (eu m)	3,135.0	3,859.0	3,669.4
Enterprise value (eu m)	27,779.44	28,958.22	28,968.67

Key ratios

EV/EBITDA (x)	13.7	5.1	4.8
EV/IC (x)	—	—	—
P/E at closing price (x)	30.9	19.5	—

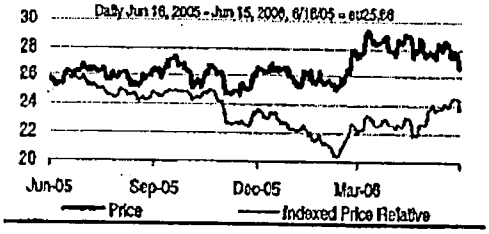
Strategic analysis

Existing strengths: Strong divisional management.
Existing weaknesses: Holding company structure.
Existing opportunities: Portfolio rationalization.
Existing threats: Regulatory environment.

Company description

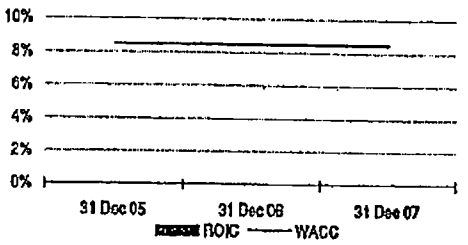
Vivendi is a Media and Telecom conglomerate with French distribution (mobile, pay-TV) and global content (music, movies, games).

Price / Indexed Europe Dow Jones Stoxx

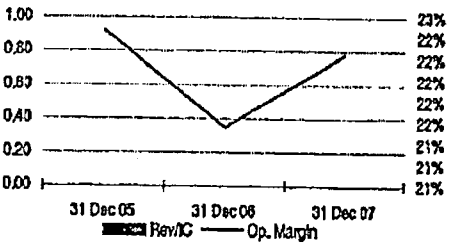


Year	12/05A	12/06E	12/07E
Q1 EPS			
Q2			
Q3			
Q4			

ROIC / WACC



REV / IC Op. Margin



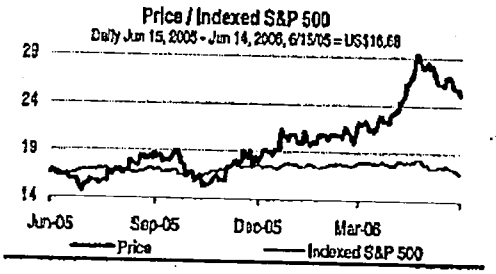
Source: Company data, Credit Suisse estimates
On 06/15/06 the Europe Dow Jones Stoxx Index closed at 328.31

Warner Music Group WMG

OUTPERFORM*

Price (15 Jun 06)	26.71 (US$)
52 week high - low	29.40 - 14.75
Target price (12 months)	30.00 (US$)
Analyst's Coverage Universe	Entertainment
Weighting (vs. broad market)	OVERWEIGHT

** Stock ratings are relative to the coverage universe in each analyst's or each team's respective sector.*



Year	9/05A	9/06E	9/07E
EPS (CS adj., US$)	1.23	1.34	1.51
P/E (x)	21.7	20.0	17.7
P/E rel. (%)	103.1	—	—
Revenue (US$ m)	3,502.0	3,532.3	3,632.8
EBITDA (US$ m)	458.0	497.3	541.0
IC (US$ m)	—	—	—
OCFPS (US$)	2.23	1.75	3.57
ROIC	—	—	—
P/OCF (x)	8.3	14.5	7.1
EV/EBITDA (x)	12.2	11.8	10.3

Year	9/05A	9/06E	9/07E
Q1 EPS	0.58	0.71	
Q2	0.34	0.21	
Q3	-0.05	0.08	
Q4	0.29	0.33	

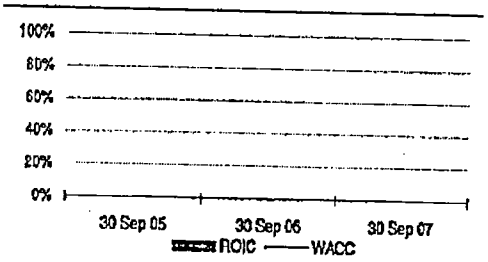
Number of shares (m)	141.90	Enterprise value (US$m)	6032
Net debt (9/05A, US$ m)	1,958.0	Dividend (Current, US$)	0.13
Net debt/Total cap. (9/05A)	2200.0%	Dividend yield	0.5%

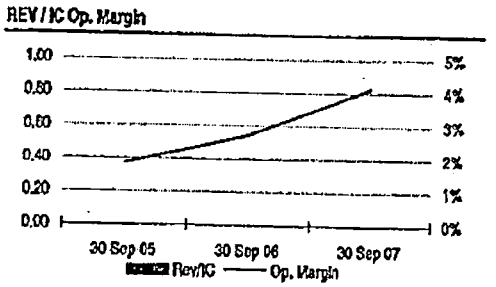
Valuation

Year	9/04A	9/05A	9/06E
Y/E closing price (US$)	—	18.51	28.71
Market cap. (US$ m)	—	—	4,028.2
End year net debt (US$ m)	—	1,958.0	2,005.8
Enterprise value (US$ m)	—	5,984	6,032

Key ratios

EV/EBITDA (x)	—	9.5	11.8
EV/IC (x)	—	—	—
P/E at closing price (x)	—	15.1	20.0





Source: Company data, Credit Suisse estimates
On 06/14/06 the S&P 500 Index closed at 1,256.18

Strategic analysis

Existing strengths: Strong artist roster, management depth, aggressive in transitioning to digital

Existing weaknesses: Weaknesses in financial reporting; highly geared balance sheet.

Existing opportunities: Economic rationale for a merger with EMI is strong.

Existing threats: Not in compliance with Sarbanes Oxley.

Company description

Warner Music is a global recorded music company and music publisher.

Music Industry SWOT Analysis

Strengths

- Digital platforms (downloads, mobile and subscription) are experiencing strong growth in demand, providing the opportunity for the music industry to offset the declines in physical sales, which have pressured revenues over the past five years. In addition, there is the potential to lift operating margins due to the absence of costs associated with physical manufacturing and distribution and the lower costs associated with increasing digital catalog sales.
- Music companies' reliance on any single artist is relatively low given the diversification in revenue source by number of artists and geography, and the split between frontline and catalog sales and music publishing.
- The capital expenditure requirements of music companies are low relative to other entertainment companies.
- The music industry's cost structure is relatively flexible, and it has been successful in achieving a major cost restructuring over the past four years. We expect industry-wide margins in 2006 to exceed those achieved in 2000 despite the considerable downward pressure on revenue that the industry has endured in the intervening period.
- The long-term nature of artists' contracts should limit talent cost inflation, at least in the short to medium term, and make the music industry less susceptible to significant margin pressure than other creative industries.

Weaknesses

- Physical sales are under continued downward pressure and the potential to more than offset with digital growth is not yet proven. However recent trends in key markets (United States and Japan) suggest a deceleration in the rate of physical decline.
- As with all creative industries, company profitability is highly dependent on successful releases, which are inherently difficult to predict and which result in significant quarter-to-quarter earnings volatility.
- The concentration of physical sales through major retailers and digital sales through Apple potentially shifts negotiating leverage from the music companies to distributors.

Opportunities

- The growth in digital platforms is expected to be substantial with increasing broadband penetration in developed markets. Music-enabled mobile phones are achieving significant growth in penetration in both developed and developing markets.
- Following significant industry restructuring, there is potential for noticeable margin expansion across the group. Further margin opportunity is available with the move to digital which should have a higher operating margin. From an industry-average EBITDA margin low of 7.4% in 2003, we expect margins to double in 2006.
- Further industry consolidation is possible with a Warner-EMI combination, bringing with it further cost reduction opportunities. In addition, we believe the scale benefits of

a more concentrated music industry potentially brings with it greater negotiating leverage in relation to physical and digital music retailers.

- Traditionally the music industry has maintained a separation of artists between its recorded music and music publishing businesses. The emergence of digital revenues and desire to clear rights expeditiously for digital platforms provides the opportunity for a greater alignment between the two business arms.

Threats

- Piracy remains a considerable threat to industry growth with increasing broadband penetration, notwithstanding recent progress in achieving favorable legal decisions. In particular, the core young demographic purchasing music has been considerably eroded by the ability to achieve free access to music through unlawful means.
- The digital opportunity arguably provides greater upside for already successful acts, bringing with it the risk of competition between music companies for talent. Upward pressure on operating costs brings with it the risk that the benefits arising from industry-wide restructuring and digital distribution could be eroded.
- The continued growth in share of mass-market retailers, such as Wal-Mart and the concentration of digital sales through Apple brings with it the risk of pricing erosion.
- The ability of consumers to "unbundle" music purchases brings with it a threat of continued downward pressure on industry sales as $15 album purchases are potentially replaced with two or three tracks for $2-3.
- As portable hard drives become increasingly prolific, so does the ease with which unprotected music collections can be rapidly and cheaply copied by the consumer.

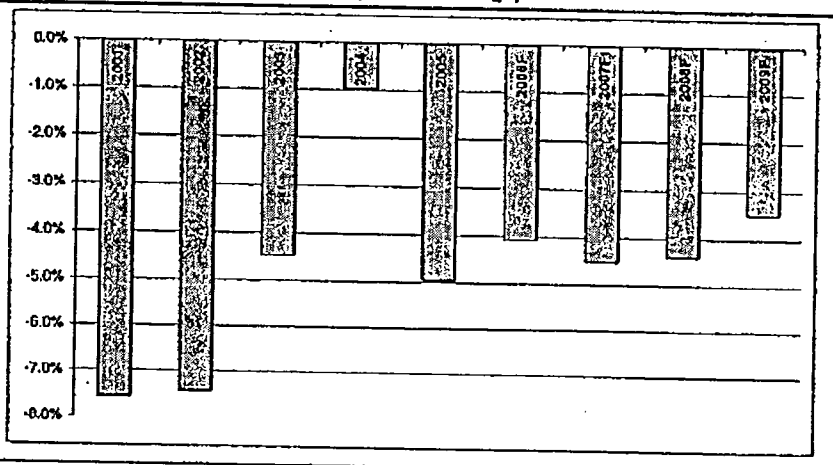
Global Physical Recorded Music Market

There have been many theories forwarded to explain the pressures the music industry has been experiencing over the course of the current decade. We examine some of the issues below, and discuss their current status in influencing the global physical music market.

1. Piracy

The decline in global music sales highlighted in Exhibit 1 below has unquestionably in our view been driven by the growth of the Internet and the ease of peer-to-peer file sharing.

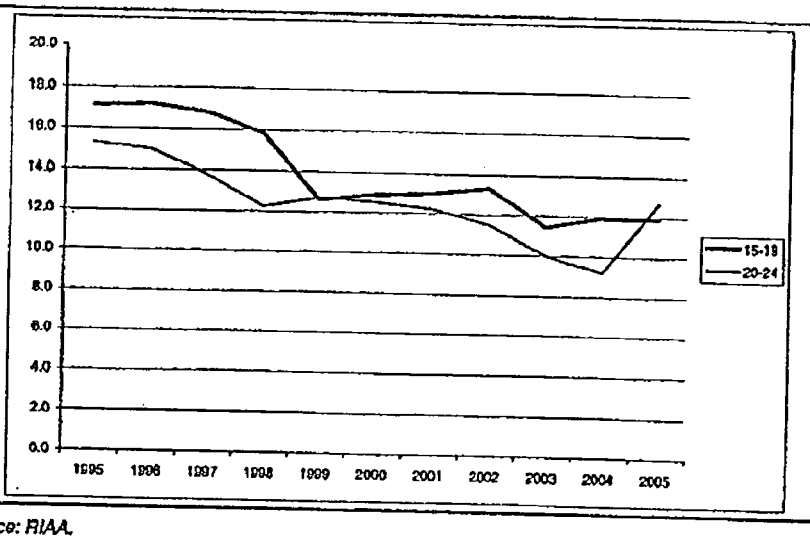
Exhibit 1: Global Physical Music Sales (Units % Change)



Source: IFPI

As highlighted in Exhibit 2 below, this trend has been particularly pronounced in younger demographics, which have historically been the largest purchasers of music. In the U.S. recorded music market, the 15-24 year old demographic had a combined share of purchase of close to one-third in 1995. This fell to a little over 20% in 2004, reflecting, in our view, the impact of new technologies in permitting file sharing.

Exhibit 2: Music Purchase by Key Younger Demographics – Improving after a decade of decline



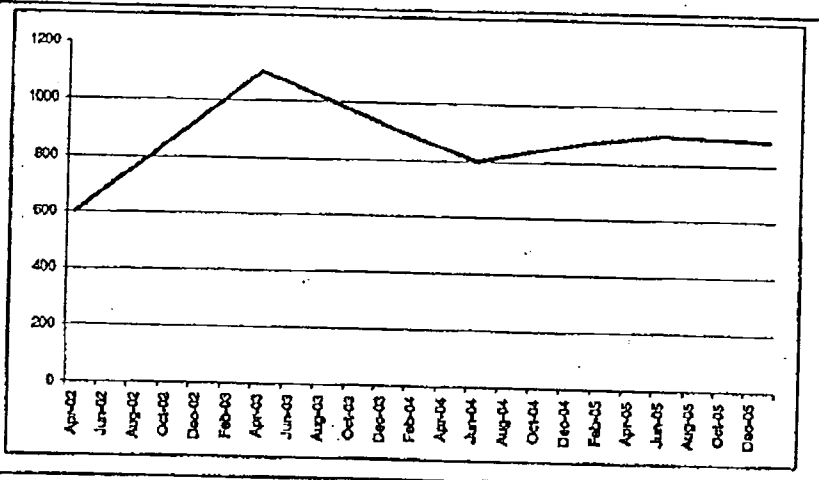
Source: RIAA.

Current status:

The most recent demographic sales data suggests that the growth in paid online music services is beginning to combat piracy among younger demographics. IFPI estimates a total of 335 service providers compared with 50 two years ago. In this past year alone, we have seen the first legal peer-to-peer agreement signed, iTunes expand to over 20 countries, the launch of portable subscription services, such as Napster To Go and Yahoo Music Unlimited, and the introduction of a la carte music video services. Consumers are now able to access up to 2m tracks and 165,000 albums in a legitimate digital environment. During 2005 there was a significant improvement in music purchase in the 20-24 demographic and a stabilization in the 15-19 demographic, reversing the negative trends of the past 10 years.

The campaign mounted by the music industry to combat piracy through peer-to-peer file sharing may be starting to have an effect. Over the past 18 months there have been notable legal victories against illegal peer to peer sites Grokster (U.S.), KaZaa (Australia), Kuro (Taiwan) and Soribada (South Korea), which have improved the landscape for legitimate music sales. The decisions have clarified the potential liability of unauthorized P2P network operators. While the scale of the piracy problem makes it impossible to decide with any certainty that the battle has been won, the response of the industry in terms of prosecutions, the ongoing educational program and the growth in legitimate alternatives has seen the rate of growth in illegitimate file sharing slow dramatically. IFPI data show the number of infringing music files on the Internet falling from 1.1 billion in April 2003 to 885 million in January 2006 as highlighted in Exhibit 3.

Exhibit 3: Infringing Music Files on the Internet

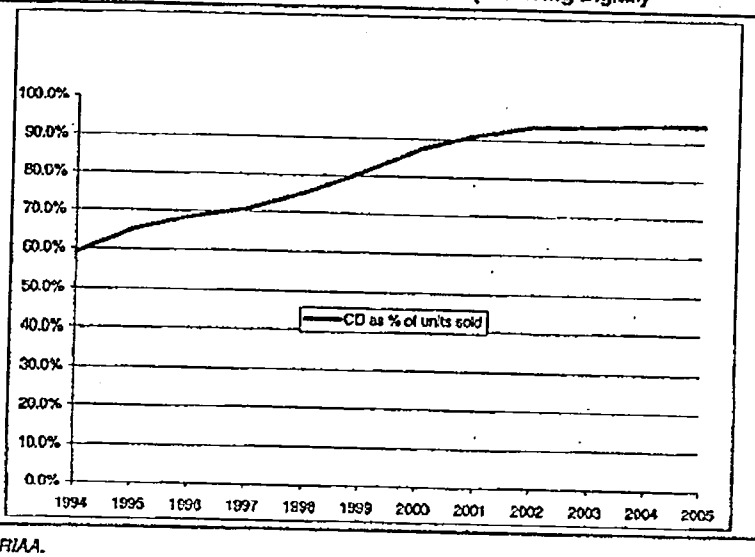


Source: IFPI.

2. End of CD replacement cycle

The impact of the CD replacement cycle, which began in 1986, clearly supported industry growth in the 1990s, with the maturity of that cycle contributing to the pressures the industry has been confronting since 2000. This trend is illustrated in Exhibit 4.

Exhibit 4: U.S. CDs Increasing as % of Total Unit Sales (excluding Digital)



Source: RIAA.

Current status

The takeup of digital does not bring with it a potential library replacement effect, as CDs did with vinyl and cassette tapes. Consequently, we see no change in the status of this issue.

3. Music Industry Rationalization

The industry crisis generated by piracy motivated a significant cost rationalization focus across music companies. We believe that an undetermined amount of the impact on global music sales results from the cost rationalization being undertaken by the industry. Some of this cost rationalization includes reductions in A&R (artists and repertoire) as the artist roster is narrowed to focus on more profitable artists. The Sony BMG joint venture was created in August 2004, and we believe a reduction in its artist repertoire has affected overall industry sales—it has certainly contributed towards the reduction in Sony BMG's market share in 2004 and 2005. Despite an estimated—3% fall in worldwide music sales in 2005, Warner, Universal (Vivendi), and EMI all reported revenue increases. Only Sony BMG has reported declining revenue, suggesting a direct link between its cost cutting measures and the broader impact on the market. The culture and management integration issues arising from the merger are also likely to be having an impact.

While rationalization appears to have negatively affected industry revenues and growth rates, there has been significant compensation in terms of profitability as margins across the industry are generally rising.

Current status

We believe that Sony BMG is coming to the end of the cost rationalization process. The negative impact on overall industry revenue growth should therefore reduce during 2006.

4. General Media Fragmentation

As highlighted in Exhibit 2, younger demographics have seen the greatest reduction in music purchase. While piracy is likely a primary explanation, we believe a secondary issue is the impact of general media fragmentation on consumers' available time and resources.

Current status

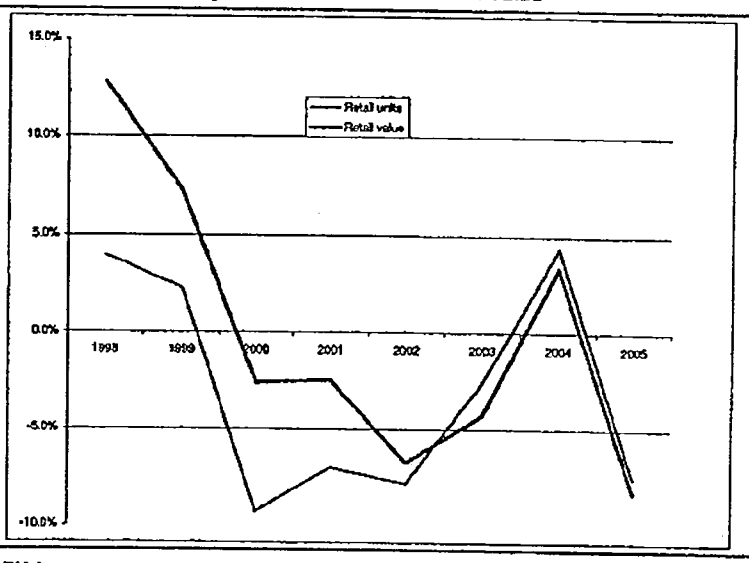
As with all other media, fragmentation is an ongoing fact of life, and therefore, is likely to continue to affect music volumes.

5. Pricing Pressure

The issue of pricing pressure is difficult to examine in a global context given the influence on the data of US dollar currency fluctuations. We have looked therefore solely at the U.S. market to determine the extent to which music pricing is being affected by greater bargaining power on the part of retailers. As highlighted in Exhibit 2, there has been a noticeable turnaround in the past three years. We believe this has been driven by a change in retail channels from record stores to general retailers, such as Wal-Mart, etc. This appears to have had the effect of driving down pricing between late 2002 to the current time where retail value has risen less than retail units in 2004 and declined more than retail units in 2005. We believe there are opposing views in the music industry about the extent of pricing pressure; some music companies are firmly of the view that lowering price does not stimulate consumer demand and are of the view that music retailers cannot afford not to stock hit product, thereby limiting their pricing

leverage. Others, like Universal, have been prepared to lower price in an effort to stimulate demand.

Exhibit 5: U.S. Music Industry—Retail Units versus Retail Value



Source: RIAA.

Current status

The Majors have taken different approaches to pricing. Universal's view is that its price cutting strategy has generated incremental volumes, while Warner's view is that consumers have a dollar amount available for spend, irrespective of pricing. We believe that pricing pressure remains a risk due to the concentration of physical and digital sales channels through a limited number of retailers.

6. Inventory Management

Given the pressures the music industry has been experiencing, we believe music companies have focused on more careful inventory management in order to reduce the level of industry returns. We believe this has likely affected overall sales levels.

Current status

We expect ongoing measures by the music industry to contain cost given the pressures at the top line. Consequently, to the extent that this is having an effect on sales levels, we expect it to be ongoing.

7. Hit Cycle

An unquantifiable aspect of the volume pressure the music industry is experiencing is the degree to which the appeal of hit artists has reduced over time. To the extent that this is an issue, it likely reflects the general fragmentation of the media environment and the greater choice in artists through new outlets such as the Internet.

Global Digital Music Market

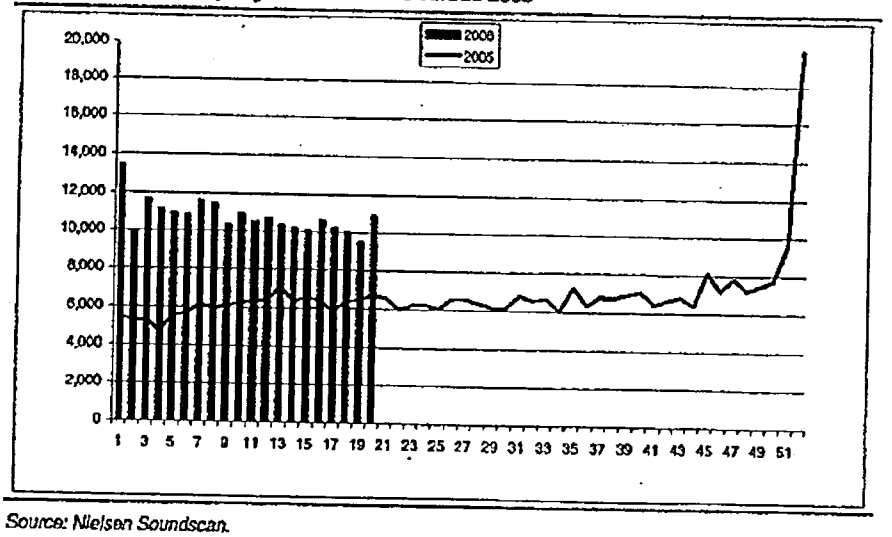
The key issue for the longer-term growth of the music market is whether the shift to legal digital downloads can restore the industry to growth, or merely represents a shift in format. We are of the view that the strong growth in digital has the potential to offset digital declines, but that the purchase is more replacement rather than incremental in nature. Historically, the industry has experienced periods of strong growth, coinciding with format changes—from vinyl to cassettes and from cassettes to CDs. The "new" format of hard disk clearly does not generate the same replacement cycle, particularly as digital sales facilitate the unbundling of albums into individual tracks. Consequently, we see the growth of digital largely at the expense of physical sales, rather than having the potential to grow the overall market. Our detailed forecasts for the digital market are outlined in Exhibit 13.

Components of digital sales

The digital music market expanded in 2005 to approximately 5% of music industry sales compared with 1.8% in 2004. We believe that the breakup of digital revenues globally in 2005 was approximately 51% online (downloads and subscriptions) and 49% mobile.

As highlighted in Figure 7 below, there are significant differences in the geographic penetration of digital downloads and mobile. The U.S. market is by far the largest digital market, and is larger in digital downloads, as the first market to launch iTunes, while mobile services and subscriptions are relatively smaller. U.S. digital downloads (single and album equivalents) grew 160% in 2005, representing in excess of 65% of global digital downloads. (The United States. represents approximately 36% of global physical sales.) Monthly trends in U.S. downloads are outlined in Exhibit 6, with the market experiencing a strong seasonal year-end surge in 2005.

Exhibit 6: U.S. Weekly Digital Sales—2006 versus 2005



Source: Nielsen Soundscan.

Conversely, to date, Japan has been overwhelmingly a mobile market. Japan leads the world market with 2.5G and 3G penetration estimated at over 70% of the mobile universe. In addition, iTunes reached the market relatively late (August 2005). This has resulted in an overwhelmingly mobile-dominated market, as highlighted in Figure 7. We estimate that the Japanese market accounts for approximately 43% of global mobile sales compared with 15% of physical sales.

Figure 7: Break Down of the Top Ten Digital Markets in 2005

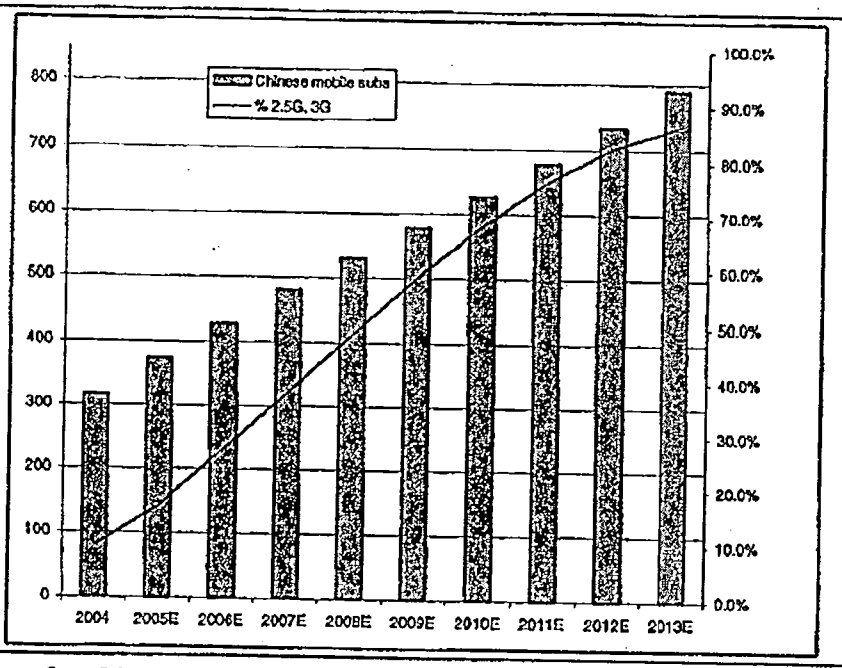
trade revenues in millions

	Total Digital Market			Digital Sales by Channel	
	US$	Local currency	Local currency	Online	Mobile
USA	636	USD	636	68%	32%
Japan	278	JPY	30587	9%	91%
UK	69	GBP	38	62%	38%
Germany	39	EUR	31	66%	34%
France	28	EUR	22	47%	53%
Italy	16	EUR	13	31%	69%
Canada	15	CAD	18	71%	29%
South Korea	12	LWR	12045	42%	58%
Australia	7	AUD	10	41%	59%
Netherlands	5	EUR	4	82%	18%

Note: online includes subscriptions.
Source: IFPI.

China is a potentially significant market for digital music in the future. The piracy issues as they relate to physical sales are well known, and broadband penetration is limited, restricting the opportunity for digital downloads. However, mobile penetration is growing rapidly, driving digital music sales that are estimated to well exceed the physical market in value.

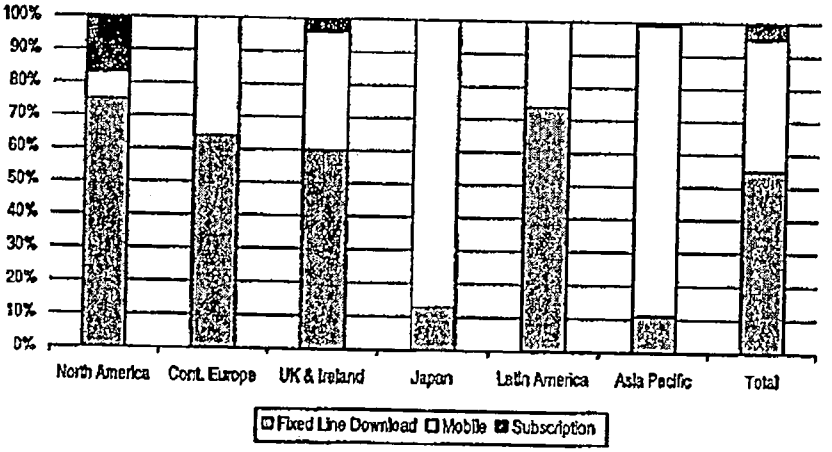
Exhibit 8: Chinese Mobile Phone Market



Source: Credit Suisse estimates.

Figure 9 illustrates EMI's digital revenue split by type and by region, which, in our view, is broadly representative for all the Majors. Master ringtones accounted for most (87%) of mobile revenues; though the highest growth was experienced in full-track downloads to mobile.

Figure 9: EMI's Split of Digital Sales



Source: Company data, Credit Suisse estimates.

Our estimates assume continued strong growth in digital downloads in 2006, but some maturing in its largest market (the United States).

Digital economics

We expect the growth in digital revenues to be substantial, expanding from an estimated 5% of industry revenues in 2005 to 24% by 2009. Importantly, we expect this revenue stream to generate higher margins than physical sales despite the fact that music companies achieve lower wholesale margins on digital than on physical sales.

Exhibit 10: Margin on Wholesale Revenues

	Physical	Digital
Wholesale revenue	100%	100%
Royalties/Publishing	-30%	-38%
Manufacturing	-20%	0%
Marketing/A&R	-25%	-25%
Fixed costs	-13%	-13%
Margin	12%	24%

Source: Company data, Credit Suisse estimates.

Exhibit 11: Margin on Retail Revenues

	Physical	Digital
Retail revenue	100%	100%
Wholesale share	63%	58%
Royalties/Publishing	-19%	-21%
Manufacturing	-13%	0%
Marketing/A&R	-16%	-14%
Fixed costs	-8%	-7%
Margin	8%	13%

Source: Company data, Credit Suisse estimates.

The growth in digital sales as a percentage of total should therefore have the effect of lifting the overall margins recorded by the industry. As highlighted in Exhibit 12, digital revenues are becoming a meaningful proportion of group revenues.

Exhibit 12: Digital Revenues as % of Total

	6 mos to March 06	March 06 Qtr
WMG	8.6%	11.3%
EMI	5.6%	7.2%
Universal	5.3%	9.9%

Source: Company data, Credit Suisse estimates. Note Sony digital sales not available.

EMI management has a target of reaching around 25% of sales by 2010. It also suggests the beneficial impact of digital sales could improve group margins from 12% to a return to the mid-teens levels not experienced since the 1990s CD replacement cycle. EMI management does acknowledge however that, in the short term, any margin improvement could be dampened by fixed digital infrastructure costs, and that in the medium term the artists would demand (and be paid) a commensurate share of this margin upside. With regard to the latter, we believe there is a two-to-three-year window of opportunity for the industry to exploit these higher digital margins before the contracts of major artists are renewed and they start to demand their share of this margin upside.

Issues

Unbundling

The issue of unbundling is important in determining the extent to which digital revenues can grow the overall music market. There are two schools of thought—one, that consumers will purchase two or three tracks of an album for $2-3 as opposed to a $10-$15 expenditure on an album, effectively reducing the overall music industry take. The

other school of thought holds that a fixed level of expenditure is likely spread more widely across single purchases, but that the overall spend is not affected. A further argument to allow consumers to experience the benefits of unbundling is that the modest costs involved for buying individual songs reduces the appeal of piracy.

Pricing power

An issue of concern in the digital world is our view that the majors tend to be price takers rather than price setters, particularly given the rising power of Apple and iTunes and of powerful discount retailers like Wal-Mart. The majors vehemently argue the opposite; they believe the balance of power will not shift to retailers. They say the majors are consolidating from five to four (and maybe eventually down to three), whereas the retailers are fragmenting in the online world, given the multitude of different ways of buying music electronically. Given the view of some of the majors that differential pricing on individual downloads should be permitted, the outcome of the debate may highlight where pricing power actually resides.

Credit Suisse Global Digital Music Model

Our estimates for the global digital music market are outlined in Exhibit 13. Our estimates assume that the download market growth in the U.S. will moderate, given its current elevated base, but that similar trends will be experienced in other markets as iTunes and other providers launch services. In Japan, however, we expect the trend to be the reverse as the market shifts more towards a download model. The United States by contrast is expected to see stronger mobile than download growth given the current rollout of new services.

Exhibit 13: Credit Suisse Global Digital Music Market Forecasts

YE Dec	2004	2005	2006F	2007F	2008F	2009F
Downloads (M)						
US - single track	143	353	584	734	890	1,012
US - albums as tracks	55	162	259	337	404	485
Japan	1	9	38	72	108	146
UK	6	28	55	132	198	267
Rest of Europe	8	36	90	180	270	365
Rest of World	4	68	340	510	765	1,033
World	218	654	1,356	1,965	2,635	3,288
On-line Subscribers (M)						
US	1.0	1.5	1.9	2.3	2.6	2.8
Rest of World	0.5	1.3	2.6	3.9	5.1	6.1
Mobile units (M)						
US	183	170	306	459	597	716
Japan	149	256	464	697	906	1087
REVENUES (US$m)						
Downloads						
US - single track	141	349	559	726	872	1,002
US - albums	54	160	257	334	400	460
Japan	1	43	47	94	140	190
UK	8	74	68	172	257	347
Rest of Europe	30	90	117	234	351	474
Rest of World	20	60	442	663	995	1,343
Total downloads	254	777	1,507	2,222	3,015	3,818
Subscription						
US	46	149	158	178	202	222
Rest of World	25	77	156	234	304	365
Total Subscription	71	226	314	410	506	587
Mobile						
US	150	422	760	1,139	1,481	1,777
Japan	170	436	785	1,177	1,530	1,836
UK	10	45	99	168	252	303
Rest of Europe	39	75	165	281	421	505
Rest of World	15	45	180	360	648	972
Total Mobile	384	1,023	1,988	3,125	4,333	5,394
Total Digital Retail Revenues	709	2,026	3,809	5,757	7,854	9,797
Total Digital Wholesale Revenues	397	1,143	2,141	3,221	4,385	5,471
% total						
Downloads	35.8%	38.3%	39.5%	38.6%	38.4%	38.0%
Subscription	10.0%	11.2%	8.2%	7.1%	6.4%	6.0%
Mobile	54.1%	50.5%	52.2%	54.3%	55.2%	55.1%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
% change						
MP3 players		440.0%	51.9%	34.1%	18.2%	15.0%
Downloads						
US - single track	592%	147.3%	50%	30%	20%	15%
US - album downloads		195.6%	60%	30%	20%	15%
Japan		600.0%	300%	100%	50%	35%
UK		353.2%	150%	100%	50%	35%
Continental Europe		350.0%	150%	100%	50%	35%
Rest of World		1600.0%	400%	50%	50%	35%
Total Downloads		203.4%	94.0%	47.5%	35.7%	26.6%
Subscription						
US		50.0%	25.0%	20.0%	15.0%	10.0%
Rest of World		160.0%	100.0%	50.0%	30.0%	20.0%
Total Subscription		218.3%	38.7%	30.6%	23.6%	16.0%
Mobile						
US		181.3%	80.0%	50.0%	30.0%	20.0%
Japan		156.5%	80.0%	50.0%	30.0%	20.0%
UK		350.0%	120.0%	70.0%	50.0%	20.0%
Continental Europe		92.3%	120.0%	70.0%	50.0%	20.0%
Rest of World		200.0%	300.0%	100.0%	80.0%	50.0%
Total Mobile		166.4%	94.4%	57.2%	38.8%	24.5%
Total Digital		185.6%	88.0%	51.1%	36.4%	24.7%

Source: IFPI, Company data, Credit Suisse estimates.

Credit Suisse Global Music Industry Forecast

Figure 14 breaks down the total recorded music sales in 2005 by market, with Figure 15 analyzing sales by format. In 2005 overall recorded music sales fell by 3%, driven by sales of physical formats down 6.7% in value and 8.0% in units. Digital sales grew 188% in the year, with trade revenues from digital sales growing from $400 million to $1.1 billion.

The 5 largest digital markets by revenues were the United States (9% of sales), Japan (7%), UK (3%), Germany (3%), and France (2%). Interestingly, countries with a higher percentage of digital sales were the strongest market for music sales overall.

Figure 14: Total Music Sales by Market in 2005

physical and digital, values in millions

		Trade Revenues 2005					Retail Value 2005	
		US$	Local currency		% Change	% Digital	US$	Local currency
1	USA	7,012	USD	7,012	-3%	9%	12,269	12,269
2	Japan	3,718	JPY	409,845	1%	7%	5,448	600,497
3	UK	2,612	GBP	1,189	-3%	3%	3,446	1,895
4	Germany	1,457	EUR	1,166	0%	3%	2,211	1,769
5	France	1,248	EUR	989	-2%	2%	1,990	1,592
6	Canada	544	CAD	659	-3%	3%	732	886
7	Australia	440	AUD	576	-10%	2%	674	883
8	Italy	428	EUR	343	0%	4%	669	535
9	Spain	369	EUR	295	-5%	1%	555	444
10	Brazil	265	BRL	645	-12%	1%	394	958
11	Mexico	263	MSP	2,863	10%	<1%	412	4,487
12	Netherlands	246	EUR	197	-14%	2%	431	345
13	Switzerland	206	CHF	257	-3%	1%	267	334
14	Russia	194	RUB	5,477	-37%	-	388	10,961
15	Belgium	162	EUR	129	-7%	2%	262	209
16	South Africa	159	CAR	1,010	10%	<1%	254	1,618
17	Sweden	148	SEK	1,107	-9%	2%	240	1,795
18	Austria	139	EUR	111	-5%	3%	285	228
19	Norway	133	NOK	857	-12%	1%	253	1,627
20	Denmark	113	DKK	679	-2%	1%	180	1,080
	Other	1,387			-8%	6%	2,096	
	Total	20,795			-3%	5%	33,456	

Source: IFPI.

Figure 15: Trade Revenues by Format

USD in millions

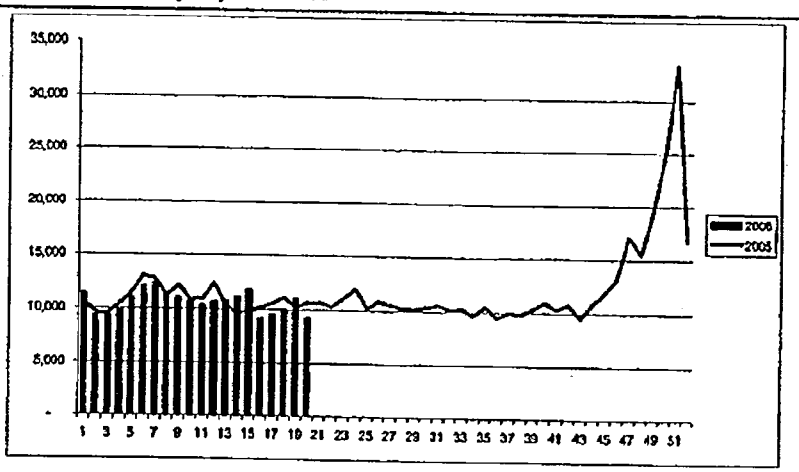
	2004	2005	Growth
CD	18,109	17,019	-6%
DVD	1,610	1,540	-4%
Digital sales	397	1,143	188%
Singles	821	721	-12%
Other physical*	531	372	-30%
	21,468	20,795	

** Cassettes, LPs, VHS, and other.*

Source: IFPI.

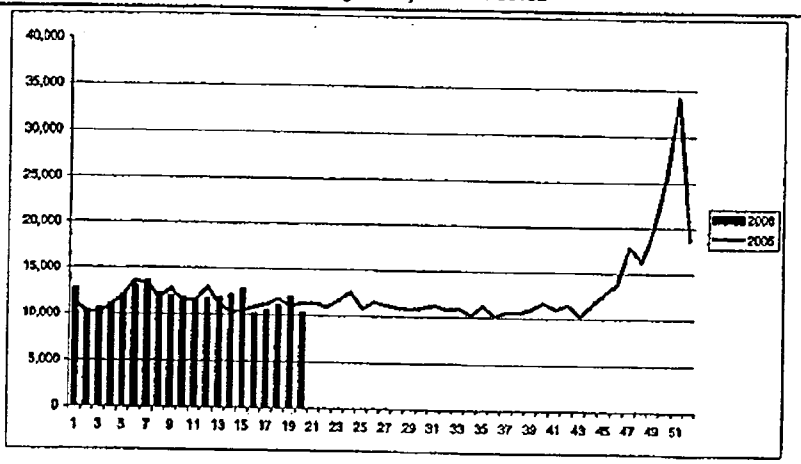
There are some encouraging signs in 2006 year to date, as the rate of decline in physical is slowing. In the United States, physical sales are down 2.3% year to date, while physical and digital sales combined are up 2%.

Exhibit 16: U.S. Weekly Physical Sales



Source: Soundscan

Exhibit 17: U.S. Weekly Physical and Digital Equivalent Sales



Source: Soundscan

In Japan, physical sales are up year to date despite a continued surge in digital sales. Given the hit driven nature of the music business, we are cautious in extrapolating these trends for the full year. However, our forecasts for 2006 assume a moderation in the rate of decline of physical sales and continued (though moderating) growth in digital. This underpins our estimate for modest overall industry growth in 2006 following the declines of 2005. Looking forward to 2007 and beyond, we have assumed the decline in physical sales moderates in the minus 3-4% range. Combined with digital growth, we expect overall industry revenues to grow in the 2% range.

Exhibit 18: Credit Suisse Global Music Forecast

YE Dec	2001	2002	2003	2004	2005	2006F	2007F	2008F	2009F
Physical Units Shipped (M)									
US	859	655	790	810	748	722	697	672	649
Japan	305	275	260	256	251	251	241	231	223
UK	251	248	189	194	189	179	171	164	159
Germany	226	215	184	181	179	170	162	158	150
France	149	153	139	127	136	129	123	119	114
Australia	58	57	51	48	37	35	33	32	31
Canada	65	61	59	60	61	58	55	53	51
Italy	48	50	43	38	35	33	31	30	29
Spain	79	65	46	38	33	32	30	29	28
Netherlands	34	32	31	30	25	24	23	22	21
Top 10 countries	2,156	2,011	1,791	1,781	1,693	1,632	1,568	1,508	1,455
Rest of World	991	902	992	975	926	879	840	798	770
World	3147	2,913	2,783	2,756	2,619	2,512	2,407	2,306	2,225
Retail Sales (USDm)									
US	13,739	12,609	11,846	12,153	11,188	10,797	10,419	10,054	9,702
Japan	5,689	5,001	4,810	5,158	4,969	4,969	4,770	4,579	4,418
UK	2,876	2,908	3,218	3,509	3,327	3,151	3,018	2,888	2,796
Germany	2,149	2,053	2,022	2,149	2,144	2,037	1,945	1,867	1,802
France	1,892	2,070	2,115	1,979	1,942	1,845	1,762	1,691	1,632
Australia	538	532	674	717	662	629	601	577	556
Canada	687	621	678	694	706	671	641	615	593
Italy	631	663	645	653	641	609	582	559	539
Spain	620	591	596	573	555	527	504	483	466
Netherlands	446	440	499	508	422	401	383	368	355
Top 10 countries	29,167	27,379	27,199	28,102	26,557	25,645	24,624	23,691	22,862
Rest of World	5,325	4,849	4,813	5,512	4,873	4,678	4,514	4,334	4,226
Total Physical Sales	34,492	32,228	32,012	33,614	31,430	30,324	29,139	28,025	27,088
Digital Sales	NA	NA	NA	709	2,026	3,809	5,757	7,854	9,707
Global Sales	34,492	32,228	32,012	34,323	33,456	34,132	34,896	35,879	36,884
Digital as % of total				2.1%	6.1%	11.2%	16.5%	21.9%	26.3%
Wholesale Sales (USDm)									
Physical	21,739	20,304	20,158	21,071	19,652	19,104	18,357	17,656	17,063
Digital	NA	NA	NA	397	1,143	2,141	3,221	4,383	5,475
Total Industry	21,739	20,304	20,158	21,468	20,795	21,245	21,578	22,041	22,538
Digital as % of total				1.8%	5.5%	10.1%	14.9%	19.9%	24.3%
% change									
Physical Units Shipped (M)									
US	-7.8%	-10.4%	-7.7%	2.6%	-7.6%	-3.5%	-3.5%	-3.5%	-3.5%
Japan	-8.2%	-9.9%	-5.3%	-1.6%	-1.8%	0.0%	-4.0%	-4.0%	-3.5%
UK	5.1%	-0.9%	-24.1%	3.0%	-2.7%	-5.0%	-4.5%	-4.0%	-3.5%
Germany	-7.8%	-4.7%	-14.5%	-1.4%	-1.4%	-5.0%	-4.5%	-4.0%	-3.5%
France	19.6%	3.0%	-9.1%	-9.1%	7.5%	-5.0%	-4.5%	-4.0%	-3.5%
Australia	14.5%	-2.5%	-10.4%	-6.1%	-22.9%	-5.0%	-4.5%	-4.0%	-3.5%
Canada	-6.2%	-5.3%	-4.2%	2.2%	0.7%	-5.0%	-4.5%	-4.0%	-3.5%
Italy	-5.4%	6.1%	-14.6%	-11.5%	-8.4%	-5.0%	-4.5%	-4.0%	-3.5%
Spain	2.1%	-17.8%	-29.2%	-17.1%	-13.4%	-5.0%	-4.5%	-4.0%	-3.5%
Netherlands	-6.1%	-6.7%	-1.9%	-4.2%	-15.0%	-5.0%	-4.5%	-4.0%	-3.5%
Top 10 countries	-4.5%	-7.2%	-10.6%	-0.5%	-4.9%	-3.6%	-4.0%	-3.8%	-3.5%
Rest of World	-13.7%	-8.0%	9.9%	-1.7%	-5.0%	-5.0%	-4.5%	-5.0%	-3.5%
World	-7.9%	-7.4%	-4.5%	-1.0%	-5.0%	-4.1%	-4.2%	-4.2%	-3.5%
Retail Sales									
US	-2.2%	-8.2%	-6.0%	2.6%	-7.9%	-3.5%	-3.5%	-3.5%	-3.5%
Japan	-13.0%	-12.1%	-1.8%	5.3%	-3.6%	0.0%	-4.0%	-4.0%	-3.5%
UK	1.7%	2.1%	9.5%	9.1%	-5.2%	-5.0%	-4.5%	-4.0%	-3.5%
Germany	-11.0%	-4.5%	-1.5%	6.3%	-0.2%	-5.0%	-4.5%	-4.0%	-3.5%
France	10.2%	9.4%	2.2%	-6.4%	-1.9%	-5.0%	-4.5%	-4.0%	-3.5%
Australia	-4.1%	-1.1%	26.6%	6.4%	-7.6%	-5.0%	-4.5%	-4.0%	-3.5%
Canada	-9.8%	-9.6%	6.0%	2.0%	1.0%	-5.0%	-4.5%	-4.0%	-3.5%
Italy	-10.2%	6.3%	14.1%	1.2%	-1.7%	-5.0%	-4.5%	-4.0%	-3.5%
Spain	-0.8%	-11.2%	0.1%	-3.8%	-3.1%	-5.0%	-4.5%	-4.0%	-3.5%
Netherlands	-1.9%	-1.3%	13.3%	1.8%	-16.8%	-5.0%	-4.5%	-4.0%	-3.5%
Top 10 countries	-4.5%	-6.1%	-0.7%	3.3%	-5.5%	-3.4%	-4.0%	-3.8%	-3.5%
Rest of World	-16.9%	-8.5%	-0.7%	14.5%	-11.6%	-4.0%	-3.5%	-4.0%	-2.5%
Total Physical Sales	-6.6%	-6.6%	-0.7%	5.0%	-6.5%	-3.5%	-3.9%	-3.8%	-3.3%
Digital Sales	NM	NM	NM	NM	185.6%	88.0%	51.1%	36.4%	24.7%
Global Sales	-6.6%	-6.6%	-0.7%	7.2%	-2.5%	2.0%	2.2%	2.9%	2.8%
Wholesale Sales									
Physical	-6.6%	-6.6%	-0.7%	4.5%	-6.7%	-2.8%	-3.9%	-3.8%	-3.3%
Digital	NM	NM	NM	NM	188.0%	87.3%	50.4%	36.1%	24.8%
Total Industry	-6.6%	-6.6%	-0.7%	6.4%	-3.1%	2.2%	1.6%	2.1%	2.2%

Source: IFPI, RIAA, RIAJ, Company data, Credit Suisse estimates.

Music Publishing

We are positive on the prospects for music publishing. In general we anticipate stronger growth coming from:

- *More efficient collection of royalties.* The collection agencies, many of which have enjoyed a de facto monopolistic position in their particular territories, are improving their operational effectiveness and efficiency, largely precipitated by anti-trust pressures. Likewise, the music publishers themselves are investing in IT systems to improve collection efficiency. The publishers' increased representation on society boards is facilitating this.
- *More rigorous collection of royalties.* Music publishers are becoming more rigorous in auditing licenses and in legally enforcing the collection of royalties, particularly in lesser-developed countries from a copyright perspective where Intellectual Property protection laws are steadily improving.
- *Quicker collection of royalties.* With greater efficiency comes quicker collection, faster distribution from the collection agencies and improved working capital management.
- *More revenue streams.* Publishers are taking advantage of new products and formats (e.g., DVDs, dual discs, enhanced content discs, video on demand), technologies and media channels, and also new territories such as in South East Asia (including China), where synchronization is especially strong, and in Central and Eastern Europe.

One negative trend to highlight is the adverse margin mix effect as the older, more favorable deals negotiated by the music publishers get replaced by newer, shorter deals with economics relatively more in favor of the artist.

In respect of the growth by subdivision of music publishing, we anticipate the following:

- *Mechanical* (derived from the sale of recorded music). These royalties are naturally dependent on physical sales and digital downloads, which taken together we believe are seeing a slowdown in the rate of decline and an imminent move into positive territory. Growth should be helped by new income tracking initiatives.
- *Performance* (revenues derived when a song is performed live on stage, played in a bar or other public venue, or broadcast on the radio or TV)—growth will be driven by chart success on songs, radio; by TV digital fragmentation, and commercialization (which increases the number of radio channels, which, in turn, increases the royalties receivable); by rate negotiations with cable and radio (e.g., negotiating a share in the new evolving satellite radio subscription models in the United States); and by the growth in general from ring tones and ring tunes.
- *Synchronization* (revenue generated by the use of songs in audiovisual works e.g., adverts, TV, radio, films, games, and mobile phones)—growth should be accentuated by better and more proactive marketing to advertisers, TV producers, computer games manufacturers, film makers, together with the development of Internet-enabled music catalogues to facilitate the process of buying rights and lowering its costs.
- *Other.* Higher print music sales as music tuition and instruments become more affordable, slightly offset by a move toward online purchases of single-track sheet music.

An illustration of the split of royalties by subdivision and of the growth generated in 2005-06 by royalty type for EMI is set out in Figure 19:

Figure 19: EMI Music Publishing—Analysis of Revenue

at constant currency, £ in millions

	FY 04/05	%	FY 05/06	%	Change
Mechanical	179.7	44.8%	185.4	45.1%	3.2%
Performance	108.0	27.0%	111.7	27.2%	3.4%
Synchronization	67.2	16.8%	70.8	17.2%	5.4%
Other	45.8	11.4%	43.2	10.5%	-5.7%
Total	400.7	100%	411.1	100%	2.6%

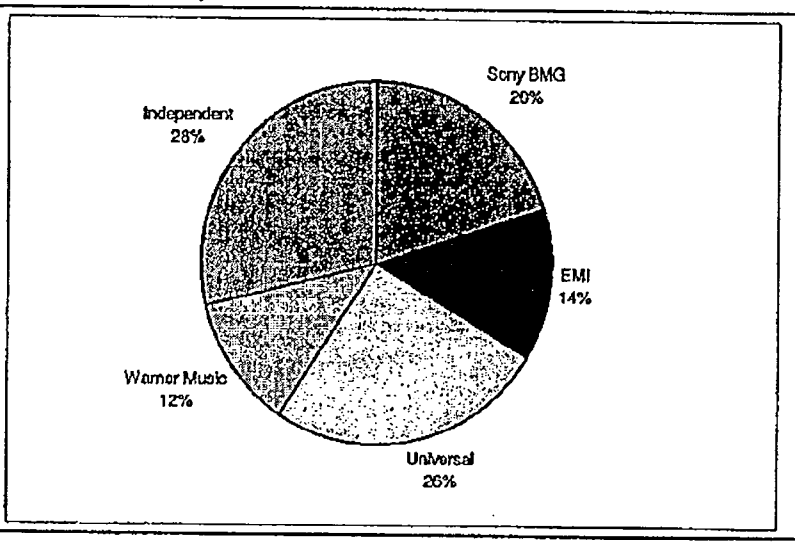
Source: EMI Group.

Market Share trends

Recorded Music

Following the formation of the Sony and BMG joint venture, the global music industry has become highly rationalized. The industry's two largest players are Universal and Sony BMG, with Warner and EMI achieving considerably smaller shares. Speculation has long abounded about a merger between EMI and Warner to create an equal-size player to Sony BMG and Universal.

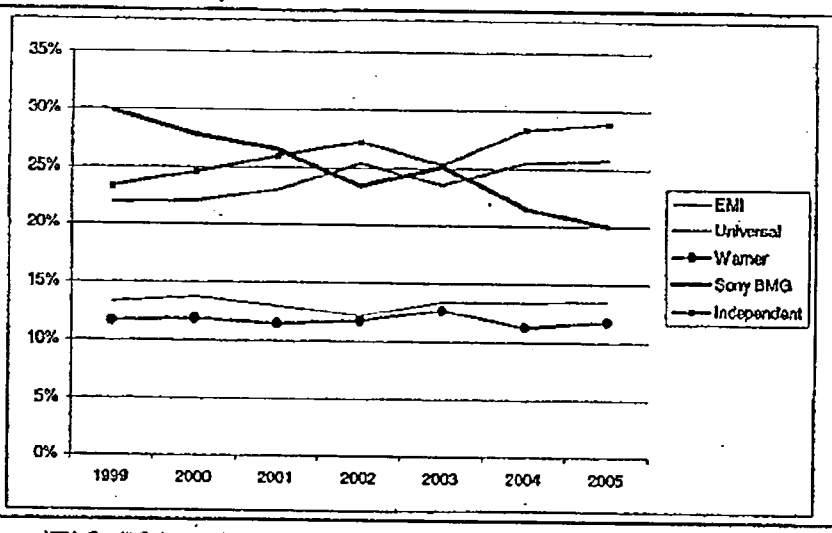
Exhibit 20: Music Industry Market Shares



Source: IFPI, Credit Suisse estimates

While the market shares of Warner and EMI have remained relatively constant, the combined Sony BMG (which were separate until August 2004) has recorded the most significant decline over the past five years, with Universal and Independents the major beneficiaries. Sony BMG's market share is likely falling due to issues associated with its restructuring program, and cutbacks in A&R spending, as well as from the integration of the two businesses.

Exhibit 21: Music Industry Market Share Trends

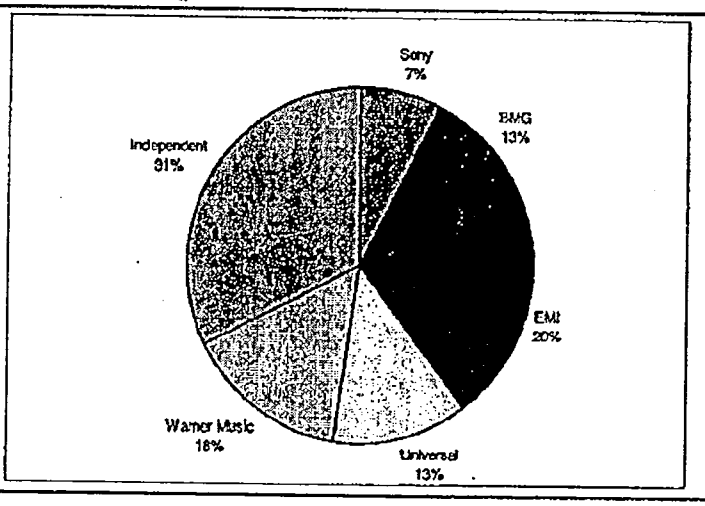


Source: IFPI, Credit Suisse estimates

Music Publishing

Market shares for the music publishing business differ markedly from the recorded music business. The industry is considerably more fragmented, reflecting a greater share of independents as well as separate music publishing businesses of Sony and BMG. EMI and Warner Music have the largest shares of the Majors, despite having smaller shares of recorded music.

Exhibit 22: Music Publishing Market Shares



Source: Company data.

Due to the size of the combined EMI and Warner music publishing businesses, our view is that any merger of the recorded music businesses would require divestment of a substantial part or all of one of the music publishing businesses.

Music Industry Margin Potential

While revenue trends for the industry potentially still remain challenging, the industry-wide cost restructuring has already yielded margin opportunities in the sector, with potentially more to come. As highlighted in Exhibit 23, the industry has already undertaken, or committed to very substantial cost reductions, which we expect to underpin earnings growth in the short term.

Exhibit 23: Music Industry Annual Cost Reductions Achieved to date

US$ in millions

Sony BMG	300
EMI	270
Universal Music	468
Warner Music	250
Industry	1288

Source: Company data, Credit Suisse estimates.

As evidence of the industry's concerted attack on costs, EMI has just announced a third restructuring plan, following on from its £100 million savings plan announced in 2002 and £50 million program in 2005. The latest initiative, affecting all regions (particularly Japan) and both divisions, targets £10 million of (achieved) savings in 2006-07, with the full £30 million run-rate achieved by end 2007-08. EMI stated that the £60 million cash cost of achieving these savings would be more than offset by proceeds from property disposals.

Currently the industry is experiencing very wide margin disparity (as highlighted in Exhibit 24) with Universal's industry-leading EBITDA margin of 15.5% contrasting with Sony BMG's 11.8%. We believe this is partially due to the timing of companywide restructuring being undertaken by the companies. We expect the benefits of cost restructuring to provide the most meaningful short-term support to industry margin growth. Other issues we see relevant to the longer-term margin opportunity for the industry are discussed below.

Exhibit 24: Global Music Company Margins
US$ in millions, unless otherwise stated

	YE	2003	2004	2005	2006F	2007F	2008F	2009F
Revenue (US$M)								
Bertelsmann	Dec	3,067	3,166	NA	NA	NA	NA	NA
Sony	Mar	3,826	3,897	2,317	NA	NA	NA	NA
Sony BMG	Mar	NA	NA	3,258	4,283	4,262	4,262	4304
EMI	Mar	3,361	3,581	3,693	3,712	3,774	3,840	3,930
Universal Music	Dec	5,625	6,201	6,080	6,141	6,264	6,389	6,517
Warner Music	Nov/Sept	3,376	3,437	3,502	3,532	3,633	3,740	3850
Group Total		19,255	20,283	18,850	17,668	17,933	18,231	18,600
Revenue Growth								
Bertelsmann		19.8%	3.2%	NA	NA	NA	NA	NA
Sony		-25.6%	1.9%	NA	NA	NA	NA	NA
Sony BMG		NA	NA	NA	NA	-0.5%	0.0%	1.0%
EMI		-4.1%	6.6%	3.1%	0.5%	1.7%	1.7%	2.3%
Universal Music		-5.0%	10.2%	-2.0%	1.0%	2.0%	2.0%	2.0%
Warner Music		2.6%	1.8%	1.9%	0.9%	2.9%	2.9%	2.9%
Group Total		-5.7%	5.3%	-7.1%	-6.3%	1.5%	1.7%	2.0%
EBITDA (US$M)								
Bertelsmann		295	288	NA	NA	NA	NA	NA
Sony		-68	90	170	NA	NA	NA	NA
Sony BMG		NA	NA	384	556	589	589	609
EMI		459	480	459	493	543	587	612
Universal Music		495	850	944	1,075	1,127	1,150	1,173
Warner Music		238	373	468	497	541	592	641
Group Total		1,418	2,181	2,424	2,620	2,800	2,918	3,035
EBITDA Growth								
Sony BMG		NA	NA	NA	NA	5.9%	0.0%	3.4%
EMI		32.3%	4.6%	-4.3%	7.2%	10.1%	8.2%	4.3%
Universal Music		-45.3%	91.7%	-0.6%	13.8%	4.9%	2.0%	2.0%
Warner Music		16.8%	58.1%	24.9%	6.7%	8.9%	9.4%	8.3%
Group Total		-29.6%	53.8%	11.1%	8.1%	6.9%	4.2%	4.0%
EBITDA Margin								
Bertelsmann		9.6%	9.1%	NA	NA	NA	NA	NA
Sony		-1.8%	2.3%	7.3%	NA	NA	NA	NA
Sony BMG		NA	NA	11.8%	13.0%	13.8%	13.8%	14.1%
EMI		13.7%	13.4%	12.4%	13.3%	14.4%	15.3%	15.6%
Universal Music		8.8%	15.3%	15.5%	17.5%	18.0%	18.0%	18.0%
Warner Music		7.0%	10.9%	13.3%	14.1%	14.9%	15.8%	16.6%
Group Total		7.4%	10.8%	12.9%	14.8%	15.6%	16.0%	16.3%

Source: Company data, Credit Suisse estimates. EBITDA is before restructuring charges. Sony BMG in March 2005 is for seven months only.

Recorded Music and Music Publishing

The margin disparity above is also attributable to the mix of Recorded music and music publishing businesses which operate with substantial margin differentials as highlighted in Figure 25. Music publishing averages a 23% margin compared with 12.6% for recorded music.

Figure 25: Recorded Music versus Music Publishing Margins
In USD millions, unless otherwise stated

USDm	YE	2003	2004	2005	2006F	2007F	2008F	2009F
RECORDED MUSIC								
Revenue								
EMI	March	2,741	2,910	2,954	2,962	3,007	3,052	3,114
Sony BMG	March	NA	NA	3,258	4,283	4,262	4,262	4,304
Universal Music	December	5,256	5,786	5,846	5,711	5,825	5,942	6,061
Warner Music	September	2,639	2,859	2,924	2,997	3,075	3,160	3,251
Total		10,636	11,555	14,783	15,954	16,169	16,415	16,730
EBITDA								
EMI		287	296	268	294	339	380	396
Sony BMG		NA	NA	384	556	589	589	609
Universal Music		403	848	836	967	1018	1038	1059
Warner Music		135	245	355	390	429	473	517
Total		825	1386	1842	2208	2375	2480	2581
EBITDA Margin								
EMI		10.5%	10.2%	9.1%	9.9%	11.3%	12.5%	12.7%
Sony BMG		NA	NA	11.8%	13.0%	13.8%	13.8%	14.1%
Universal Music		7.7%	14.6%	14.8%	16.9%	17.5%	17.5%	17.5%
Warner Music		4.7%	8.6%	12.1%	13.0%	13.9%	15.0%	15.9%
Total		7.6%	12.0%	12.5%	13.8%	14.7%	15.1%	15.4%
MUSIC PUBLISHING								
Revenue								
EMI		620	672	738	749	767	789	816
Universal Music		369	415	434	430	438	447	456
Warner Music		563	552	607	565	587	611	630
Total		1,552	1,639	1,779	1,744	1,793	1,847	1,902
EBITDA								
EMI		171	185	192	198	203	207	216
Universal Music		92	104	108	107	110	112	114
Warner Music		102	127	111	114	119	126	132
Total		365	415	411	419	432	445	461
EBITDA Margin								
EMI		27.7%	27.5%	26.0%	26.4%	26.5%	26.2%	26.5%
Universal Music		25.0%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%
Warner Music		18.1%	22.9%	18.2%	20.1%	20.3%	20.7%	20.9%
Total		23.5%	25.3%	23.1%	24.0%	24.1%	24.1%	24.3%

Source: Company data, Credit Suisse estimates. Note: Corporate overheads allocated to each division for WMG. EMI depreciation & amortization allocated to each division in proportion to revenue. Universal recorded music revenues are disclosed; EBITDA is based on estimated margins.

Theoretically, therefore, music companies with large publishing exposure should be experiencing higher group margins than those with low publishing exposure given that this is a higher margin business. As we highlight in Exhibit 26, however, Universal has a low publishing exposure relative to Warner and EMI, and yet is achieving overall group margins that are noticeably higher. This suggests to us that economies of scale are meaningful in the business, as Universal, as the largest player is achieving the highest margins in the industry despite its low publishing exposure.

Exhibit 26: Recorded Music versus Publishing Revenue Splits (Fiscal 2005)

	Recorded	Publishing
Warner Music	85%	15%
EMI	80%	20%
Universal	93%	7%
Sony BMG	100%	0%

Source: Company data, Credit Suisse estimates.

Digital

We believe a potential margin opportunity for the industry comes from the growth in digital sales as a proportion of total music revenues. This upside has been referred to by the management teams of UMG, WMG and EMI. Despite lower wholesale margins for digital than physical sales (as discussed in the digital section of this report), we see two reasons why digital revenue can contribute to margin expansion as digital revenue increases, by our estimates, from 5% of industry sales in 2005 to 24% in 2009:

- Digital margins benefit from the absence of manufacturing and distribution costs and returns despite the higher royalties paid to artists.
- Digital sales are generated more from catalogue (two-thirds of sales) rather than physical sales which are more frontline and, therefore, requires lower marketing and advertising cost.

Conclusion

Our estimates assume that average music company EBITDA margins can expand from the 12.9% achieved in 2005 to 16.3% in 2009. The benefits of industry restructuring, together with favorable digital economics are expected to compensate for the modest revenue growth we forecast for the industry.

Merger Opportunities

Warner Music and EMI have twice previously been on the verge of merging. First in 2000 when European Union competition concerns saw a transaction fall apart, and second in 2003 when a private consortium headed by current chairman and CEO, Mr. Edgar Bronfman, purchased the business from Time Warner. Merger synergies in each case were estimated at $300-400 million. (Cost savings estimated from the combined Sony BMG were around $300 million). As indicated earlier, cost benefits from restructuring have supported margin growth across the music industry despite revenue pressures. A third attempt recently faltered when WMG rejected a $28.50 per share bid from EMI. We believe the cost benefits of a merged entity remain compelling and outline the cost opportunities as well as other issues pertinent to a merger below.

Cost Reduction Potential

We believe estimates of cost reduction potential for a potentially combined Warner-EMI need to take into account the significant cost restructuring that has been undertaken by the two companies individually over the past two years. The $300-400 million cost opportunity cited in the past is not all still available. We have compared a profile of a combined EMI-Warner group with that of Universal in Exhibit 27. It highlights that on the basis of 2005 revenues and market shares, a combined Warner-EMI would have similar shares of the recorded music market.

Exhibit 27: Comparison of EMI-Warner with Universal

12 months to March	2006 EMI	2006 Warner	EMI-Warner Combined	Dec 05 Universal
US$m				
Recorded Music Revenue	3,060	2,959	6,019	5,746
Operating costs	2,756	2,580	5,336	4,895
EBITDA	304	379	683	851
£M				
Recorded Music Revenue	1,660	1,605	3,265	3,117
Operating costs	1,495	1,399	2,894	2,655
EBITDA	165	206	371	461
Margin	9.9%	12.8%	11.4%	14.8%
Costs as % of revenues	90.1%	87.2%	88.6%	85.2%

Source: Company data, Credit Suisse estimates.

In assessing the cost reduction potential at EMI-Warner, we highlight the margin differential with Universal. It is difficult to quantify exactly how much of this differential is due to management ability and how much is due to the benefits of economies of scale. To the extent that it is the latter, it is conceivable that the scale of a combined EMI-Warner group could achieve a similar level of margin. We have looked at four scenarios to determine the potential benefit to that could accrue to the two companies in Exhibit 28.

- First, we have assumed that the combined group is able to achieve a margin at the level that WMG has achieved in the 12 months to March 2006. This yields annual pre-tax cost savings of $88 million/£48 million.

- Second, we have assumed that the combined group can close half the gap to the margin that Universal currently enjoys, with annual pre-tax cost savings of $108 million/£59 million.
- Third, we have assumed the combined group can achieve Universal's margin for the 12 months to December 2005. This would yield pre-tax benefits of $208 million/£113 million.
- Fourth, we have assumed that the combined group can achieve our forecast of Universal's margin for the 12 months to December 2006F. This would yield pre-tax benefits of $336 million/£182 million.

In our analysis in Figure 30 and Figure 31 we have assumed an outcome between scenarios three and four, with annual cost savings assumed of $230 million/£125 million, or approximately 4% of the combined cost base of the two companies.

Exhibit 28: Warner-EMI Cost Restructuring Scenarios

Recorded Music Costs	At Warner level	Halfway to Universal Margin Dec 05	At Universal Margin Dec 05	At Universal Margin Dec 06F
US$m				
Operating costs	5,248	5,228	5,128	5,000
Cost savings potential	88	108	208	336
£M				
Operating costs	2,846	2,836	2,782	2,712
Cost savings potential	48	59	113	182
Warner-EMI EBITDA margin	12.6%	13.2%	14.8%	16.9%
Cost savings as % total costs	1.7%	2.0%	3.9%	6.3%

Source: Company data, Credit Suisse estimates.

Who buys whom?

The first move in a potential EMI/Warner combination has been made by EMI and the structure of WMG's share register suggests that it is more likely to be acquired than be an acquirer should the private equity holders achieve an acceptable return. In addition, the highly leveraged nature of its balance sheet limits its financial flexibility.

Exhibit 29: EMI and Warner Debt/Market Capitalization

YE	Mar-06 EMI	Mar-06 Warner	EMI-Warner Combined
$M			
Market Capitalization	4,377	4,026	8,404
Net Debt	1,632	1,884	3,516
Enterprise value	6,009	5,910	11,920
£M			
Market Capitalization	2,363	2,173	4,535
Net Debt	881	1,017	1,897
Enterprise value	3,243	3,190	6,433
Debt/Market Capitalization	37.3%	46.8%	41.8%

Source: Company data, Credit Suisse estimates.

However it is not impossible that WMG becomes the motivator of any potential transaction. We have examined the two scenarios below.

EMI bid for WMG

We have modeled EMI bidding for WMG in Figure 30. We have assumed

1. A $30 purchase price;
2. $232 million (£125 million) p.a of cost savings and $377 million of restructuring costs—our savings are around 4% of the combined cost base, achievable, in our view, given the substantial cost duplication. Some industry estimates assume $371 million (£200 million) or 6% of the combined cost base. We ignore any revenue synergies that may arise;
3. The Warner Chappell music publishing business is sold to meet regulatory requirements for a price of 12.5 times EBITDA. Given the strong demand for music publishing assets from private equity and from trade players such as Universal, and the business's capability to take on significant leverage, this multiple may be too conservative;
4. Net debt/EBITDA of 3 times. Given the additional EBITDA generated by cost savings, there should be scope to take on additional debt but still remain within this threshold. The balance is financed by the issue of new EMI shares—we assume via a placing at a 10% discount, again conservative if the vendors accept EMI stock directly for their shares;
5. A combined tax rate of 30%—conservative given EMI's current 23% rate, the tax loss carryforwards at WMG, and its tax deductible amortization of intangibles.

On this conservative basis, the deal would be 18% accretive to EMI's earnings one year after the merger is completed. If debt/EBITDA could be stretched to 4 times, the positive accretion would stretch to 28%. The biggest sensitivity is our cost savings assumption—if we increased this to $370 million (£200 million) p.a., the accretion would be 46% on 3 times debt/EBITDA and 65% on 4 times. This accretion is substantial and can best be explained by :

1. The significant improvement in EBITDA from cost savings ($230 million/£125 million) is over 50% of the current EBITDA generated by WMG's recorded music business;
2. The corresponding additional debt that can be raised at a lower average cost of capital; and
3. The disposal of the publishing business for a price that is significant relative to WMG's market capitalization. In fact, the incremental EBITDA multiple payable for WMG, after disposing of its publishing business and after $230 million (£125 million) p.a. of cost savings is just 8.0 times, well below EMI's 10.5 and WMG's current 11.2 multiple.

WMG bid for EMI

We regard this as a far less likely scenario than a further EMI bid for WMG given the dominance on WMG's register of private equity interests. However, we have modeled a WMG bid for EMI with a similar set of assumptions. We have assumed a £3.41 offer price, a 25% premium to the current market price. We have made the same

assumptions on cost savings and restructuring costs as in the EMI acquisition case, and assumed the sale of the EMI music publishing business for 12.5 times EBITDA. We have also assumed that equity would be raised at a 10% discount to the current market price. At a 3 times debt/EBITDA multiple, such a transaction would be 25% accretive to WMG, and at 4 times debt/EBITDA, 32% accretive one year from acquisition.

Figure 30: EMI Bids for Warner

	US$	US$	£	£
BALANCE SHEET ANALYSIS				
WMG share price - assumed offer		$30.00		
WMG outstanding shares fully diluted		150.7		
Market Cap at offer price		4,522		2,441
WMG Net Debt (March 2006)		1,884		1,017
WMG Enterprise Value		6,406		3,457
EMI share price				£2.73
EMI outstanding shares fully diluted				873
Market Cap		4,416		2,383
EMI Net Debt (March 2006)		1,632		881
EMI Enterprise Value		6,048		3,264
WMG & EMI Combined Debt		3,516		1,898
Less : Sale of Warner Chappell		-1,792		-967
Plus : Restructuring costs		371		200
WMG acquisition cost (debt financed)		4,522		2,441
Group debt fully debt financed		6,617		3,571
WMG/EMI Group EBITDA		1,229		663
Net debt/EBITDA (full debt financing)		5.4x		5.4x
Target Net Debt/EBITDA multiple	3x	4x	3x	4x
Target Net Debt	3,658	4,917	1,990	2,654
Additional Net Debt	2,055	3,285	1,109	1,773
Incremental Interest Expense	164	263	89	142
Equity required	2029	1700	1581	917
No. of new EMI shares (10% discount to market)			643	373
WARNER CHAPPELL VALUATION				
YE Sept 2006 EBITDA	143		77	
@ 12.5x multiple	1,792		967	
EARNINGS ANALYSIS	2006	2007	2006	2007
WMG Revenue	3532	3330	1,906	1,961
Less : Publishing	-535	-556	-289	-301
Adj WMG Revenue	2,997	3,075	1,617	1,658
EMI Revenue	3,919	3,987	2,115	2,152
WMG/EMI Revenue	6,915	7,062	3,732	3,811
WMG EBITDA	497	541	268	292
Less : Publishing	-143	-149	-77	-81
Adj WMG EBITDA	354	392	191	211
EMI EBITDA	560	606	302	327
Savings		232		125
WMG/EMI EBITDA	913	1,229	493	663
EBITDA Margin	13.2%	17.4%	13.2%	17.4%
ACCRETION				
Target Debt Levels	3x	4x	3x	4x
Adj WMG EBITDA	392	392	211	211
Cost savings	232	232	125	125
Less : Interest expense	-164	-263	-89	-142
Less tax @ 30%	-138	-108	-74	-58
Incremental Net Income	321	252	173	136
EMI Old Net Income	304	304	164	164
New EMI Net Income	625	556	337	300
New shares to be issued			643	373
Total shares			1518	1248
New EMI EPS			£0.22	£0.24
Previous EMI EPS			£0.19	£0.19
Increase in EPS			£0.03	£0.05
Increase in EPS %			16.0%	26.1%
Net Cost of WMG RM		4,614		2,490
Restructuring Costs		371		200
Total Cost		4,984		2,690
WMG RM EBITDA		392		211
Cost Savings		232		125
Total EBITDA		623		336
EV/EBITDA WMG RM		8.0x		8.0x

Source: Company data, Credit Suisse estimates.

Figure 31: WMG Bids for EMI

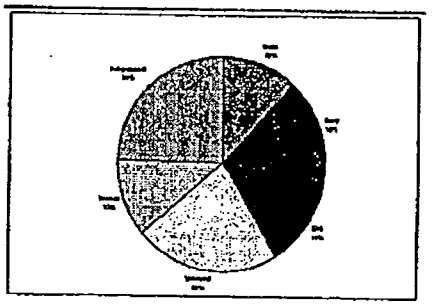
	US$	US$	£	£
BALANCE SHEET ANALYSIS				
WMG share price		$28.71		
WMG outstanding shares fully diluted		150.7		
Market Cap at offer price		4,026		2,173
WMG Net Debt (March 2006)		1,884		1,017
WMG Enterprise Value		5,910		3,190
EMI share price - assumed offer				£3.41
EMI outstanding shares fully diluted				873
Market Cap		5,520		2,979
EMI Net Debt (March 2006)		1,632		881
EMI Enterprise Value		7,152		3,860
WMG & EMI Combined Debt		3,516		1,898
Less : Sale of EMI Publishing		-2,420		-1,309
Plus : Restructuring costs		371		200
EMI acquisition cost (debt financed)		5,520		2,979
Group debt fully debt financed		6,981		3,768
WMG/EMI Group EBITDA		1,181		637
Net debt/EBITDA (full debt financing)		5.9x		5.9x
Target Net Debt/EBITDA multiple	3x	4x	3x	4x
Target Net Debt	3,542	4,723	1,912	2,549
Additional Net Debt	1,658	2,839	895	1,532
Incremental Interest Expense	133	227	72	123
Equity required	3439	2258	1856	1219
No. of new WMG shares (10% discount to market)	143	94		
EMI PUBLISHING VALUATION				
YE Sept 2006 EBITDA	194		105	
@ 12.5x multiple	2,425		1,309	
EARNINGS ANALYSIS	2006	2007	2006	2007
WMG Revenue	3832	3833	1,906	1,981
EMI Revenue	3,919	3,987	2,115	2,152
Less : Publishing	-773	-794	-417	-429
Adj EMI Revenue	3,146	3,193	1,698	1,723
WMG/EMI Revenue	6,978	6,826	3,604	3,684
WMG EBITDA	497	541	268	292
EMI EBITDA	560	605	302	327
Less : Publishing	-194	-198	-105	-107
Adj EMI EBITDA	366	408	197	220
Savings		232		125
WMG/EMI EBITDA	863	1181	466	637
EBITDA Margin	12.9%	17.3%	12.9%	17.3%
ACCRETION				
Target Debt Levels	3x	4x	3x	4x
Adj EMI EBITDA	366	366	197	197
Cost savings	232	232	125	125
Less : Interest expense	-133	-227	-72	-123
Less tax @ 30%	-139	-111	-75	-60
Incremental Net Income	325	259	175	140
WMG Old Net Income	228	228	123	123
New WMG Net Income	553	487	299	263
New shares to be issued	143	94		
Total shares	294	245		
New WMG EPS	$1.88	$1.99		
Previous WMG EPS	$1.51	$1.51		
Increase in EPS	$0.37	$0.48		
Increase in EPS %	24.6%	31.8%		
Net Cost of EMI FM		4,727		2,551
Restructuring Costs		371		200
Total Cost		5,097		2,751
EMI FM EBITDA		408		220
Cost Savings		232		125
Total EBITDA		640		345
EV/EBITDA EMI FM		8.0x		8.0x

Source: Company data, Credit Suisse estimates.

Regulatory Issues

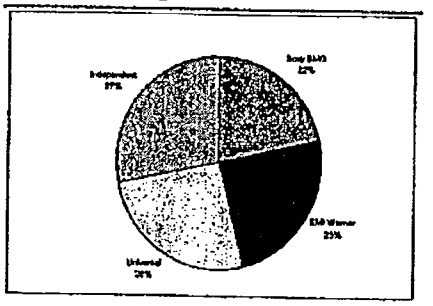
The fact that the European Union allowed the Sony BMG 50/50 joint venture to proceed without any particularly onerous conditions may suggest the regulatory concerns, which prevented the EMI-Warner merger in 2000 have dissipated. Our discussions with an expert in competition law indicate that the authorities do not have to show the resulting combination would be dominant, just that it would lessen competition. First, although reducing the number of players from four to three may seem like it is decreasing competition, in fact, it may actually have the opposite effect by creating three giants to battle each other in the industry. The anticompetition argument may lose some validity as the market share of independents has actually increased over the five-year period, suggesting that consolidation has not had a negative effect on their competitive standing.

Exhibit 32: Music Industry Shares—2000



Source: IFPI.

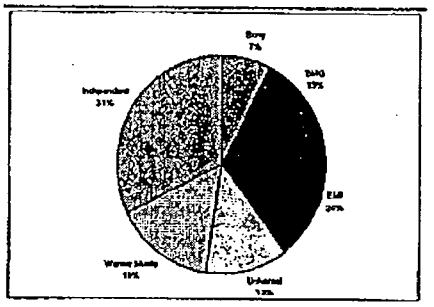
Exhibit 33: Music Industry Shares post EMI/Warner Merger—2005



Source: IFPI.

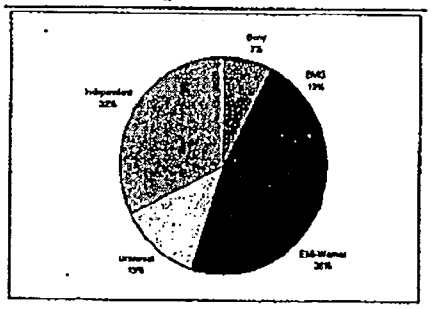
Second, to disallow an EMI/Warner merger after allowing a Sony BMG combination would appear inconsistent. Finally, the European Union seems less likely to block deals than before, given its recent history. We do, however, believe that only the recorded music businesses could be merged and not the music publishing businesses, given the potential dominance of an EMI/Warner combination, representing the number 1 and 2 players in the industry. We do not see a required sale of WMG's publishing business as a barrier to a merger given the publicly stated desire of Universal to expand in that area and the appetite of private equity investors.

Exhibit 34: Music Publishing Shares—2004



Source: Universal Music.

Exhibit 35: Music Industry Shares post EMI/Warner merger—2005



Source: Universal Music.

Management issues

We believe management a key issue in assessing a combination of WMG and EMI. As highlighted in Exhibit 36, the WMG register is dominated by private equity investors, presumably willing to crystallize a profit on their investment.

Exhibit 36: WMG Share Register

	Shares (M)	%
Thomas H Lee	55.6	37.4%
Bain Capital Investors	24.1	16.2%
Music Capital (Bronfman)	14.2	9.6%
Providence Group	12.9	8.7%
Total	106.7	71.9%

Source: Company data, Credit Suisse estimates.

However, it does not necessarily follow that WMG management has the same short-term agenda. Without a desire by management to cash out of the business rather than manage it, the combined Warner-EMI would be at risk of significant management disruption and a negative impact on the business as has arguably been the case with Sony BMG.

Valuation Comparison

EBITDA Multiple

We have compared the four major music companies in terms of valuation. Warner Music and EMI are the only two pure listed plays, with Universal contributing approximately 20% of the value of Vivendi Universal and Sony BMG contributing less than 5% to the value of Sony. The latter two have been included for comparative purposes.

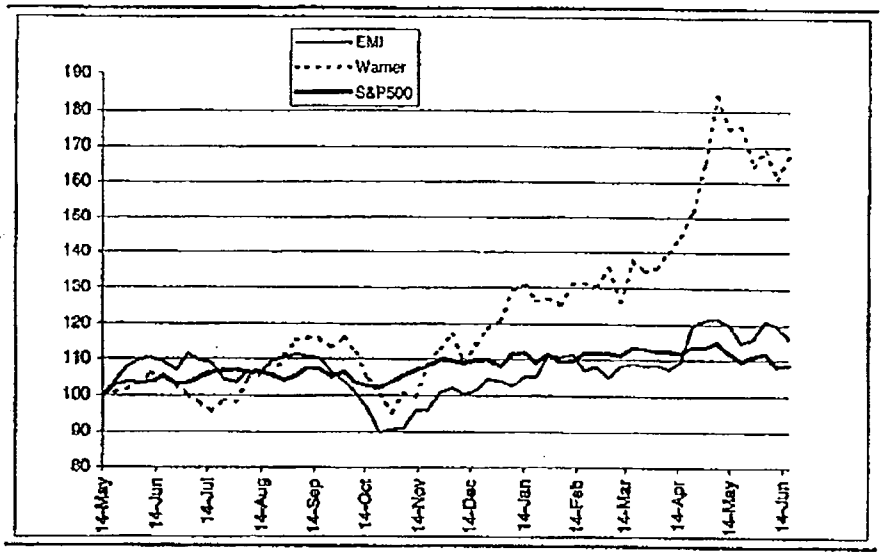
Exhibit 37: Music Company EBITDA Multiple and PE multiple Comparison

Stock	EMI	Warner	Vivendi	Sony
Fiscal Year End	March	Sept	Dec	March
Currency	£M	US$M	€M	¥ Billions
Music exposure	100%	100%	20% of valuation	> 5% of valuation
Share price	£2.73	$26.71	€ 26.80	¥4,840
Shares outstanding (M)	874	151	1154	1048
Market Capitalization	2,386	4,025	30,914	5,063
Latest Net Debt	880	1,952	3,869	-102
Adjustments	-150	-281	-8899	0
Adjusted Enterprise Value (local)	3,116	5,696	25,884	4,961
Adjusted Enterprise Value (US$m)	5,774	5,696	32,731	43,256
EBITDA (calendarized)				
2005	269	472	3,321	487
2006E	297	507	3,642	560
2007E	323	553	3,844	614
EV/EBITDA Multiple (x)				
2005	11.6	12.1	7.8	10.2
2006E	10.5	11.2	7.1	8.9
2007E	9.6	10.3	6.7	8.1
EPS (calendarized)				
2005	0.15	1.30	1.38	158.0
2006E	0.17	1.37	1.55	47.0
2007E	0.19	1.54	1.70	204.0
PE (x)				
2005	18.2	20.6	19.7	30.6
2006E	16.0	19.5	17.3	103.0
2007E	14.4	17.4	15.8	23.7

Source: Company data, Credit Suisse estimates, Bloomberg. Earnings data are calendarized for EMI, WMG, and Vivendi. Sony is March year-end and has limited comparability due to limited music exposure.

The multiples of EMI and Warner have both expanded, reflecting some elements of takeover speculation.

Exhibit 38: EMI and Warner Share Price Performance



Source: Bloomberg.

Tax assets and other adjustments to Enterprise Value

EMI enjoys a lower-than-average tax rate because of losses brought forward in certain tax jurisdictions. For example, in 2005-06 its rate was just 17.6%, helped by a better use of tax losses and a lower tax liability settlement. Management confirmed this rate would revert to 22% in 2006-07, with a 25% rate in the medium term. Simplistically, we value EMI's tax asset as being the NPV of the differential between our forecast rate and a normalized blended rate of, about 33% over the next five years. This equates to £81 million.

We make two other adjustments to derive EMI's Enterprise Value. First, we deduct £70m in respect of our estimate of the capitalised value of the minority interests, namely the 45% interest held by Toshiba in Toshiba-EMI Ltd (Japan). In addition, we add back £139m in respect of EMI's convertible bond, to be consistent with our hypothetically assumption that the options to convert into 78.9m shares are exercised and included within our 874m share base. The total adjustment amounts to £150m.

WMG enjoys a tax benefit on its deductible amortization in the order of $100 million per annum over 15 years. On a NPV basis we value this asset at $275 million.

We incorporate these as adjustments in our EV/EBITDA multiples analysis above. For the P/E ratio analysis we simply take as our denominator for EMI after actual cash tax paid, on the grounds that this is reflective of sustainable earnings for some time to come. For WMG, we normalize earnings by adding back the after-tax amortization expense.

DCF Valuation

We have undertaken a discounted cash flow analysis of WMG, outlined in Exhibit 39. We have assumed a terminal growth rate of 2.5% for WMG in-line with our cautious view of longer-term overall industry growth. This delivers a valuation outcome modestly

below the current share price. The sensitivity of this valuation approach to assumptions on terminal growth are considerable, with an incremental 1% increase in the terminal growth rate delivering valuation upside of close to 12%.

Exhibit 39: WMG DCF Valuation

Effective Tax Rate	35%	Current Share Price	$ 26.71
Risk Free Rate (10Y)	5.0%	Market Value of Equity ($m)	4,026
Borrowing Margin	3.0%	Book Value of Debt ($m)	1,958
Equity Risk Premium	5.5%	After Tax Cost of Debt	5.2%
Equity Beta	1.30	Required Equity Return	11.8%
Terminal Growth Rate	2.5%	WACC	9.6%
Terminal EBITDA multiple	8.1	Weighted Average Equivalent Shares	150.7

Year ending 30 September	2006E	2007E	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F	Terminal
EBITDA	487.3	541.8	592.2	641.0	677.9	707.5	732.5	754.0	780.7	812.9	839.3	
Taxation	174.8	189.3	207.3	224.4	236.9	247.4	256.4	263.9	273.3	284.5	293.8	
Increase in Working Capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Operating Cash Flow	323.2	351.8	384.9	416.7	440.9	459.3	475.1	490.1	507.5	528.4	545.8	
Capital Expenditure	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0	
Free Cash Flow	295.2	323.8	356.9	388.7	412.9	431.3	446.1	462.1	479.5	500.4	517.8	525.9
Discount Factor	0.97	0.88	0.81	0.74	0.67	0.62	0.56	0.51	0.47	0.43	0.39	0.35
PV of Cash Flows	287.8	287.5	289.3	287.4	277.9	263.6	251.8	234.7	224.0	213.8	199.5	186.9
PV of Cash Flows FY06 - FY16												2,826.6
PV of Terminal Cash Flow												2,622.4
Total PV												5,442.7
Less : Net debt												-1,958
Add : PV of tax assets												221
Net Asset Value												3,706
Value per WMG share												$ 24.61
Current share price												$ 26.71
Discount												-8.0%

Source: Company data, Credit Suisse estimates, Bloomberg.

Conclusion

The valuation of EMI and WMG is not compelling on current earnings forecasts with EBITDA multiples at a premium to entertainment companies. WMG's valuation on a DCF basis is largely in-line with its current share price. However, as outlined in the merger economics section of this report, earnings, and, therefore valuation prospects would be significantly enhanced by a merger of the two companies.

Companies

EMI

SWOT analysis

Strengths

- *Strong and disciplined management.* EMI was the first music Major to initiate a major restructuring program back in 2002 when it undertook to cut costs by over £100 million per annum. This was followed in 2004 by a second wave of restructuring, cutting a further £50 million p.a. from the cost base, and augmented by the more recent £30m cost reduction programme.
- *Leading music publishing business.* EMI has the biggest music publishing catalogue in the world, representing 20% of its group sales. Rival catalogues constitute a much smaller proportion of sales. We prefer publishing to recorded music because of its higher margins (about 25% versus 10%), lower volatility (owing to the diversification of royalty sources), and higher growth potential (boosted by structural growth in synchronization and performance royalties).
- Market share gain momentum: 2005/06 H1 saw EMI's market share increase from 12.5% to 13.1%, boosted by the success of Coldplay and Gorillaz new releases. This 13.1% share was sustained for the full year.
- Relative strength in UK and Ireland with around 19% market share.

Weakness

- Relative weakness in United States. (11% market share in 2005/06 H1 and in Japan (just 8% market share in 2005/06 H1).
- Use of exceptional items: in the past four years EMI processed an average operational exceptional charge of £108 million p.a. Although we witnessed unprecedented changes in the industry during this period, some investors might argue a substantial "exceptional" charge (e.g., £100 million p.a.) should be built into the underlying profit base.
- Below investment grade debt rating results in high cost of debt and reduces strategic flexibility.

Opportunities

- Possible merger of recorded music business with Warner, with the resultant scale benefits from increasing individual market shares from 12-13% to a combined 25%, together with cost savings from the elimination of duplication of activities. We estimate annual cost savings to be around £125 million p.a.
- Reduction of cost of debt from an underlying 8-9% (we estimate a fiscal 2006-07 interest charge of £87 million). The £5 million exceptional refinancing cost taken at the interims heralded the start of this process, with management already forecasting better rates for 2006/07.

Threats

- Possible weakening of front list and artists' roster from cost reduction (although management argues strongly that A&R has become more efficient, rather than cut back).

Assumptions underpinning earnings forecasts

We forecast EMI's Recorded Music revenue will grow by 1.5% this year (in 2005-06 growth was 3.7%, or 1.9% in constant currency), in-line with consensus expectations. In its full-year results press release, EMI suggested, "the global recorded music industry will return to growth in due course." It expects "declining physical sales" and strong consumer demand for digital music. At its results presentation in May management said the return to growth would happen "soon." In fact, Recorded Music CEO Alain Levy suggested EMI's sales growth would be positive this year through a combination of overall market growth and/or market share growth.

In support of this positive outlook, EMI's release schedule for this year looks quite strong, with expected releases from Janet Jackson, Norah Jones, The Beatles, Joss Stone, KT Tunstall, Hikaru Utada (important for Japan), Robbie Williams, and Chingy. This may help to offset concerns that the revenue growth experienced of 1.9% (against a market down 0.9%) in 2005-06 was a one-off, boosted by the Coldplay and Gorillaz successes, and that EMI's share gain from 12.9% to 13.1% could not be sustained. However, management does acknowledge that the year's sales should be more second-half weighted given the difficult prior-year comparison with the Coldplay and Gorillaz effect.

We forecast EMI's Music Publishing revenue will grow by 2.6% this year (in 2005-06 growth was 4.7%, or 2.6% in constant currency), broadly in-line with consensus expectations. Our growth estimate reflects the fact that 45% of EMI's Music Publishing revenues are linked to recorded music sales through mechanical royalties, with some outperformance against our recorded music growth once more coming from synchronization (which grew 5.4% in constant currency in 2005-06). EMI Music Publishing expects to benefit from releases from artists such as Pharrell Williams, Pink, Scissor Sisters, The Zutons, and Diddy.

Overall we forecast 1.7% revenue growth for the group. Given the operational leverage of EMI, this translates into Group EBITA of £277 million, up 11%, again in-line with consensus. Our forecasts also reflect EMI's £30 million cost-savings plan. This new initiative, affecting all regions (particularly Japan) and both divisions, targets £10 million of (achieved) savings in 2006-07, with the full £30 million run-rate achieved by end 2007-08. EMI has stated that the £60 million cash cost of achieving these savings would be more than offset by proceeds from property disposals.

We forecast "Adjusted Profit Before Tax" (ABT) of £190 million, up 19% on 2005-06. This is after deducting a £87 million interest charge (under £90 million, according to management), an underlying rate of interest of over 8%.

Exhibit 40: EMI Earnings Model

US$ in millions, unless otherwise stated

Y/e 31st March	2004A	2005A	2006A	2007E	2008E	2009E
REVENUE						
Recorded music	1,723	1,601	1,660	1,685	1,710	1,745
% growth	-2.9%	-7.1%	3.7%	1.5%	1.5%	2.0%
digital sales	*8*	*34*	*92*	*169*	*231*	*297*
% growth		*340%*	*173%*	*82%*	*37%*	*28%*
% of total recorded music revenues	*0.4%*	*2.1%*	*5.5%*	*10.0%*	*13.5%*	*17.0%*
Music publishing	398	401	420	430	441	457
% growth	-0.8%	0.7%	4.7%	2.5%	2.6%	3.5%
digital sales	*7*	*13*	*20*	*32*	*51*	*69*
% growth		*75.7%*	*51.5%*	*63.8%*	*57.2%*	*35.1%*
% total music publishing revenues		*3.2%*	*4.7%*	*7.5%*	*11.5%*	*15.0%*
Total Group Revenues	2,121	2,001	2,079.9	2,115	2,152	2,202
OPERATING PROFIT						
Total recorded music	147	126	145	170	193	202
% margin	8.6%	7.8%	8.7%	10.1%	11.3%	11.6%
% growth	-2.1%	-14.9%	15.6%	17.2%	13.2%	5.1%
Total music publishing	102	100	105	107	109	112
% margin	25.6%	24.9%	25.1%	24.9%	24.7%	24.5%
% growth	-1.5%	-2.3%	5.6%	1.7%	1.7%	2.7%
Group Operating Profit (reported EBITA)	249	225	250	277	301	314
% margin	11.8%	11.2%	12.0%	13.1%	14.0%	14.3%
% growth	-1.9%	-9.7%	11.3%	10.7%	8.7%	4.2%
Goodwill	(4)	-	-	-	-	-
Amortisation music copyrights	(47)	(48)	(50)	(51)	(52)	(53)
% change	20%	2%	4%	2%	2%	2%
Amortisation	(51)	(48)	(50)	(51)	(52)	(53)
Operating exceptional items	(138)	-	4.0	-	-	-
Total deductions	(189)	(48)	(45.9)	(51)	(52)	(53)
Group operating profit (EBIT)	60	177	205	226	250	261
% margin	2.8%	8.8%	9.8%	10.7%	11.6%	11.9%
% growth	-67.8%	194.7%	15.5%	10.6%	10.2%	4.7%
EBITDA (excluding copyright am.)	*284*	*249*	276	*304*	*329*	*343*
% change	*-4.3%*	*-12.4%*	*10.8%*	*10.1%*	*8.3%*	*4.2%*
Share of operating profit	-	-	-	-	-	-
Associates	(0.3)	1.1	1.0	-	-	-
Total operating profit	60	178	205.8	226	250	261
Losses on businesses disposed						
Profit on disposal of fixed asset invest / Other	(17)	(17.5)	-			
Non-operating exceptional items	(17)	(17.5)	4.7	-	-	-
Profit before finance charges	43	161	210	226	250	261
Net interest paid	(96)	(62)	(92)	(87)	(81)	(67)
Joint venture - all HMV interest	-	-	-	-	-	-
Finance charges	(96)	(62)	(92)	(87)	(81)	(67)
Profit before Tax (PBT)	(53)	99	118.1	139	168	194
% growth	-117%	-288%	19%	18%	21%	16%
Adjusted PBT	163	141	159.4	190	220	247
% growth		-14%	13%	19%	16%	12%
Tax	(20)	(24)	(28)	(44)	(53)	(62)
Effective rate	-37%	24%	24%	23.3%	24%	25%
Profit before minorities	(73)	75	90	95	115	132
Minority interests	1	1	(4)	(5)	(6)	(7)
Net profit attributable to group	(72)	76	86	90	109	125

Source: Company data, Credit Suisse estimates.

Exhibit 41: EMI Valuation Data and Summary

US$ in millions, unless otherwise stated

YE March	2005A	2006A	2007E	2008E
Current Stock Price	£2.73			
Market cap (millions)	£2,382.7			
Rating			OUTPERFORM	
Target Price			£3.10	
Recorded Music	1,601	1,560	1,685	1,710
Music Publishing	401	420	430	441
Total Consolidated Revenues	2,001	2,080	2,115	2,152
% Growth	-5.6%	3.9%	1.7%	1.7%
Total Consolidated EBITDA	249	276	304	329
Growth	(12.4%)	10.8%	10.1%	8.3%
Margin	12%	13%	14%	15%
EBITDA per share	£0.29	£0.32	£0.35	£0.38
Operating Income	177	205	228	250
Growth	194.7%	15.5%	10.6%	10.2%
Margin	8.8%	9.8%	10.7%	11.6%
After tax cash flow (net inc. + D&A)	177	203	218	240
Growth	(29.0%)	14.5%	7.6%	10.2%
ATCF Per share	£0.20	£0.23	£0.25	£0.27
Growth	(32.7%)	14.3%	7.6%	10.2%
Free cash flow	42	50	128	152
Growth	(67.2%)	19.2%	158.0%	18.3%
FCF per share	£0.05	£0.06	£0.15	£0.17
Growth	(66.9%)	19.0%	158.0%	18.3%
Cash	243	193	193	193
Debt	1,080	1,072	1,007	918
Minority Interest	-8	59	74	89
Net Debt	830	938	888	814
Earnings per share (pence)	£0.131	£0.157	£0.171	£0.194
Growth	-15.5%	19.9%	9.4%	13.4%
Shares outstanding	872.8	874.2	874.2	874.2
Current Multiples				
Price/Earnings	20.9	17.4	15.9	14.1
Total Enterprise Value/EBITDA	12.3	11.5	10.3	9.3
Price/After tax cash flow	13.5	11.8	10.9	9.9
Price/Free cash flow	57.1	48.0	18.6	15.7

Source: Company data, Credit Suisse estimates.

Sony BMG

SWOT Analysis

Strengths

- *Scale.* Sony BMG is the second largest of the music majors after Universal, providing the joint venture with significant benefits of scale.
- *Strong artist roster.* Sony BMG artists produced 20 of the top 50 albums of 2004
- *Cost reductions* as a result of the merger are supporting better-than-expected profit growth.

Weaknesses

- Declining market share. It is not clear at this stage how much this is a function of a deliberate reduction in the artist roster following the merger and how much a function of a less successful release slate.
- Separation of publishing and recorded music. Sony and Bertelsmann have retained the individual music publishing businesses. The separation from the recorded music business reduces the opportunity for cross selling between business units in our view.
- The business has experienced considerable management upheaval as a result of the merger.

Opportunities

- Cost restructuring. The newly merged company is towards the end of a significant restructuring program, which was initiated following the merger. The joint venture likely has the largest margin upside opportunity of the music majors. However, margins on a relative basis may continue to underperform the peer group due to the separation of the higher margin publishing business.
- Bertelsmann appears to be exploring strategic options for its music business. This may bring the recorded music business under Sony control; it may also provide the opportunity for Sony to acquire BMG's music publishing business.

Threats

- *Management instability.* Tensions between the joint venture partners concerning management direction risk affecting the operational momentum of the business.
- *Fallout from copyright protection scandal.* Sony BMG may experience an ongoing impact on its business due to consumer concern about vulnerabilities arising from its copyright protection software.

Assumptions underpinning earnings forecasts

Our forecasts assume that Sony BMG completed its restructuring plan in the year to March fiscal 2006. For the year to March fiscal 2007, we assume Sony BMG will continue to underperform market growth following the cuts in the artist roster undertaken in the previous year. However, cost cutting benefits are expected to underpin further margin expansion in the year to March 2007.

Exhibit 42: Sony BMG Earnings Model

US$ in millions, unless otherwise stated

YE March	2005	2006	2007F	2008F	2009F	2010F
Sales	3,258	4,283	4,262	4,262	4,304	4,304
% change	*NA*	*NA*	*-0.5%*	*0.0%*	*1.0%*	*0.0%*
COSTS						
Product	640	835	837	837	846	846
Royalties	768	1,010	1,005	1,005	1,015	1,015
A&R	231	304	302	302	305	305
Other	89	117	117	117	118	118
Cost of Goods Sold	1,728	2,266	2,261	2,261	2,284	2,284
Gross Profit	1,529	2,017	2,001	2,001	2,021	2,021
Distribution	92	127	127	127	127	127
Variable Marketing	415	480	466	466	466	466
Selling Overhead	103	135	131	131	131	131
Marketing Overhead	172	239	232	232	232	232
G&A Overhead	364	480	456	456	456	456
Total SG&A	1,146	1,461	1,411	1,411	1,411	1,411
Total Costs	2,874	3,727	3,672	3,672	3,695	3,695
% change		*NA*	*-1.5%*	*0.0%*	*0.6%*	*0.0%*
EBITDA	383	556	589	589	609	609
% change						
Depreciation & amortiz	147	220	220	220	220	220
EBIT	237	336	369	369	389	389
Restructuring charges	-290	-186	0	0	0	0
Pre-tax profit reported	-53	150	369	369	389	389
Tax	-13	-55	-74	-74	-78	-78
Net Income	-66	95	295	295	311	311
Sony 50% in USD	-33	48	148	148	156	156
Sony 50% in JPY	-3.6	5.4	16.2	16.2	17.1	17.1
EBITDA Margin pre-res	11.6%	13.0%	13.8%	13.8%	14.2%	14.2%
EBITDA Margin post-r	2.9%	8.6%	13.8%	13.8%	14.2%	14.2%
EBIT Margin %	7.3%	7.8%	8.7%	8.7%	9.0%	9.0%

Source: Company data, Credit Suisse estimates.

Exhibit 43: Sony Valuation Data and Summary

US$ in millions, unless otherwise stated

YE March	2004	2005	2006	2007E	2008E
Current Stock Price	¥4,720.00	Rating	OUTPERFORM		
Market cap (millions)	¥4,707	Target Price	¥7,500.00		
Electronics	5,042	5,022	5,150	5,361	5,580
Games	780	730	959	1,163	1,847
Pictures	758	734	746	763	815
Financial Services	594	581	743	743	743
Other	709	504	409	421	434
Eliminations	(385)	(390)	(532)	(520)	(502)
Total operating revenues	7,496	7,160	7,475	7,951	8,917
% change	10.5%	-5.8%	6.2%	0.0%	0.0%
Electronics	204	241	245	429	563
Games	125	60	25	-14	75
Pictures	43	69	34	60	62
Financial Services	112	108	241	108	108
Other	12	23	33	32	32
Corporate/Eliminations	-30	-16	-18	-1	-1
Total Consolidated EBITDA	465	487	560	614	842
Growth	(13.4%)	4.6%	15.0%	9.7%	37.1%
Margin	6%	7%	7%	8%	9%
EBITDA per share	¥445.22	¥466.37	¥535.26	¥587.21	¥805.08
Operating income	59	114	191	206	415
Growth	(46.7%)	15.2%	67.9%	7.6%	101.9%
Margin	1.3%	1.6%	2.6%	2.6%	4.7%
Net income	69	164	124	213	360
D&A	386	373	382	408	426
After tax cash flow (net inc. + D&A)	455	537	505	621	787
Growth	(3%)	18%	(5%)	23%	27%
ATCF Per share	¥435.27	¥514.19	¥483.15	¥594.12	¥752.51
Growth	7%	(18%)	6%	(23%)	(27%)
Free cash flow	-147	-73	-440	-9	22
Growth		(50.2%)	502.4%	(98.0%)	(354.2%)
FCF per share	-¥140.38	-¥70.02	-¥420.82	-¥8.25	¥20.97
Growth		(50.1%)	501.0%	(98.0%)	(354.2%)
Cash	1,129	1,241	1,240	1,242	1,275
Debt	1,253	909	1,101	1,101	1,101
Minority Interest	23	24	37	37	37
Net Debt	147	-308	-102	-104	-137
Earnings per share (adjusted)	¥85	¥158	¥47	¥204	¥345
Growth	(27%)	86%	(71%)	337%	69%
Shares outstanding (bn)	1.045	1.044	1.048	1.046	1.048
Current Multiples					
Price/Earnings	55.6	29.9	101.3	23.2	13.7
Total Enterprise Value/EBITDA	10.4	9.0	8.2	7.5	5.4
Price/After tax cash flow	10.8	9.2	9.8	7.9	6.3
Price/Free cash flow	-34	-67	-11	-572	225

Source: Company data, Credit Suisse estimates.

Vivendi (Universal Music Group)

SWOT Analysis

Strengths

- Scale and portfolio diversification. In a hit or miss business like music, scale helps reducing volatility and limiting the negotiation power of each of the artists taken individually. UMG is the largest group with over 25% market share of the global recorded music.
- *Sound financial position.* Lack of financial constraints may represent a strength given the uncertainty of future revenue growth and it may allow a smoother management of the operations together with small acquisitions. UMG is 92% owned by Vivendi Universal, which could increase its firepower by about €1 billion.

Weaknesses

- Limited exposure to publishing. With the development of new media to distribute music, publishing becomes a key link to value creation that UMG may not take full advantage of. UMG has only about 13% market share of the global music publishing, same as Sony BMG, but well behind Warner (16%) and EMI (20%).

Opportunities

- Expansion in publishing. Management has announced plans to boost its presence in music publishing from the current 9% of total revs to about 20%. The potential merger of Warner EMI could represent an opportunity, as we would expect the newco to be forced to dispose of some publishing assets (Warner Chapell).
- *Cross selling within the conglomerate.* Being part of Vivendi Universal UMG could take advantage of in-house knowledge to cross sell its content into telecom, games, or movies, although we would expect very limited revenue synergies.

Threats

- *Further distribution consolidation.* In the move from physical to digital distribution music Majors had to cope with increased price pressure from iTunes enjoying around 70% market share. High concentration of distribution also limits music Majors' ability to price digital downloads at different levels.

Assumptions underpinning earnings forecasts

We forecast UMG's revenues to increase by 1% in 2006, broadly in-line with consensus. Thanks to the end of the restructuring plan, flow-through from a strong schedule release last year, and the disposal of zero-margin music clubs, we expect EBITA margin to increase from 9.8% in 2005 to 11% in 2006. Our forecasts assume relatively stable market share from 2006 onward.

Exhibit 44: Universal Music Earnings Model

€ in millions, unless otherwise stated

	2004A	2005A	2006E	2007E	2008E
Sales	4,989	4,893	4,942	5,041	5,142
of which: digital	95	259			
operating costs	-4,225	-4,133	-4,077	-4,133	-4,216
EBITDA	764	760	865	907	925
D&A	-342	-281	-321	-353	-360
other (restructuring, etc.)	-63	-19			
EBITA	359	480	544	554	565
growth / margins					
Revenue growth	*0.3%*	*-1.9%*	*1.0%*	*2.0%*	*2.0%*
% of costs	*-84.7%*	*-84.5%*	*-82.5%*	*-82.0%*	*-82.0%*
EBITDA margin	*15.3%*	*15.5%*	*17.5%*	*18.0%*	*18.0%*
D&A as % of revs	*-6.9%*	*-5.3%*	*-6.5%*	*-7.0%*	*-7.0%*
EBITA margin	*7.2%*	*9.8%*	*11.0%*	*11.0%*	*11.0%*

Source: Company data, Credit Suisse estimates.

Exhibit 45: Vivendi Valuation Data and Summary

€ in millions, unless otherwise stated

YE Dec	2005	2006E	2007E	2008E
Current Stock Price €26.80	Rating		Neutral	
Market cap (millions) 30,913.2	Target Price		€24.00	
Canal+	3,452	3,612	3,792	3,963
Music (UMG)	4,893	4,942	5,041	5,142
Games	641	737	767	798
SFR	8,687	8,861	9,127	9,400
Maroc Telecom	1,860	2,046	2,189	2,299
Other	-49	63	64	66
Total Consolidated Revenues	19,484	20,260	20,980	21,667
% Growth	*9.0%*	*4.0%*	*3.6%*	*3.3%*
Canal+	369	340	406	635
Music (UMG)	760	865	907	925
Games	86	97	109	113
SFR	3,209	3,551	3,658	3,768
Maroc Telecom	1,056	1,186	1,269	1,323
Other	-149	-179	-186	-192
Total Consolidated EBITDA	5,331	5,861	6,164	6,573
Growth	*8.0%*	*9.9%*	*5.2%*	*6.6%*
Margin	27%	29%	29%	30%
EBITDA per share	$4.60	$5.04	$5.30	$5.65
Operating Income	3,977	4,597	4,900	5,287
Growth	*13.0%*	*15.6%*	*6.6%*	*7.9%*
Margin	20.4%	22.7%	23.4%	24.4%
Net Income	3,154	2,378	2,632	2,922
D&A	1,525	1,711	1,807	1,859
After tax cash flow (net inc. + D&A)	4,679	4,089	4,439	4,781
Growth	*(13.7%)*	*(12.6%)*	*8.6%*	*7.7%*
ATCF Per share	€4.04	€3.51	€3.82	€4.11
Growth	*(14.2%)*	*(13.0%)*	*8.6%*	*7.7%*
Free cash flow	1,298	1,294	1,428	1,643
Growth	*14.7%*	*(0.1%)*	*10.3%*	*15.1%*
FCF per share	€1.12	€1.11	€1.23	€1.41
Growth	*13.9%*	*(0.5%)*	*10.3%*	*15.1%*
Cash	2,902	2,902	2,902	2,902
Debt	6,760	6,771	5,692	4,471
Minority interest				
Net Debt	3,858	3,869	2,790	1,569
Earnings per share	€1.36	€1.55	€1.70	€1.88
Growth	*78.6%*	*14.2%*	*9.8%*	*10.7%*
Shares outstanding	1,158.5	1,163.5	1,163.5	1,163.5
Current Multiples				
Price/Earnings	19.7	17.2	15.6	14.1
Total Enterprise Value/EBITDA	7.8	7.1	6.5	5.8
Price/After tax cash flow	6.6	7.6	7.0	6.5
Price/Free cash flow	23.9	23.9	21.6	18.8

Source: Company data, Credit Suisse estimates.

Warner Music

SWOT Analysis

Strengths

- Strong artist roster. This is driving an expansion in WMG's recorded music market share, particularly in the United States.
- Management depth. CEO Edgar Bronfman has experience at two major music companies (WMG and Universal) and the ability to attract talent such as Lyor Cohen who joined WMG from Universal.
- *Cost cutting program.* WMG has removed $250 million from its cost base since the separation from Time Warner. Group EBITDA margins are forecast to reach 14.1% in fiscal 2006, more than double the 7% margins reported for fiscal 2003.
- *Aggressive digital business development.* WMG has been aggressive in developing its digital business and is the leading music company with respect to digital revenues as a proportion of total in the March 2006 quarter, WMG's digital revenues made up 11.3% of group revenue compared with 10% for Universal and 7.2% for EMI.
- Strong music publishing business. Music publishing market share is second only to EMI.

Weaknesses

- Financial transparency is limited. The company has a relatively short listed history, and has experienced changes in financial reporting periods. In addition, it provides low levels of information on its release roster. As a "controlled company," WMG is exempt from certain corporate governance requirements of the New York Stock Exchange.
- *Lowest market share of the major music companies.* This may limit its margin upside due to absence of economies of scale.
- *Highly geared balance sheet.* This limits WMG's strategic options.
- *The company's register is dominated by private equity investors.* There is a small free float (approximately 28%). While greater liquidity would arguably have favorable consequences for share price performance, a move by private equity holders to monetize their investments would likely raise fears of a share overhang.

Opportunities

- The economic rationale for a merger with EMI is strong, and would place the merged group in close to top position in terms of market share. As highlighted in our detailed analysis of the merger opportunity, overall cost savings opportunities could amount to $230 million, providing meaningful margin upside to a combined group.
- There may be opportunities for the recorded music and music publishing businesses to work more closely together and facilitate greater exploitation of digital opportunities.

Threats

- Takeover premium? Arguably the market has awarded a valuation premium to WMG for a potential merger or takeover by EMI. There is, therefore, a risk of share price downside were this not to occur.
- *Warner Music is not in compliance with Sarbanes-Oxley.* The company needs to implement appropriate internal controls to achieve this. Two of three material weaknesses have been addressed. The remaining weakness relates to accounting for royalty payments.
- It is unclear whether WMG has been overly aggressive in reducing its A&R investment, which may affect its future release schedule. Since its separation from Time Warner, the company has reduced its artist roster by approximately 30%.

Assumptions underpinning earnings forecasts

Recorded music. We have assumed that WMG's trends in its physical business will be broadly in-line with the market. However, we expect the digital business to considerably outperform the market, reflecting the trends evident in the first two quarters of fiscal 2006. For the full year, we expect digital revenue growth of 131% compared with our estimates for the total market of 87%. Recorded music revenue growth of 2.5% is in-line with that achieved in fiscal 2005. We expect continued margin expansion, reflecting a continued cost focus, and the growing proportion of higher margin digital revenues. Full-year EBITDA margins are forecast to achieve 16% compared with the 15.3% achieved in fiscal 2005. (These margins are before the impact of corporate overheads). Longer term, we have assumed that WMG's physical recorded music business continues to perform in-line with the broader market given the difficulty of forecasting release slates. However, we have continued to assume above-average growth in digital given WMG's success in positioning itself in that business.

Music publishing: We expect a modest decline in the contribution of the business reflecting asset sale impacts and the weaker trends of the first two quarters. We expect divisional margins to expand, reflecting the sale of lower-margin businesses and strong growth forecast for digital revenue growth. Longer term we have forecast modest declines in the traditional business, but continued strong growth in digital, for overall revenue growth around 2%.

Exhibit 46: Warner Music Valuation Data and Summary

US$ in millions, unless otherwise stated

YE September	2005	2006E	2007E	2008E
Current Stock Price	$28.7	Rating	OUTPERFORM	
Market cap (millions)	4,028.2	Target Price	$30.00	
Recorded Music	2,924	2,997	3,075	3,160
Music Publishing	607	565	587	611
Total Consolidated Revenues (excl. eliminations)	3,502	3,532	3,633	3,740
% Growth	*1.5%*	*0.9%*	*2.8%*	*3.0%*
Total Consolidated EBITDA	468	497	541	592
Growth	*24.6%*	*6.7%*	*8.8%*	*9.5%*
Margin	13.3%	14.1%	14.9%	15.8%
EBITDA per share	$3.60	$3.30	$3.58	$3.92
Operating Income	228	265	313	367
Growth	*117.1%*	*16.2%*	*18.0%*	*17.3%*
Margin	6.5%	7.5%	8.6%	9.8%
After tax cash flow (net inc. + D&A)	245	281	304	330
Growth	*NM*	*14.6%*	*8.2%*	*8.6%*
ATCF Per share	$1.89	$1.86	$2.01	$2.19
Growth	*(391.6%)*	*(1.7%)*	*8.0%*	*8.8%*
Free cash flow	-257	-25	275	277
Growth	*NM*	*NM*	*NM*	*0.8%*
FCF per share	($2.06)	($0.16)	$1.82	$1.84
Growth	*NM*	*NM*	*NM*	*0.8%*
Cash	288	263	538	815
Debt	2,246	2,269	2,319	2,369
Minority Interest	0	0	0	0
Net Debt	1,958	2,006	1,781	1,554
Earnings per share (normalized)	$1.23	$1.34	$1.51	$1.71
Growth	*NM*	*8.6%*	*13.2%*	*13.0%*
Shares outstanding	129.4	150.7	151.0	151.0
Current Multiples				
Price/Earnings	21.7	20.0	17.7	15.6
Total Enterprise Value/EBITDA	12.2	11.6	10.3	9.1
Price/After tax cash flow	14.1	14.3	13.3	12.2
Price/Free cash flow	-12.9	-162.8	14.7	14.5

Source: Company data, Credit Suisse estimates.

Board

WMG's board consists of 13 directors, including two independent directors (Mr. Shelby W. Bonnie and Ms. Michele Hooper). The company is not in compliance with New York Stock Exchange rules and is in the process of finding one additional independent candidate to join its board and serve as a member of its audit committee.

Management

Edgar Bronfman, Jr.—Chairman of Board and CEO

Mr. Bronfman has served as chairman of the board and CEO since March 2004. Previously he served as chairman and CEO of Lexa Partners LLC, a management venture capital group. Prior to that his roles included executive vice chairman of Vivendi Universal from December 2000 to December 2003, and president and CEO of The Seagram Company from June 1994 to December 2000.

Lyor Cohen—Chairman and CEO of U.S. Recorded Music

Mr. Cohen has served as chairman and CEO of WMG's U.S. Recorded Music division since March 2004. Previously he served as chairman and CEO of Universal Music Group's Def Jam Music Group, and was president of Def Jam from 1988 to 2002.

Patrick Vien—Chairman and CEO of Warner Music International

Mr. Vien joined WMI in February 2006 from NBC Universal's Global Networks division.

Richard Blackstone—Chairman and CEO of Warner/Chappel Music

Mr. Blackstone has served as chairman and CEO of Warner/Chappell Music since May 2005. He joined WMG from Zomba Music Publishing where he served as president and in other capacities since 1989.

Michael D. Fleisher—Executive Vice President and Chief Financial Officer

Mr. Fleisher joined WMG as executive vice president and chief financial officer in January 2005. Previously he was chairman and CEO of Gartner Inc. and served in various capacities from 1993.

Accounting Issues

WMG's balance sheet has a value of $1.7 billion of assets, which are subject to amortization (recorded music catalog, music publishing copyrights, and trademarks). The annual amortization charge of $188 million is effective in reducing WMG's tax rate due the tax deductibility of $100 million of the amortization charge. Our EPS estimates are "normalized" by adding back the after-tax amortization charge.

Exhibit 47: Warner Music Income Statement

FYE September 30 ($ in millions) INCOME STATEMENT ANALYSIS	Dec-04 Q1 05A	Mar 05 Q2 05A	Jun-05 Q3 05A	Sep 05 Q4 05A	Dec-05 Q1 06A	Mar-06 Q2 06A	Jun-06 Q3 06E	Sep-06 Q4 06E	FY 05A	FY 06E	FY 07E	FY 08E
Revenue	1068	767	742	905	1044	796	758	934	3502	3532	3633	3740
Costs and Expenses	-933	-679	-672	-793	-842	-692	-682	-819	-3038	-3035	-3092	-3143
Cost of Revenue	-511	-400	-398	-473	-530	-398	-402	-495	-1850	-1872	-1825	-1862
Selling, General, & Administrative	-312	-279	-276	-320	-312	-294	-280	-324	-1188	-1163	-1158	-1158
OIBDA	135	88	70	112	202	104	76	115	486	497	541	592
FAS 123 Expense	2	7	9	7	6	2	6	6	25	20	20	20
OIBDA excl. FAS 123 Expense	137	95	79	119	208	106	82	121	491	517	561	612
Depreciation	-14	-14	-12	-11	-11	-11	-11	-11	-51	-44	-40	-37
Amortization	-46	-47	-47	-47	-47	-46	-46	-47	-187	-186	-186	-186
Operating Income	135	27	11	54	144	45	19	57	223	265	313	367
Non-operating Income (expense)												
Net Interest Expense	-36	-52	-50	-42	-45	-45	-40	-38	-182	-168	-162	-157
Equity in losses	-1	0	0	0	0	1	0	-1	-1	0	0	0
Other	4	0	2	2	0	2	0	-2	8	0	0	0
Unrealized Gain on Warrants	-22	39	0	0	0	0	0	0	17	0	0	0
Minority Interest	-5	0	0	0	0	0	0	0	-5	0	0	0
Total Non-operating Income	-62	-13	-48	-40	-45	-42	-40	-41	-163	-168	-162	-157
Pre-tax Income	73	14	-37	14	99	3	-21	16	65	97	150	209
Income Taxes	-32	-10	-7	-9	-30	-10	-4	-4	-58	-48	-75	-105
Tax Rate (%)	44%	71%	-19%	64%	30%	333%	-20%	25%	89%	50%	50%	50%
Net Income before non-recurring	41	4	-44	5	69	-7	-25	12	7	49	75	105
Addback : Tax effected amortization	37	38	38	38	38	39	37	38	152	153	153	153
Normalized Net Income	78	42	-6	43	107	32	12	50	159	201	228	258
Non-recurring items												
Impairment Charges			-73	0					-73			
Restructuring charges (net)				-7					-7			
Loss on sale									0			
IPO-related cash bonus			-10						-10			
Bonus related to stock awards			-19						-19			
Management fees	-8		-1						-8			
Loss on repayment of debt			-65						-65			
Other				-29					-29			
Cumulative effect of a/c change									0			
Total non-recurring items	-8	0	-168	-35	0	0	0	0	-170			
Tax effect on non-recurring items			3						0			
Reported Net Income	36	4	-179	-30	69	-7	-25	12	-168	49	75	105
Reported Basic EPS	$0.33	$0.04	($1.41)	($0.21)	$0.49	($0.05)	($0.18)	$0.08	($1.40)	$0.34	$0.53	$0.74
Reported Diluted EPS	$0.31	$0.03	($1.41)	($0.21)	$0.46	($0.05)	($0.17)	$0.08	-$1.31	$0.32	$0.50	$0.69
Normalized Diluted EPS	$0.58	$0.34	($0.05)	$0.29	$0.71	$0.21	$0.08	$0.33	$1.23	$1.34	$1.51	$1.71
% Growth	NM	NM	NM	NM	8.0%	-37.5%	NM	13.2%	NM	8.6%	13.2%	13.0%
Shares Outstanding (Basic)	107.5	107.7	127.0	141.2	141.4	141.9	141.9	141.9	120.9	141.9	141.9	141.9
Shares Outstanding (Diluted)	115.3	123.3	127.0	150.2	150.5	150.8	150.8	150.8	129.6	150.7	151.0	151.0

Source: Company data, Credit Suisse estimates.

Figure 48: WMG Divisional Analysis

(£ in millions)

SEGMENT ANALYSIS	Q1 05A	Q2 05A	Q3 05A	Q4 05A	Q1 06A	Q2 06A	Q3 06E	Q4 06E	FY 05A	FY 06E	FY 07E	FY 08E
Revenue												
Recorded Music	840	621	583	775	820	679	612	769	2,924	2,997	3,075	3,160
Music Publishing	155	154	161	137	131	129	153	152	607	565	587	611
Intersegment Elimination	-7	-8	-7	-7	-7	-9	-8	-8	-29	-30	-29	-30
Total Revenue	1,088	767	742	905	1,044	798	758	904	3,502	3,532	3,633	3,740
Digital Revenues	25	35	44	53	69	90	85	108	157	362	579	802
% total	2.3%	4.6%	5.9%	5.9%	8.6%	11.3%	12.5%	11.6%	4.5%	10.2%	15.9%	21.4%
Cash Costs												
Recorded Music	744	543	515	672	711	594	533	690	2,476	2,518	2,555	2,594
Music Publishing	131	106	131	94	109	82	128	105	462	422	439	454
Corporate	16	23	17	20	16	14	18	26	79	75	79	81
Total Cash Costs	891	672	663	786	836	690	678	813	3,011	3,015	3,072	3,129
OIBDA (before options expense)												
Recorded Music	196	78	73	103	209	82	78	109	448	479	519	566
Music Publishing	24	48	30	43	22	47	27	47	145	143	149	157
Corporate	-23	-31	-24	-27	-23	-23	-34	-35	-102	-103	-107	-111
Total OIBDA	197	95	79	119	208	106	82	121	491	517	561	612
Options expense												
Recorded Music	2	4	5	5	3	1	3	3	17	10	10	10
Music Publishing	0	1	1	1	1	0	1	1	3	3	3	3
Corporate	0	2	2	1	2	1	2	2	5	7	7	7
Total options expense	2	7	9	7	6	2	6	6	25	20	20	20
D&A												
Recorded Music	42	42	41	40	40	41	39	40	165	160	160	155
Music Publishing	14	15	15	15	15	15	15	15	59	60	60	60
Corporate	4	4	3	3	3	3	3	3	14	12	9	10
Total Dep & Amortization	60	61	59	58	58	59	57	58	238	232	228	225
Operating Income												
Recorded Music	152	32	28	58	166	40	36	65	268	309	349	401
Music Publishing	10	32	14	27	6	32	11	31	83	80	88	96
Corporate	-27	-37	-29	-31	-28	-27	-39	-40	-121	-124	-123	-128
Total Operating Income	135	27	11	54	144	45	19	57	229	265	313	367
OIBDA Margin												
Recorded Music	20.9%	12.6%	12.4%	13.3%	22.7%	12.1%	12.8%	13.8%	15.3%	16.0%	16.9%	17.9%
Music Publishing	15.5%	31.2%	18.6%	31.4%	16.8%	36.4%	17.8%	31.0%	23.9%	25.4%	25.4%	25.7%
Total Margin	18.1%	12.4%	10.8%	13.1%	19.9%	13.3%	10.8%	13.0%	14.0%	14.6%	15.4%	16.4%
SEGMENT GROWTH ANALYSIS												
Revenue												
Recorded Music	-8.8%	4.9%	1.9%	17.1%	-2.1%	8.9%	4.0%	1.0%	2.3%	2.5%	2.6%	2.8%
Music Publishing	-2.5%	3.4%	0.0%	-2.1%	-15.5%	-18.2%	-5.0%	11.0%	-0.3%	-6.9%	4.0%	4.0%
Intersegment Elimination	-22.2%	93.3%	-41.7%	75.0%	0.0%	12.5%	-12.5%	7.5%	-8.5%	2.2%	-1.2%	3.0%
Total Revenue	-7.8%	4.4%	2.2%	13.4%	-4.0%	3.0%	2.2%	3.2%	1.9%	0.9%	2.8%	3.0%
Cash Costs												
Recorded Music	-15.5%	-4.8%	0.5%	11.8%	-4.4%	8.4%	3.5%	1.2%	-3.6%	1.7%	1.5%	1.5%
Music Publishing	-0.8%	1.9%	-1.5%	-1.1%	-18.8%	-22.6%	-4.0%	11.5%	-0.4%	-8.7%	3.9%	3.5%
Corporate	126.9%	91.7%	142.9%	122.2%	0.0%	-33.1%	3.0%	38.4%	135.5%	3.0%	4.0%	3.0%
Total Cash Costs	-12.6%	-2.2%	1.8%	11.3%	-6.2%	2.7%	2.0%	3.4%	-1.7%	0.1%	1.9%	1.8%
OIBDA												
Recorded Music	32.4%	271.4%	10.0%	71.7%	6.6%	6.1%	7.5%	6.0%	54.0%	6.9%	8.5%	8.0%
Music Publishing	-11.1%	6.7%	7.1%	-4.4%	-8.5%	-2.1%	-9.4%	9.8%	0.0%	-1.1%	4.1%	5.2%
Corporate	42.8%	72.2%	28.9%	107.7%	9.0%	-25.8%	-1.6%	30.4%	64.6%	2.8%	2.9%	3.0%
Total OIBDA	23.9%	97.9%	8.3%	29.3%	5.6%	11.6%	3.9%	1.8%	31.3%	5.3%	8.5%	9.1%
Operating Income												
Recorded Music	53.4%	NM	8.3%	205.3%	9.2%	25.0%	40.4%	14.2%	141.8%	18.1%	13.1%	14.8%
Music Publishing	58.7%	33.9%	7.7%	-15.8%	-40.0%	0.0%	-20.1%	15.5%	10.7%	-3.1%	7.0%	9.1%
Corporate	35.0%	68.2%	31.8%	63.2%	3.7%	-27.0%	-0.2%	30.0%	53.2%	2.7%	-1.0%	4.2%
Total Operating Income	70.9%	NM	-26.7%	68.8%	6.7%	56.7%	70.4%	5.8%	115.1%	15.2%	18.0%	17.3%

Source: Company data, Credit Suisse estimates.

Exhibit 49: Warner Music Recorded Music Model

YE Sept	FY03A	FY 04A	FY 05A	FY 06E	FY 07E	FY 08E
Sales (net of returns)	2,699	2,691	2,646	2,540	2,428	2,319
Digital Sales	0	28	137	316	505	700
Licencing Revenues	140	140	141	141	141	141
Total Recorded Music Sales	2,839	2,859	2,924	2,997	3,075	3,160
% change						
Sales (net of returns)		*-0.3%*	*-1.7%*	*-4.0%*	*-4%*	*-5%*
Digital Sales		*NM*	*389.3%*	*131%*	*60%*	*39%*
Licensing Revenues		*0.0%*	*0.7%*	*0%*	*0%*	*0%*
Total Recorded Music Sales		*0.7%*	*2.3%*	*2.5%*	*2.6%*	*2.8%*
% of total						
Digital as % of total music sales	*0.0%*	*1.7%*	*5.7%*	*11.0%*	*16.6%*	*22.0%*
COSTS						
Product	587	560	556	533	510	487
Royalties	638	640	658	674	692	711
A&R	243	202	148	150	154	158
Other	80	73	70	72	74	76
Cost of Goods Sold	1526	1475	1430	1430	1429	1432
Gross Profit	1,313	1,384	1,494	1,567	1,645	1,728
Distribution	95	95	70	72	74	76
Variable Marketing	430	418	356	365	374	385
Selling Overhead	110	89	87	90	94	97
Marketing Overhead	180	130	110	114	119	123
G&A Overhead	382	387	430	447	465	481
Restructuding Costs	-43	-26	-7	0	0	0
Total SG&A	1154	1093	1046	1089	1126	1162
Total Costs	2680	2568	2476	2518	2555	2594
% change		*-4.2%*	*-3.6%*	*1.7%*	*1.5%*	*1.5%*
EBITDA	159	291	448	479	519	566
% change		*82.7%*	*54.0%*	*6.9%*	*8.5%*	*9.0%*
Margin	*5.6%*	*10.2%*	*15.3%*	*16.0%*	*16.9%*	*17.9%*

Source: Company data, Credit Suisse estimates.

Exhibit 50: Warner Music—Music Publishing Model

YE Sept	FY03A	FY 04A	FY 05A	FY 06E	FY 07E	FY 08E
SALES						
Sales	563	499	552	519	514	509
Sheet Music - divested		49	35			
Digital	0	4	20	46	74	102
Total	563	552	607	565	587	611
% change						
Sales		*-11.4%*	*10.6%*	*-6.0%*	*-1.0%*	*-1.0%*
Digital		*NM*	*400.0%*	*131%*	*60%*	*39%*
Total		*-2.0%*	*10.0%*	*-6.9%*	*4.0%*	*4.0%*
Digital % total		*0.7%*	*3.3%*	*8.2%*	*12.6%*	*16.7%*
OPERATING COSTS						
Royalties	328	322	354	328	342	356
A&R	30	29	30	30	31	32
Cost of Goods Sold	358	351	384	358	374	388
Gross Profit	205	201	223	207	214	222
Margin	*36.4%*	*36.4%*	*36.7%*	*36.7%*	*36.4%*	*36.4%*
G&A Overhead	95	56	78	64	65	65
Total costs	453	407	462	422	438	454
% change		*-10.2%*	*13.5%*	*-8.7%*	*3.9%*	*3.5%*
EBITDA	110	145	145	143	149	157
% change		*31.9%*	*0.0%*	*-1.1%*	*4.1%*	*5.2%*
Margin	*19.5%*	*26.3%*	*23.9%*	*25.4%*	*25.4%*	*25.7%*

Source: Company data, Credit Suisse estimates.

Exhibit 51: Warner Music Cash Flow Estimates

YE Sept	Q1 05A	FY 05A	FY 06E	FY 07E	FY 08E
Cash flows from operating activities					
Net income (loss)	36	-169	48	75	105
Adjustments:					
Cumulative effect of a/c change					
Impairment of goodwill and other intangible assets	0	0	0	0	0
Depreciation and amortization	60	230	232	228	225
Deferred taxes	-3	0	-2	0	0
Non-cash interest expense	10	68	52	50	50
Loss on debt repayment		35	0	0	0
Net investment-related losses (gains)	0	-1	0	0	0
Equity in the losses of equity-method investees	1	1	-1	0	0
Non-cash, stock-based compensation expense	2	25	20	20	20
Unrealized gains on warrants	22	-17	0	0	0
Minority interest expense	5	5	0	0	0
Changes in operating assets and liabilities:					
Accounts receivable	-220	-58	6	-29	-20
Inventories	2	-3	3	-5	-2
Royalty advances	15	0	-29	0	0
Accounts payable and accrued liabilities	115	10	-58	38	8
Other balance sheet changes	18	70	-19	1	-6
Net cash provided by (used in) operating activities	63	205	253	379	331
Cash flows from investing activities					
Acquisition of Old WMG	0	0	0	0	0
Investments and acquisitions	-20	-78	-66	0	0
Investment in short term investments	0	0	-61	0	0
Investment proceeds	1	54	0	0	0
Capital expenditures	-6	-30	-28	-28	-28
Net cash (used in) provided by investing activities	-25	-54	-175	-28	-28
Cash flows from financing activities					
Borrowings	696	946	0	0	0
Financing costs of borrowings	-17	-20	0	0	0
Debt repayments	-3	-588	-8	0	0
Capital contributions	0	0	0	0	0
Proceeds from the issuance of common stock	1	522	0	0	0
Proceeds from the issuance of subsidiary preferred stock	0	0	0	0	0
Proceeds from the issuance of restricted shares	0	1	0	0	0
Cash paid to repurchase warrant		-138	0	0	0
Repurchase of subsidiary preferred stock	-209	-200	0	0	0
Dividends paid on subsidiary preferred stock	0	-9	0	0	0
Returns of capital and dividends paid	-764	-917	-97	-76	-76
Decrease in amounts due from TWX-affiliated companies	0	0	0	0	0
Other	0	-13	0	0	0
Net cash (used in) provided by financing activities	-296	-416	-105	-76	-76
Effect of foreign currency exchange rate changes on cash	0	-2	2	0	0
Net (decrease) increase in cash and equivalents	-249	-267	-25	275	277
Cash and equivalents at beginning of period	555	555	288	263	538
Cash and equivalents at end of period	306	288	263	538	815

Source: Company data, Credit Suisse estimates.

Exhibit 52: Warner Music Balance Sheet

YE Sept	Q1 05A	FY 05A	FY 06E	FY 07E	FY 08E
ASSETS					
Current assets:					
Cash and equivalents	300	268	263	538	815
Short term investments		0	61	61	61
Accounts receivable	821	637	632	661	680
Inventories	65	52	49	54	58
Royalty advances	204	190	196	196	196
Deferred tax assets	46	36	35	37	38
Other current assets	74	39	45	40	42
Total current assets	1,518	1242	1,282	1,588	1,889
Royalty advances	204	190	196	196	196
Investments	9	21	24	24	24
Net PPE	180	157	141	128	119
Goodwill	966	869	944	944	944
Net intangible assets subject to amortization	1,825	1,815	1,644	1,456	1,268
Intangible assets not subject to amortization	100	100	100	100	100
Other assets	121	104	107	108	111
Total assets	5,023	4,498	4,437	4,544	4,650
LIABILITIES AND STOCKHOLDERS' EQUITY					
Current liabilities:					
Accounts payable	223	247	219	257	265
Accrued royalties	1,168	1,057	1,088	1,088	1,068
Taxes and other withholdings	32	23	43	43	43
Current portion of long-term debt	12	17	17	17	17
Note payable to shareholders	0	0	0	0	0
Dividend payable	0	0	20	20	20
Other current liabilities	622	404	327	327	327
Total current liabilities	2,055	1,748	1,714	1,752	1,760
Long-term debt	2,534	2,229	2,252	2,302	2,352
Deferred tax liabilities, net	272	201	192	192	192
Other noncurrent liabilities	287	228	225	225	225
Minority interest in preferred stock of subsidiary	0	0	0	0	0
Dividends payable		5	5	5	6
Total liabilities	5,148	4,409	4,389	4,477	4,535
Shareholders' equity (deficit):					
Common Stock	0	0	0	0	0
Additional paid-in capital	93	548	568	588	608
Retained deficit	-202	-480	-549	-550	-521
Accumulated other comprehensive income, net	-16	21	29	28	28
Group equity			0		
Due from Time Warner					
Total shareholders' equity (deficit)	-125	89	47	66	115
Total liabilities and shareholders' equity	5,023	4,498	4,437	4,544	4,650

Source: Company data, Credit Suisse estimates.

Appendix 2—Music Industry Fundamentals

As highlighted earlier in the report, the music industry is structured with little overlap between recorded music and music publishing businesses. Sony BMG has left the publishing businesses with the partners; and Universal, the largest player, has a small exposure to the businesses. Historically, EMI and Warner have operated these two businesses separately, with little overlap in terms of artists. This may well have been driven by a risk reduction strategy. However, we believe the motivation in the digital environment may be to see a greater overlap in artists given the importance of rights management over several distribution platforms. EMI has talked of delays experienced in clearing digital rights for some of its recorded music artists, which cause a lag in its receipts.

Recorded Music

Approximately one-third of physical recorded music sales are generated from catalogue and two-thirds from front-line releases of both new and established artists. Less than 10% of group revenues are generated from new artists. Digital sales are the reverse of physical, with two-thirds generated by catalogue and one-third from frontline. Music companies expense the cost of new artists through A&R (artists and repertoire). Cost associated with established artists are capitalized and offset through royalties.

Recorded Music Statistics

Soundscan data are the most up-to-date source of U.S. industry sales, with both physical and digital sales published weekly. Some of the music companies have raised questions as to the accuracy of Soundscan data as they measure only a select group of retailers in the United States, and do not capture growing parts of the market, e.g., Starbucks outlets. However, we believe there is a strong indication of underlying trend from the Soundscan data. Soundscan also tracks digital downloads, although these data are freely available on single-track downloads rather than on digital albums.

Figure 53: U.S. Weekly Music Sales

Week	% ch Albums week 2004	2005 Adj	2006	% ch Albums YTD 2004	2005 Adj	2006	% ch Digital week 2004	2005	2006	% ch Digital YTD 2004	2005	2006	% ch Albums/ Digital equiv week 2004	2005	2006	% ch Albums/ Digital equiv YTD 2004	2005	2006
1	18.2%	1.0%	7.3%	102.9%	1.0%	7.3%		229.8%	146.0%		223.8%	146.0%	-14.0%	4.5%	14.0%	-14.0%	4.5%	14.0%
2	7.7%	-6.2%	-2.4%	59.7%	-2.6%	2.7%		208.3%	82.7%		218.9%	118.4%	6.7%	-2.7%	2.4%	-4.8%	0.9%	8.6%
3	3.8%	-8.4%	-0.8%	43.0%	-4.5%	1.6%		195.1%	122.0%		210.6%	118.8%	7.3%	-6.0%	5.6%	-1.1%	-1.1%	7.8%
4	10.3%	-2.3%	-4.7%	38.1%	-4.0%	-0.1%		138.0%	137.0%		190.4%	123.5%	14.7%	0.3%	1.4%	2.5%	-0.7%	6.0%
5	10.0%	-10.0%	-4.0%	35.1%	-5.4%	-0.9%		180.4%	98.1%		188.8%	118.2%	33.0%	-7.1%	0.7%	8.3%	-2.2%	4.8%
6	10.7%	-24.5%	-7.4%	37.3%	-10.0%	-2.2%		167.2%	92.1%		184.3%	113.5%	52.2%	-22.2%	-3.2%	16.3%	-7.0%	3.2%
7	24.6%	1.2%	-2.9%	29.4%	-8.3%	-2.3%		193.9%	88.5%		188.5%	108.5%	-7.8%	4.4%	1.2%	11.5%	-5.7%	2.9%
8	8.2%	-5.9%	-0.9%	25.9%	-8.0%	-2.1%		193.7%	92.9%		187.5%	107.2%	4.2%	-2.6%	3.8%	10.5%	-5.0%	3.0%
9	-2.2%	4.4%	-9.4%	22.2%	-8.7%	-3.0%		206.0%	70.9%		189.0%	102.8%	-2.9%	7.8%	-5.8%	9.2%	-3.8%	2.0%
10	-0.3%	-4.4%	-0.6%	19.5%	-8.5%	-2.8%		211.3%	74.9%		191.9%	98.7%	-1.3%	-0.6%	3.5%	8.2%	-3.3%	2.1%
11	1.1%	-2.7%	-4.5%	17.8%	-8.1%	-2.9%		196.3%	65.7%		192.3%	96.3%	2.2%	1.0%	-0.3%	7.6%	-2.9%	1.9%
12	13.0%	-3.6%	-13.3%	18.6%	-5.9%	-3.9%		197.9%	66.7%		192.8%	93.5%	30.6%	-0.3%	-8.3%	9.3%	-2.7%	0.9%
13	11.2%	-17.4%	4.1%	17.9%	-8.6%	-3.3%		235.3%	45.4%		193.3%	88.0%	11.4%	-13.2%	6.7%	9.5%	-3.5%	1.3%
14	18.4%	-23.5%	15.1%	18.3%	-8.4%	-2.1%		213.7%	61.1%		187.6%	88.9%	28.2%	-22.9%	18.0%	10.8%	-5.0%	2.4%
15	20.8%	-5.0%	20.0%	16.8%	-8.2%	-0.8%		233.7%	52.3%		200.0%	84.3%	-3.4%	-0.5%	22.0%	9.7%	-4.8%	3.6%
16	-21.5%	-3.9%	-10.5%	14.1%	-7.9%	-1.4%		218.8%	58.3%		201.2%	83.1%	-17.8%	0.3%	-5.9%	7.7%	-4.5%	3.0%
17	-1.5%	-4.5%	-10.0%	13.5%	-7.7%	-1.9%		158.5%	73.1%		193.2%	82.8%	4.7%	-1.1%	-5.8%	7.5%	-4.3%	2.6%
18	11.6%	-5.6%	-8.5%	13.7%	-7.8%	-2.3%		195.7%	66.3%		190.5%	81.1%	20.9%	-2.0%	-5.9%	8.2%	-4.2%	2.0%
19	7.1%	-1.0%	7.9%	12.7%	-7.3%	-1.8%		210.7%	46.2%		193.5%	78.1%	-4.1%	3.2%	10.2%	7.5%	-3.8%	2.4%
20	7.3%	0.7%	-13.3%	12.8%	-7.0%	-2.4%		188.8%	61.5%		189.0%	78.1%	12.5%	4.7%	-8.0%	7.8%	-3.5%	1.9%
21	1.5%	-7.3%		12.5%	-7.0%			173.0%			187.5%		13.0%	-3.6%		8.0%	-3.5%	
22	11.2%	-6.5%		12.2%	-7.0%			160.0%			185.7%		8.6%	-3.1%		8.0%	-3.4%	
23	5.4%	1.7%		11.9%	-6.8%			191.1%			183.5%		5.5%	5.4%		7.9%	-3.1%	
24	-14.8%	-5.2%		11.2%	-6.5%			144.7%			182.9%		0.9%	-2.2%		7.6%	-3.0%	
25	18.6%	-8.7%		11.3%	-6.6%			133.2%			183.0%		7.5%	-5.5%		7.8%	-3.1%	
26	6.4%	-8.5%		11.1%	-6.7%			154.0%			188.2%		16.9%	-6.0%		7.9%	-3.3%	
27	12.4%	-5.3%		10.8%	-6.7%		797.4%	142.2%			188.1%		6.3%	-1.8%		7.9%	-3.2%	
28	10.9%	-8.7%		11.0%	-6.8%		810.1%	134.1%			183.8%		16.0%	-6.4%		8.1%	-3.3%	
29	6.8%	-11.4%		10.9%	-6.9%		772.5%	136.8%			181.5%		9.9%	-8.1%		8.2%	-3.5%	
30	6.1%	-15.2%		10.8%	-7.2%		855.7%	115.4%			178.9%		15.2%	-12.2%		8.4%	-3.8%	
31	15.2%	-7.7%		10.8%	-7.2%		785.5%	147.5%			177.7%		8.9%	-4.0%		8.5%	-3.8%	
32	8.5%	-11.2%		10.8%	-7.4%		691.4%	156.4%			175.9%		11.0%	-7.5%		8.5%	-3.9%	
33	7.2%	-5.9%		10.5%	-7.3%		800.0%	127.9%			175.0%		4.1%	-2.1%		8.4%	-3.9%	
34	-2.3%	-19.5%		10.4%	-7.7%		1032.3%	87.8%			171.9%		10.6%	-16.9%		8.5%	-4.3%	
35	9.2%	-7.7%		10.2%	-7.7%		824.0%	131.9%			170.4%		5.6%	-4.0%		8.4%	-4.2%	
36	12.4%	-7.7%		10.0%	-7.7%		658.7%	111.0%			168.2%		4.3%	-4.3%		8.3%	-4.2%	
37	0.5%	-3.0%		9.8%	-7.6%		610.2%	111.8%			166.1%		5.2%	-1.6%		8.2%	-4.2%	
38	-3.2%	-4.1%		9.4%	-7.5%		552.2%	142.4%			165.4%		-3.2%	-0.2%		7.9%	-4.1%	
39	-17.7%	-4.5%		8.7%	-8.8%		490.8%	144.9%			164.6%		-11.6%	-0.7%		7.3%	-4.0%	
40	-7.5%	-0.4%		8.4%	-8.7%		530.3%	140.0%			164.0%		-3.7%	3.3%		7.0%	-3.8%	
41	-8.1%	-2.5%		7.9%	-8.6%		581.0%	113.5%			162.5%		-6.2%	0.7%		6.7%	-3.7%	
42	-12.6%	0.8%		7.4%	-7.8%		666.5%	114.9%			161.0%		-8.5%	4.1%		6.3%	-3.6%	
43	-6.0%	-8.7%		7.0%	-7.1%		368.9%	112.5%			159.5%		-5.9%	-5.1%		6.0%	-3.5%	
44	-5.3%	-0.1%		6.8%	-6.5%		262.0%	105.1%			157.5%		0.9%	2.8%		5.9%	-3.4%	
45	-23.8%	-18.7%		6.7%	-7.1%		305.0%	140.0%			157.4%		2.2%	-10.0%		5.8%	-3.6%	
46	-7.8%	-14.1%		6.5%	-7.3%		248.9%	107.1%			155.9%		3.3%	-11.4%		5.7%	-3.8%	
47	-8.1%	-12.7%		5.8%	-7.5%		211.4%	114.7%			154.6%		18.6%	-10.4%		6.1%	-4.1%	
48	-5.1%	-12.9%		5.1%	-7.7%		131.7%	108.0%			153.2%		-12.1%	-10.8%		5.4%	-4.3%	
49	-5.3%	-11.9%		6.4%	-7.8%		203.5%	92.7%			151.3%		17.0%	-10.1%		5.8%	-4.5%	
50	-15.7%	-11.0%		6.7%	-8.0%		198.2%	111.8%			150.2%		14.8%	-9.4%		6.2%	-4.7%	
51	-13.4%	1.8%		6.5%	-7.5%		233.1%	83.5%			147.8%		2.9%	3.0%		6.0%	-4.3%	
52	4.5%	5.2%		3.8%	-7.2%		283.4%	137.5%		392.3%	150.3%		-47.2%	12.9%		3.5%	-3.9%	

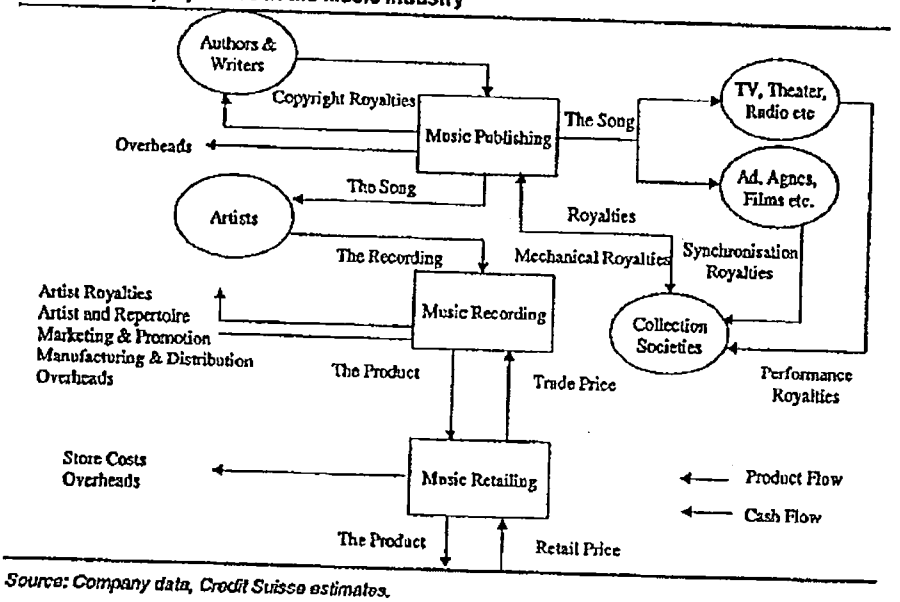
Source: Soundscan

Music Publishing

Music publishing is a poorly understood business, in our view. It refers to the exploitation of the commercial ownership of a song. Owners of publishing rights are entitled to royalties whenever music is sold (e.g., CD, tape, vinyl, and digital), played in public or on the air, or when a song is used in a film or a commercial. There are three types of owners of publishing rights: (1) the author of the lyrics; (2) the composer, who wrote the music; and (3) the publisher, who owns the rights to exploit the song (just like a book publisher).

In Figure 36, we set out the various flows of royalties within the music industry.

Figure 54: Royalty Flows in the Music Industry



Source: Company data, Credit Suisse estimates.

There are three main royalty streams.

1. *Mechanical.* These royalties are collected whenever a CD or other music format is sold. In the UK, mechanical royalties are 8.5% of the PPD (published price per dealer or wholesale price). In Europe, mechanical royalties are typically 9.1%, and in the United States they are 6.95 cents per track up to five minutes, based on the retail price. Usually 50% of mechanical royalties go to the publisher, 25% to the author, and 25% to the composer.
2. *Performance.* These are collected when a song is played on air, typically split evenly between publisher, author and composer.
3. *Synchronization.* These are royalties received for music in advertisements, films, games, etc.

The songwriters may sign publishing deals with publishing companies for financial advances (e.g., for up-and-coming songwriters) or expertise (e.g., contacts, session

artists, and studio facilities, etc.). The publisher may also assist in marketing the song to record companies and other media (e.g., advertising agencies) and may collect the royalties through the respective collecting societies (PRS/MCPS in the UK) on behalf of the songwriter. Alternatively, songwriters may want to retain their publishing rights and collect direct from the collecting society—or retain the rights to sell later for money if confident of the eventual success of the song.

Copyright duration—not an issue, even for recorded music copyrights

There has been some concern among investors that valuable music publishing rights will expire imminently. In fact, they last for 70 years after the death of the last remaining author. A more relevant concern is the finite duration of the copyright for music recording rights. These rights relate to the commercial ownership of a recording, e.g., The Beatles' *Love Me Do*, which belongs to EMI. Recorded music copyrights last for 95 years from the date of first release in the United States (having been recently extended after extensive lobbying by Disney), although just for 50 years in Europe.

Once the copyright expires, anyone can produce a CD with that particular song-although they would still have pay publishing royalties. So in theory copyrights of major recordings produced in the early 1960s will expire sometime after 2010. For EMI, this would include some of The Beatles' songs, which were so lucrative (e.g., the number 1 double album released a few years ago). In fact, we believe there are several mitigating factors.

1. EMI's management is hopeful that it can persuade the European Union to extend the copyright period to that of the United States, for consistency and in sympathy with the value of intellectual property rights.
2. EMI would most likely try to ensure these recordings were fully exploited just before expiry of copyright.
3. Not all the tracks for one artist (e.g., The Beatles) would expire together, limiting the ability to produce a comprehensive collection of songs.

Companies Mentioned *(Price as of 16 Jun 06)*

Apple Computer Inc. (AAPL, $57.56, OUTPERFORM, TP $90.00, MARKET WEIGHT)
EMI Group plc (EMI.L, 271.00 p, OUTPERFORM, TP 300.00 p, OVERWEIGHT)
Napster, Inc. (NAPS, $3.08)
Sony (6758, ¥4,940, OUTPERFORM, TP ¥7,500, MARKET WEIGHT)
Time Warner, Inc (TWX, $16.96, OUTPERFORM, TP $22.00, OVERWEIGHT)
Vivendi (VIV.PA, Eu26.95, NEUTRAL, TP Eu24.00, OVERWEIGHT)
Wal-Mart Stores, Inc. (WMT, $48.31, OUTPERFORM, TP $55.00, MARKET WEIGHT)
Walt Disney Company (DIS, $29.45, OUTPERFORM, TP $41.00, OVERWEIGHT)
Warner Music Group (WMG, $27.15, OUTPERFORM, TP $30.00, OVERWEIGHT)
Yahoo Inc. (YHOO, $30.36, OUTPERFORM, TP $45.00, OVERWEIGHT)

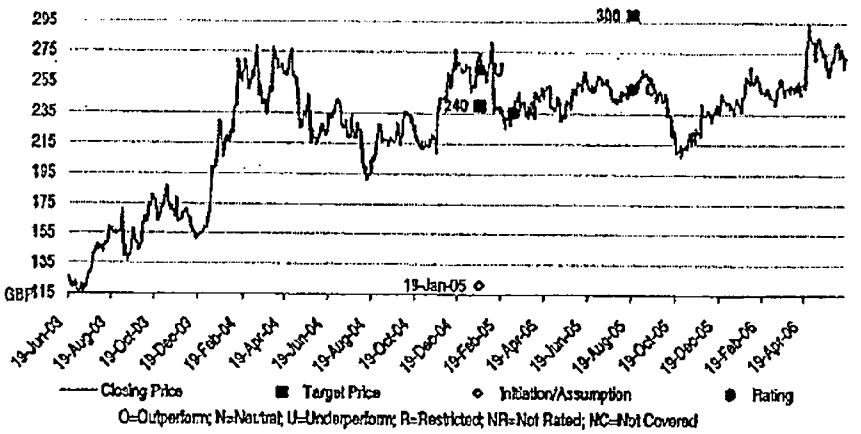
Disclosure Appendix

Important Global Disclosures

William B. Drewry, Jolanta Masojada, Nick Bertoloti & Giasone Salati each certify, with respect to the companies or securities that he or she analyzes, that (1) the views expressed in this report accurately reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

See the Companies Mentioned section for full company names.

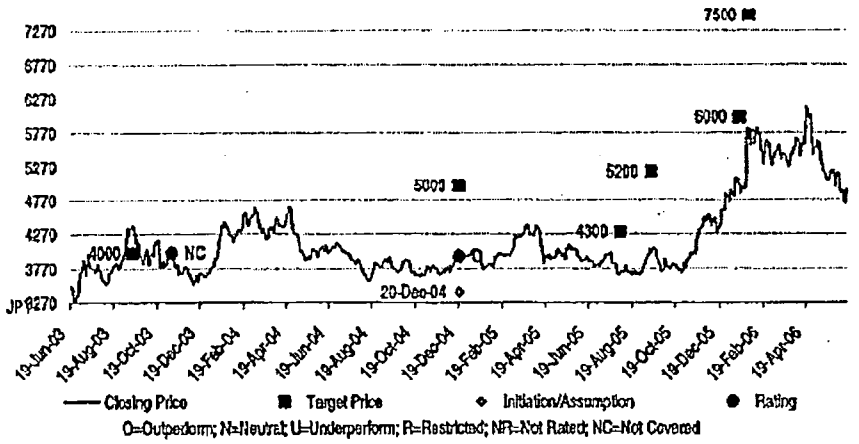
3-Year Price, Target Price and Rating Change History Chart for EMI.L



O=Outperform; N=Neutral; U=Underperform; R=Restricted; NR=Not Rated; NC=Not Covered

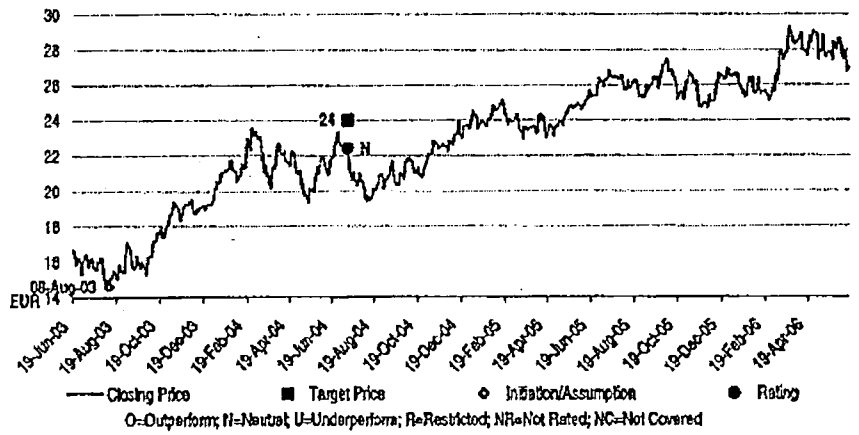
EMI.L Date	Closing Price Price (p)	Target Price Price (p)	Rating	Initiation/ Assumption
19-Jan-05	263.5	240	UNDERPERFORM	X
7-Mar-05	235.25		NEUTRAL	
18-Aug-05	251.5	300	OUTPERFORM	

3-Year Price, Target Price and Rating Change History Chart for 6758



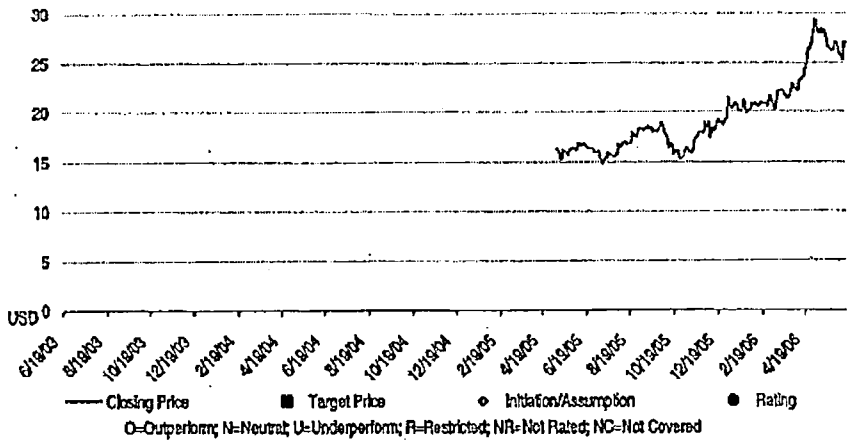
6758 Date	Closing Price Price (JPY)	Target Price Price (JPY)	Rating	Initiation/ Assumption
16-Sep-03	4360	4000		
10-Nov-03	4000		NOT COVERED	
20-Dec-04	3950	5000	OUTPERFORM	X
3-Aug-05	3750	4300		
15-Sep-05	4010	5200		
17-Jan-06	4910	6000		
31-Jan-06	5700	7500		

3-Year Price, Target Price and Rating Change History Chart for VIV.PA



VIV.PA Date	Closing Price Price (EUR)	Target Price Price (EUR)	Rating	Initiation/ Assumption
8-Aug-03	0		NOT COVERED	X
12-Jul-04	22.38	24	NEUTRAL	

3-Year Price, Target Price and Rating Change History Chart for WMG



WMG	Closing Price	Target Price	Initiation/

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Outperform: The stock's total return is expected to exceed the industry average* by at least 10-15% (or more, depending on perceived risk) over the next 12 months.

Neutral: The stock's total return is expected to be in line with the industry average* (range of ±10%) over the next 12 months.

Underperform:** The stock's total return is expected to underperform the industry average* by 10-15% or more over the next 12 months.

**The industry average refers to the average total return of the analyst's industry coverage universe (except with respect to Asia/Pacific, Latin America and Emerging Markets, where stock ratings are relative to the relevant country index, and Credit Suisse Small and Mid-Cap Advisor stocks, where stock ratings are relative to the regional Credit Suisse Small and Mid-Cap Advisor investment universe.*

***In an effort to achieve a more balanced distribution of stock ratings, the Firm has requested that analysts maintain at least 15% of their rated coverage universe as Underperform. This guideline is subject to change depending on several factors, including general market conditions.*

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Overweight: Industry expected to outperform the relevant broad market benchmark over the next 12 months.

Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

Underweight: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

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***An analyst's coverage universe consists of all companies covered by the analyst within the relevant sector.*

****The broad market benchmark is based on the expected return of the local market index (e.g., the S&P 500 in the U.S.) over the next 12 months.*

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Neutral/Hold*	42%	(55% banking clients)
Underperform/Sell*	15%	(49% banking clients)
Restricted	3%	

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Price Target: (12 months) for (EMI.L)

Method: Our 310p target price for EMI is based on a discounted cash flow valuation analysis, supported by an analysis of merger economics from a potential takeover or merger with WMG. Our merger analysis is based on a $30 offer price (a 5% premium to EMI's previous offer) and assumes cost savings of £125m per annum. Our discounted cash flow analysis uses a weighted average cost of capital of 9.1%, a terminal growth rate of 2.5%, net debt of £860m and 874m shares outstanding (including 78m convertible shares).

Risks: Risks to our 310p target price for EMI include: (1) an EMI/WMG merger not materialising; (2) the music industry economics are still in the process of evolving and downside risks exist if digital revenues fall below expectations or if physical sales decline more than we have forecast; and (3) the balance of power within the music industry possibly shifting more towards the artists and the retailers (both physical and digital).

Price Target: (12 months) for (6758)

Method: Our Y7,500 target price for Sony is based on a sum-of-the-parts valuation of the major divisions: (1) the electronics business is valued at 8x estimated FY3/07 EBITDA of Y429bn, adding back restructuring charges of Y64bn; (2) the game business at 12x the 5-year average EBITDA of FY3/06-10 of Y77bn; and (3) the pictures business at 10x estimated FY03/07 EBITDA of Y60bn. We value the finance business at 1.5x book value of Y584bn. Our analysis assumes net cash of Y104bn and 998mn shares outstanding.

Risks: Risks to our Y7,500 target price for Sony are: (1) earnings at the electronics business, which is the biggest single earnings and valuation contributor; (2) lower-than-expected demand or lower-than-expected pricing for television products; (3) launches at related PS3 businesses; and (4) foreign exchange fluctuations.

Price Target: (12 months) for (VIV.PA)

Method: Our eu 24 target price for Vivendi is based on a sum-of-the-parts valuation on which we apply a 15% holding discount. The main copmponents of our SOTP are: i) 56% stake in SFR valued at16.9x FCF 06E, or eu16bn; ii) UMG valued on 7.7x EBITDA 06E, or 6.6bn; iii) 20% stake in NBC-U valued at 8.9x EBITDA 06E or 5.8bn; iv) 51% of Maroc Telecom valued at market price, or eu5.4bn; v) Canal+ Group at 9x EBITDA, or 2.5bn for Vivendi stake. We also value the Global Tax System at eu1.6bn (NPV of cash flows from 2007 onwards, consistent with net debt of eu3.9bn at the end of 2006.

Risks: Risks to our eu24 target price for Vivendi are: (1) regulatory approval for the Canal+/TPS proposed merger and related restructuring plan; (2) European mobile telephony regulation; (3) impact of potential acquisitions on our holding discount; and (4) foreign exchange fluctuations.

Price Target: (12 months) for (WMG)

Method: Our target price of $30 for WMG is based on a discounted cash flow valuation analysis supported by an analysis of merger economics from a potential takeover from EMI. Our merger analysis is based on a

$30 share price, a 5% premium to EMI's previous offer. Our discounted cash flow analysis uses a weighted average cost of capital of 9.6%, terminal growth rate of 2.5%, net debt of $1.9bn and 150.7m shares outstanding.

Risks: Risks to our target price of $30 for WMG revolve around a further offer from EMI not being forthcoming. In addition, music industry economics are still in the process of evolving and downside risks exist if digital revenues are below expectations or if physical sales decline more than forecast

See the Companies Mentioned section for full company names.

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As of the end of the preceding month, Credit Suisse beneficially owned 1% or more of a class of common equity securities of (EMI.L, VIV.PA). This holding is calculated according to U.S. regulatory requirements which are based on Section 13(d) of the Securities and Exchange Act of 1934.

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The analyst(s) involved in the preparation of this report have not visited the material operations of the subject company (EMI.L, 6758, VIV.PA, WMG) within the past 12 months.

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EXHIBIT CO 0957

Company Bulletin

North America United States
TMT Entertainment

22 September 2006

Deutsche Bank

Warner Music Group

Reuters: WMG.N Bloomberg: WMG UN Exchange: NYS Ticker: WMG

Resuming Coverage with Buy Rating

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Resuming Coverage

We are resuming our coverage of Warner Music with a Buy rating and only minor changes to our forecasts (including F3Q06 results). TP now $28 (was $26 before suspension of coverage).

Investment Thesis

The music sector, and Warner in particular, is benefiting from a dramatic increase in distribution brought about by broadband internet and wireless, globally. We say Warner in particular as they are leading the sector in redefining their product; producing, packaging and marketing music "content" in innovative ways that have led to significant market share leads over their peers. This is a reflection of its very strong senior management team, the best by far in music in our view. Wireless music could become a dramatic growth driver for the sector by 2008 and another round of improved wireless devices this holiday season should spark investor interest in this theme. 2007/08 should benefit from a sharp rise in licensee fees from Satellite Radio. Concerns regarding slowing digital growth should be mollified as the seasonally strong holiday period drives a pick-up in sales and WMG begins to participate in ad-revenue (streaming videos on YouTube). Lastly, there remains some potential for achieving synergies in an EMI deal if the European courts approve the Sony/BMG tie-up upon review (especially given Sony's mkt shr losses, and changes brought on by digital).

Valuation

WMG is trading in line with the entertainment group at 9.4x CY07E EBITDA and 16.4x P/FCF. Our 12-Month DCF-based target is $28/share, 16% upside (10% cost of equity on 64% of capital, 5% cost of debt on 36% of capital, 2% terminal growth below 4% sector rate due to sector growth uncertainty).

Risks

Choppy transition to digital, shifts in release slate, tough Dec qtr comps (which might not be fully reflected in Street estimates), popularity of its releases, potential for dilutive acquisitions and minority shareholder position (including potential for insider selling).

Year End Sep 30	2005A	2006E	2007E
1Q EPS*	0.31	0.46A	-
2Q EPS	0.03	-0.05A	-
3Q EPS	-1.41	-0.10A	-
4Q EPS	-0.21	-0.03	-
FY EPS (USD)	-1.33	0.29	0.36

Source: Deutsche Bank estimates, company data

*Includes the impact of FAS123R requiring the expensing of stock options.

Resuming Coverage

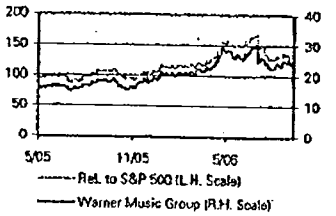
Buy

Price at 21 Sep 2006 (USD)	24.29
Price target	28.00
52-week range	30.88 - 15.25

Key changes

Rating	No Recommendation to Buy ↑	
Price target	0.00 to 28.00 ↑	-
EPS (USD)	0.03 to 0.29 ↑	791.7%
Revenue (USDm)	3,461.9 to 3,559.9 ↑	2.8%

Price/Rel. Relative



Performance (%)	1m	3m	12m
Absolute	0.1	-9.4	35.2
S&P 500	1.6	5.3	8.9

Stock data

Market Cap (USDm)	3,472.0
Shares outstanding (m)	142.9
Free float (%)	100
Volume	184,700
S&P 500	1,318.03

Key indicators

ROE (%)	65.1
ROA (%)	3.2
Net debt/equity (%)	-
Book value/share (USD)	0.38
Price/book (x)	63.3
Net interest cover (x)	1.5
EBIT margin (%)	7.5

Deutsche Bank Securities Inc.

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DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1

Figure 1: Cable, Entertainment and Satellite Company Comparisons (US$mm, except per share data)

9/21/2006	Entertainment Companies								Total/ Avg	Cable & Satellite Companies						Total/ Avg
	CBS	Discovery Hldgs (1)	Liberty Capital	News Corp.	Time Warner	Viacom	Walt Disney	Warner Music		Comcast	Charter	Cable-vision	Media com	DirecTV	EchoStar	
DBSI Rating	Buy	Hold	Hold	Buy	Buy	Buy	Buy	Buy	–	Buy	NR	Buy	NR	Hold	Buy	–
Ticker	CBS	DISCA/B	LCAPA/B	NWS	TWX	VIA.B	DIS	WMG	–	CMCSA	CHTR	CVC	NCCO	DTV	DISH	–
PRO FORMA ENTERPRISE VALUE (EV)																
Stock Price	$28.25	$14.00	$62.33	$19.08	$17.49	$37.00	$30.71	$24.28	–	$35.20	$1.50	$22.99	$7.09	$18.91	$31.81	–
Diluted Shs	769	285	149	3257	4488	718	2216	153	–	2100	307	297	117	1210	450	–
Eq Mkt Cap	21,733	4,017	11,620	63,227	78,487	26,475	68,053	3,715	277,307	73,907	461	6,826	829	22,890	14,218	119,132
% of group	7.8%	1.4%		22.8%	28.3%	9.5%	24.5%	1.3%		62.0%	0.4%	5.7%	0.7%	19.2%	11.9%	
PF Net Debt	4,796	3,005	2,914	5,844	33,050	7,939	6,472	1,916	65,917	23,150	20,666	11,972	2,782	1,529	4,230	63,730
Subtotal	26,509	7,027	14,534	69,071	111,518	34,314	74,525	5,631	337,306	97,057	21,127	18,199	3,611	24,419	18,448	182,862
Hidden Value	-1,542	-2,979	14,211	17,187	-581	369	4,993	367	32,013	17,158	0	5,056	0	3,350	529	26,094
PF EV 12/31/06	28,051	10,001	370	51,884	112,099	33,926	69,553	5,264	310,911	79,900	21,127	13,142	3,611	21,069	17,918	156,768
CY06E FCF	613	87	-34	1,352	1,561	1,009	815	60	5,468	1,172	-435	260	19	11	292	1,285
CY/E '06 EV	27,438	9,909	357	50,332	110,538	32,917	68,748	5,204	305,443	78,728	21,668	12,883	3,592	21,058	17,656	155,469
CY07E FCF	1,251	164	-81	2,612	4,161	1,614	3,589	230	13,639	3,932	-775	521	74	1,010	658	5,420
CY/E '07 EV	26,087	9,745	418	47,720	108,377	31,903	65,178	4,974	291,604	74,796	22,340	12,362	3,518	20,048	18,088	150,062
	All Operating Estimates except group totals are presented on a Fiscal Year basis															
Fiscal Year	Dec	Dec	Dec	Jun	Dec	Dec	Sep	Sep	–	Dec	Dec	Dec	Dec	Dec	Dec	–
Pro Forma Net Revenues									CY							
2007E	$15,174	$3,297	$1,642	$27,538	$47,643	$11,606	$35,309	$3,654	$151,822	$25,982	$8,061	$4,368	$1,281	$14,826	$9,600	$62,198
2006E	14,546	2,966	$1,550	25,327	46,915	10,908	34,215	3,560	144,507	23,565	5,810	4,059	1,202	13,640	9,109	57,180
2005E	14,117	2,672	$1,459	23,858	45,911	9,610	31,944	3,502	135,882	21,260	5,260	3,451	1,009	12,216	7,055	51,241
07/06 % Chg	4.3%	11.2%	5.9%	8.7%	1.6%	6.4%	3.2%	2.6%	5.1%	10.3%	8.0%	8.1%	6.5%	8.7%	6.0%	8.8%
06/05 % Chg	3.0%	11.0%	6.2%	6.2%	2.2%	13.5%	7.1%	1.7%	6.3%	10.8%	6.7%	17.6%	9.4%	11.7%	14.5%	11.6%
05/04 % Chg	-3.0%	13.0%	7.0%	14.7%	2.2%	18.2%	4.0%	5.9%	6.2%	10.0%	8.3%	18.0%	3.9%	25.1%	19.1%	14.6%
04/03 % Chg	7.3%	–	8.3%	19.9%	13.5%	11.3%	13.5%	-1.8%	12.0%	19.5%	2.7%	13.3%	5.7%	23.9%	23.4%	14.7%
Pro Forma Opex (Revenue less EBITDA)																
07/06 % Chg	4.5%	9.7%	4.2%	6.5%	-3.0%	3.9%	2.0%	2.6%	4.0%	5.8%	5.8%	5.5%	6.3%	3.4%	6.5%	5.3%
06/05 % Chg	3.5%	15.0%	5.9%	5.1%	0.6%	14.3%	3.5%	0.7%	4.9%	8.3%	7.1%	17.8%	8.2%	0.3%	10.1%	7.0%
05/04 % Chg	-23.9%	16.6%	16.4%	13.1%	-0.2%	20.0%	2.4%	2.7%	1.9%	9.5%	8.8%	20.4%	7.8%	19.7%	10.1%	12.3%
04/03 % Chg	7.3%	–	–	20.5%	13.0%	9.8%	11.1%	-3.4%	11.7%	9.3%	4.9%	16.1%	7.4%	38.5%	27.2%	17.5%
Pro Forma EBITDA																
2007E	$3,293	$779	$219	$6,626	$13,000	$3,420	$7,323	$519	$35,216	$10,974	$2,290	$1,691	$478	$3,719	$2,687	$21,739
2006E	3,087	654	$186	4,748	11,915	3,181	6,773	500	33,314	9,375	2,047	1,601	452	2,854	2,477	18,745
2005E	3,053	687	$171	4,281	11,173	2,882	6,446	453	29,845	8,282	1,933	1,280	405	1,500	1,930	15,331
07/06 % Chg	3.8%	19.2%	18.3%	18.5%	9.1%	7.5%	8.1%	2.6%	8.7%	17.0%	11.9%	12.4%	5.9%	29.5%	4.4%	16.0%
06/05 % Chg	1.1%	-3.3%	8.4%	10.9%	6.6%	10.4%	24.4%	8.2%	11.6%	13.2%	5.9%	17.3%	11.4%	92.9%	28.3%	22.3%
05/04 % Chg	NM	3.6%	-33.5%	22.4%	10.6%	14.0%	12.3%	27.8%	23.0%	19.9%	1.0%	13.0%	-2.0%	137.3%	59.9%	29.3%
04/03 % Chg	NM	39.3%	–	17.3%	18.3%	14.8%	29.0%	15.4%	18.0%	17.7%	-0.7%	13.5%	2.0%	-29.9%	8.8%	8.4%
Pro Forma EBITDA Margin																
2007E	21.1%	23.4%	13.4%	20.4%	27.3%	29.5%	20.7%	14.1%	23.3%	42.2%	28.8%	38.6%	37.3%	25.1%	26.8%	34.9%
2006E	21.2%	22.4%	12.0%	18.7%	25.4%	29.2%	19.8%	14.1%	23.1%	39.8%	35.5%	37.0%	37.6%	21.3%	27.2%	32.8%
2005E	21.6%	25.7%	11.7%	17.9%	24.3%	30.0%	17.0%	13.2%	22.0%	39.0%	36.7%	37.1%	36.9%	12.3%	24.3%	29.9%
Earnings Per Share (net income ex. unusual items / fully diluted shs out)									EY							
2007E	$ 1.78	$ 0.21	$ (0.03)	$ 1.08	$ 1.00	$ 2.25	$ 1.88	$ 0.36	–	$1.41	NM Z	-$0.41	NM Z	$1.26	$1.32	–
2006E	1.66	0.21	1.66	0.84	0.86	1.96	1.66	0.34	–	$0.61		($0.34)		$0.99	$1.44	–
2005E	1.62	0.12	($2.61)	0.69	0.79	1.71	1.18	($0.10)	–	$0.43	($4.10)	($0.42)	($1.69)	$0.24	$3.20	–
07/06 % Chg	7.3%	8.5%	-102.1%	28.6%	16.2%	13.3%	6.4%	6.5%	12.5%	72.9%	NM	NM	NM	27.5%	-8.2%	30.9%
06/05 % Chg	2.6%	76.0%	-163.8%	21.1%	9.5%	14.6%	41.1%	NM	28.8%	87.3%	NM	NM	NM	NM	-55.2%	15.0%
05/04 % Chg	NM	-58.0%	316.1%	28.1%	12.0%	18.6%	240%	NM	7.5%	0.6%	NM	NM	NM	NM	NM	0.8%
04/03 % Chg	NM	NM	NM	-34.2%	46.2%	NM	33.1%	NM	17.0%	-70.1%	NM	NM	NM	NM	-0.1%	-35.2%
Cash Free Cash Flow (CFO - capex + affiliates)																
2007E	$1,351	$184	-$61	$2,178	$4,161	$1,614	$3,427	$240	$13,072	$3,932	-$775	$521	$74	$1,010	$658	$5,420
2006E	1,249	226	$178	2,291	3,500	1,515	3,322	142	12,413	2,500	-773	154	22	577	801	3,282
2005E	1,547	-31	$276	2,470	4,328	1,454	2,445	241	12,731	1,293	-1,043	157	-49	284	466	1,109
07/06 % Chg	8.2%	-27.5%	NM	-4.5%	18.9%	6.5%	3.1%	69.1%	5.3%	57.3%	NM	NM	NM	74.9%	-17.9%	65.2%
06/05 % Chg	-19.3%	-893.0%	-35.5%	-7.7%	-19.1%	4.2%	35.8%	-41.0%	-2.5%	93.3%	NM	-1.7%	NM	103.7%	71.1%	195.9%
05/04 % Chg	NM	-184.2%	NM	21.4%	NM	-9.2%	193.8%	NM	69.6%	21.5%	NM	NM	NM	NM	NM	-901.2%
04/03 % Chg	NM	NM	NM	-629.0%	-0.6%	NM	NM	–	60.3%	NM	NM	NM	NM	NM	-61.8%	-90.6%
Cash Free Cash Flow Per Share (CFO - capex + affiliates / fully diluted shs out)																
2007E	$1.76	NM	$ (0.44)	$0.69	$1.14	$ 2.32	$ 1.69	$ 1.57	–	$1.96	($2.52)	$1.75	$0.63	$0.83	$1.46	–
2006E	1.62	NM	$ 1.27	0.71	1.02	2.09	1.61	0.98	–	1.19	(2.51)	0.52	0.19	0.48	1.78	–
2005E	1.95	NM	$ 1.97	0.80	0.92	1.93	1.17	1.68	–	0.60	(3.40)	0.53	(0.42)	0.20	0.97	–
07/06 % Chg	8.2%	NM	104	-2.6%	11.4%	11.2%	4.9%	63.2%	16.0%	64.6%	NM	NM	NM	74.9%	-18.0%	-40.5%
06/05 % Chg	-16.9%	NM	-35.7%	-11.9%	10.9%	8.3%	37.3%	-43.4%	-3.4%	99.8%	NM	-2.2%	NM	137.5%	84.2%	79.6%
05/04 % Chg	NM	NM	NM	10.3%	39.1%	5.3%	-18.2%	NM	7.8%	26.9%	NM	NM	NM	NM	NM	25.6%
04/03 % Chg	7.2%	NM	NM	NM	-1.0%	NM	71.3%	NM	25.9%	NM	NM	NM	NM	NM	-91.4%	-91.6%

(1) Discovery Holdings valuation is presented as the valuation for 100% of Discovery Communications as it stand we sold for $500m and the remaining 60% of Discovery were purchased at the current implied public valuation, with the exception of EPS and P/E.
Source: Deutsche Bank Securities Inc. estimates; Company Reports.

Figure 2: Cable, Entertainment and Satellite Company Valuations (US$, sub data in 000s except per sub data)

9/21/2006	Entertainment Companies								Total/ Avg	Cable & Satellite Companies						Total/ Avg
	CBS	Discovery Hldgs (1)	Liberty Cap	News Corp.	Time Warner	Viacom	Walt Disney	Warner Music		Comcast	Charter	Cable-vision	Media com	DirecTV	EchoStar	
Rating	Buy	Hold	Hold	Buy	Buy	Buy	Buy	Buy	–	Buy	NR	Buy	NR	Hold	Buy	–
Ticker	CBS	DISCA/B	LCAPA/B	NWS	TWX	VIA.b	DIS	WMG	–	CMCSA	CHTR	CVC	MCCC	DTV	DISH	–
Sh Price	$28.25	$14.00	$82.33	$19.68	$17.49	$37.09	$38.79	$24.29	–	$35.28	$3.50	$22.99	$7.09	$19.91	$31.61	–
All Valuation Comparisons are based on Calendar Year periods																
Enterprise Value/EBITDA (pro forma and based on period end EV)																
2007E	8.1	12.6	1.9	8.3	8.2	9.2	9.0	8.4	8.1	7.0	No Estimate	7.4	No Estimate	5.5	6.5	6.9
2006E	8.9	14.9	1.9	9.7	9.3	10.3	10.7	10.7	9.2	8.4		8.8		7.3	7.4	8.3
2005E	9.2	14.0	1.9	11.4	10.0	11.8	13.7	11.1	10.4	9.0		10.2		15.6	10.7	10.2
FY06-FY08E CAGR	3.8%	7.2%	14.2%	11.8%	11.8%	8.6%	10.8%	6.4%	9.3%	13.3%		12.9%		31.5%	21.7%	20.6%
2006 EV/EBITDA-O	2.37	2.07	0.14	0.82	0.10	1.22	0.99	1.07	1.26	0.80		0.87		0.23	0.33	0.41
'06 mult-equity value	7.0x	6.1x	52.7x	13.3x	8.6x	6.3x	10.0x	7.4x	8.3x	7.9x		4.8x		7.0x	5.7x	6.4x
'06 mult-debt value	1.8x	4.5x	15.7x	1.2x	2.8x	2.5x	1.0x	3.0x	2.0x	2.5x		7.5x		6.5x	1.7x	3.4x
'06 mult-FCF value	-0.2x	-0.1x	0.2x	-0.3x	-0.1x	-0.3x	-0.1x	-0.1x	-0.2x	0.0x		0.0x		0.0x	0.0x	0.0x
'06 mult-Hidden Value	0.5x	0.5x	-78.2x	-9.5x	0.0x	-0.1x	-3.7x	-0.2x	-1.0x	-1.0x		-3.4x		-1.2x	-0.2x	-0.4x
Owned & Operated Basic Video Subscribers																
2007E	—	—	—	—	—	—	—	—	—	21,609	6,849	3,142	1,364	18,890	13,902	62,958
2006E	—	—	—	—	—	—	—	—	—	21,712	5,851	3,142	1,374	16,136	13,502	61,727
2005E	—	—	—	—	—	—	—	—	—	21,449	5,885	3,027	1,423	15,133	12,040	58,956
Enterprise Value Per Basic Video Subscriber																
2007E	—	—	—	—	NA	—	—	—	—	$3,504	$3,728	$3,963	$7,374	$1,215	$1,206	$15,989
2006E	—	—	—	—	NA	—	—	—	—	3,707	3,553	4,125	2,383	1,345	1,286	16,382
2005E	—	—	—	—	NA	—	—	—	—	3,781	3,359	4,327	2,404	1,542	1,379	16,791
P/E																
2007E	15.9	61.1	NM	17.2	17.4	18.4	17.8	53.5	28.4	25.0	No Estimate	55.8	No Estimate	15.0	24.0	29.9
2006E	17.1	56.2	48.9	20.3	20.2	18.9	20.1	NM	30.4	43.2		NM		19.1	22.0	29.1
2005E	18.6	NM	NM	25.8	22.2	21.6	24.6	NM	22.6	81.0		NM		78.3	9.9	56.4
'06-'08 CAGR	8.8%	NM	-73.8%	18.6%	17.7%	16.3%	17.4%	NM	15.8%	NM		NM		0.0%	29%	14.4%
P/Cash FCF Per Share				Adj. HV												
2007E	18.1	34.1	NM	17.2	15.4	15.9	17.1	16.3	18.9	19.9	No Estimate	13.2	No Estimate	22.7	21.0	18.9
2006E	17.4	41.0	66.0	20.3	17.3	17.7	19.1	19.0	27.1	23.6		44.3		39.8	17.7	32.8
2005E	14.5	29.7	41.8	23.3	19.0	19.2	20.8	15.5	23.0	59.1		43.3		94.1	32.7	57.3
'06-'08 CAGR	3%	NM	NM	16%	9%	13%	18%	0.8%	9.9%	59%		73%		82%	150%	91%
Capex/FY06E EBITDA	12.0%	15.2%	49.5%	19.9%	31.5%	6.1%	11.2%	5.2%	18.7%	41.7%		44.8%		51.2%	57.2%	51.2%
FCF margin FY06E	8.6%	7.6%	11.0%	8.9%	7.5%	13.8%	9.7%	4.0%	8.6%	10.6%		3.8%		4.2%	8.8%	6.8%
FCF % EBITDA FY06E	40.4%	34.0%	96.1%	48.1%	29.4%	47.6%	49.1%	28.4%	37.3%	26.7%		10.3%		20.0%	32.4%	22.3%
Net Debt/TTM EBITDA	1.8x	4.0x	16.8x	1.2x	2.1x	2.4x	1.1x	3.6x	4.3x	2.7x		6.0x		-0.6x	2.2x	2.5x
Dividend Yield	2.5%	0.0%	0.0%	–	1.1%	0.9%	0.4%	2.2%	–	–		–		–	–	–
TARGET PRICE																
DCF	33	–	–	24	23	58	38	28	–	41	–	28	–	17.50	40	–
Sum of the Parts	34	14.64	88	23	22	50	37	–	–	–	–	–	–	–	–	–
Price/SOTP	83%	96%	94%	83%	79%	74%	87%	–	83%	–	–	–	–	–	–	–
Average Target	33	14.64	88	24	23	58	38	28	–	40	na	28	na	17.50	40	–
% Change to Target	17%	5%	7%	26%	32%	57%	24%	15%	25%	14%	–	22%	–	-7%	27%	14%
CY07E EBITDA Target	9.3x	12.0x	5.6x	10.8x	10.1x	13.5x	11.3x	11.9x	11.4x	7.7x	–	6.2x	–	4.8x	8.0x	7.2x
CY07E P/E Target	18.5x	62.9x	NM	21.5x	22.8x	25.7x	20.4x	–	29.0x	26.4x	–	67.9x	–	13.3x	30.3x	39.1x
CY07E P/FCF Target	19.8x	–	NM	20.1x	20.3x	24.8x	21.2x	–	22.8x	20.4x	–	16.0x	–	21.6x	27.4x	21.2x

Note: All data are presented on a calendar year basis.

(1) Discovery Holdings valuation is presented on the valuation for 100% of Discovery Communications as it Assumes sale for $500m and the remaining 50% of Discovery were purchased at the current implied public valuation, with the exception of EPS and P/E.

Source: Deutsche Bank Securities Inc. estimates; Company Reports.

ESTIMATE CHANGES

For FY06 revenue, we have raised our estimate from $3.462b to $3.560b, led by stronger than expected revenues from recorded music (both traditional and digital) in F2Q and F3Q. Our FY06 EBITDA estimate has been raised slightly from $492m to $500m on stronger-than-expected F2Q and F3Q results at both recorded music and music publishing. We now estimate FY06 EPS of $0.34, a $0.26 raise from our previous estimate – as strong 2Q and 3Q EBITDA, as well as lower than expected taxes in those quarters caused the increase.

For FY07, our revenue estimate is increased $27m to $3.654b, EBITDA estimate is down $4m to $513m, and our EPS estimate is up $0.28 to $0.36. While 3% revenue and EBITDA growth, and 6.5% EPS growth, could be considered modest, we see FY08 and FY09 as breakout years for Warner and the entire music sector due to our expectation for a positive lift from a new satellite radio deal and a potential explosion in wireless growth.

LATEST THOUGHTS ON WIRELESS

There remains the potential that wireless will ultimately unlock the greatest value for music content, even more so than iTunes and the Internet have been able to do. The bull case is fairly straightforward. First, distribution would be greater than any other format given billions of mobile phone users globally and a billion new phones sold every year. The networks are secure, closed systems with DRM easily built in – so less piracy. Availability would increase dramatically as phone customers can effect transactions anywhere, anytime (and instantly given the mobile billing relationship). Utility would increase as the music can be stored and carried with the phone (which these days is everywhere the customer goes), and further content such as ringtones, videos and specialized clips can be offered at little incremental cost.

We see a number of hurdles and improvements necessary for wireless music to become a substantial contributor to growth. Thus, while we are very bullish on wireless prospects long-term, we expect the financial impact for music companies to fall more in FY08 and beyond. Hurdles include: (1) interoperability – among phones, among DRM, between mobile services and internet services – is potentially the greatest hurdle for wireless music and the most vexing to solve because it requires numerous major companies (Apple, Microsoft, Verizon, AT&T, etc.) to change their business philosophy from a closed system to an open architecture; (2) need dramatic improvements in mobile search including voice activated search, playlist sharing, tagging songs over the air, recommendation engines, personalization; (3) battery life can become a major hurdle for heavy mobile content users, as well as audio quality; (4) allow off-deck aggregators onto the phone or risk customers becoming used to side-loading their phones from the at-home libraries of digital music; and (5) a willingness of wireless carriers to invest in the potential of mobile content before the revenue streams have fully developed (a major hurdle!).

Several other factors are interesting to consider. While some consumers might not purchase a phone or iPod for its potential as a music playback device, they might as a video playback unit? Thus, the spread of video-capable devices could help expand the potential market for music companies. Second, will the mobile companies struggle to form any consensus on industry standards, leading MP3 to become broadly used to listen to music on mobile phones? This would effectively wipe out the piracy benefits we currently expect from the transition to a mobile market. With limited slots on the face of a mobile phone to promote new music and artists, will marketing costs increase dramatically? Will mobile music become ad-supported in some form? It appears unlikely given the failure in Korea (consumers felt that even though the music was free they were paying for it with usage on the network). Currently, the music companies are producing and packaging content to fit the

technology in place, rather than the other way around. As technology improves, will greater creativity by the music companies lead to improved value of music content and accordingly increased usage by customers.

Lastly, we would note that the prospect of all songs, available all the time, on all mobile phones, open to third-party aggregators, with a simple to use, easily searchable interface, with a commerce engine built in leveraging the mobile billing relationship, integrated with any home internet service, without hampering the utility of the basic phone service, and inter-operable with other phones and device, sounds like nirvana for a music executive (and will probably take most of the next decade to fully achieve). But what might be even more impactful is the organic aspect to such scale of distribution, and knowledge of presence. For example, it will be quite simple to gift songs to friends and family (with the receiving phone having simple instructions to download and play a song; as an example, with an m-card from the giver). P2P sharing could become a viral and expansive marketing tool – songs could be shared with a friend for a single play, with future plays requiring a purchase. Credits against future purchases could be built up for every friend that purchases a song you shared with them.

The key for Warner's stock is how fast this rosy view on wireless becomes reality. New phones arriving for this holiday season might be a nice first step.

Valuation

WMG is trading in line with the entertainment group at 9.4x CY07E EBITDA and 16.4x P/FCF. Our 12-Month DCF-based target is $28/share, 16% upside (10% cost of equity on 64% of capital, 4.9% cost of debt on 36% of capital, 2% terminal growth below 4% sector rate due to sector growth uncertainty). Previous target of $26/share was based on 10% cost of equity on 63% of capital, 5.3% cost of debt on 37% of capital and 2% terminal growth.

Risks

Choppy transition to digital, shifts in release slate, tough Dec qtr comps (which might not be fully reflected in Street estimates), popularity of its releases, potential for dilutive acquisitions and minority shareholder position (including potential for insider selling).

Figure 3: Warner Music Group – Changes to Annual Estimates

($MM, except per share data)	FY06 Estimates And Changes						FY07 Estimates And Changes				
	FY05A	Old Est	Chg	New Est	Old Grwth	New Grwth	Old Est	Chg	New Est	Old Grwth	New Grwth
Digital Downloads	370	702	+0	702	90.0%	90.0%	1,229	+0	1,229	75.0%	75.0%
REVS											
Digital Recorded	$137	$300	+21	$321	119.2%	134.4%	$504	+15	$519	67.9%	61.6%
Traditional Recorded	2,787	2,658	+66	2,724	-4.6%	-2.3%	2,551	-3	2,548	-4.0%	-6.5%
Publishing	807	533	+11	544	-12.3%	-10.4%	601	+15	616	12.9%	13.3%
Rev. Elimination	(29)	(29)	+0	(29)	0.0%	0.0%	(29)	+0	(29)	0.0%	0.0%
Cons. Revenue	3,502	3,462	+98	3,560	-1.1%	1.7%	3,627	+27	3,654	4.8%	2.6%
OPEXP											
Recorded Music	2,478	2,481	+79	2,560	0.1%	3.3%	2,551	+17	2,568	2.8%	0.3%
Publishing	463	418	+3	421	-9.7%	-9.0%	480	+5	485	14.9%	15.2%
Corp & Options	99	71	+7	78	-27.9%	-20.8%	79	+9	87	10.7%	11.7%
Cons. Opexp	3,040	2,970	+89	3,059	-2.3%	0.7%	3,110	+31	3,140	4.7%	2.6%
EBITDA											
Recorded Music	446	477	+7	485	7.1%	8.7%	504	-6	499	5.6%	2.8%
Publishing	144	114	+8	123	-20.5%	-14.9%	121	+10	131	5.9%	6.9%
Segment EBITDA	590	592	+16	607	0.3%	3.0%	625	+4	630	5.6%	3.8%
Corp. Exp.	128	100	+7	107	-21.6%	-16.1%	108	+9	116	7.6%	8.5%
Cons. EBITDA	463	492	+9	500	6.4%	8.2%	518	-4	513	5.2%	2.6%
As Reported											
Revenue	3,502	3,462	+98	3,560	-1.1%	1.7%	3,627	+27	3,654	4.8%	2.6%
EBITDA	463	492	+9	500	6.4%	8.2%	518	-4	513	5.2%	2.6%
EBIT	225	260	+8	267	15.6%	19.1%	286	-4	282	10.1%	5.5%
EPS	$ (0.10)	$0.08	$+0.26	$ 0.34	-181.5%	NM	$0.08	$+0.28	$ 0.36	-2.8%	6.5%
FCF	241	193	-51	142	-19.7%	-41.0%	247	-7	240	27.7%	69.1%
FCF/shr	$ 1.66	$1.28	$-0.32	$ 0.96	-31.2%	-48.4%	$1.62	$-0.05	$ 1.57	26.4%	63.2%

Source: Company reports; Deutsche Bank Securities

Figure 4: Warner Music Group – Consolidating Segment Results ($mm except per share data)

	FY04 Sep-04	1Q05 Dec-04	2Q05 Mar-05	3Q05 Jun-05	4Q05 Sep-05	FY05 Sep-05	1Q06a Dec-05	2Q06a Mar-06	3Q06a Jun-06	4Q06e Sep-06	FY06e Sep-06	FY07e Sep-07	FY08e Sep-08	FY09e Sep-09	FY10e Sep-10	'06-'10 CAGR
Recorded Music																
Traditional Revenue	$ 2,626	$ 919	$ 590	$ 550	$ 728	$ 2,787	$ 858	$ 590	$ 590	$ 688	$ 2,724	$ 2,545	$ 2,388	$ 2,231	$ 2,076	-8.6%
growth y/y	–	+10.3%	0.3%	-3.2%	17.7%	-1.4%	-6.9%	0.0%	7.3%	-5.5%	-2.2%	-6.6%	-6.0%	-7.0%	-7.0%	–
Digital Revenue	32	21	31	38	47	137	64	86	89	83	321	519	789	1,082	1,329	42.6%
growth y/y	NM	NM	NM	NM	213.3%	328.1%	204.8%	177.4%	131.6%	77.0%	134.4%	61.6%	52.0%	37.2%	22.8%	–
% of revenue	1.1%	2.2%	5.0%	6.8%	6.1%	4.9%	7.0%	12.7%	13.0%	10.8%	10.9%	16.9%	24.8%	32.7%	39.0%	–
Total Revenue	2,659	940	621	588	775	2,924	920	676	678	771	3,045	3,067	3,188	3,313	3,402	3.8%
growth y/y	–	-8.8%	4.9%	1.9%	17.2%	3.3%	-2.1%	8.9%	15.3%	-0.5%	4.1%	0.7%	3.8%	4.0%	2.7%	–
Opexp	2,574	746	545	515	672	2,478	714	585	596	665	2,560	2,568	2,648	2,732	2,791	2.2%
growth y/y	–	-16.3%	-4.8%	0.8%	11.8%	-3.7%	-4.2%	7.2%	13.5%	-1.0%	3.3%	0.3%	3.1%	3.2%	2.2%	–
EBITDA	284	194	76	73	103	446	206	81	82	106	485	498	538	580	611	8.1%
growth y/y	–	41.6%	281.0%	13.8%	71.7%	57.0%	6.2%	6.6%	28.0%	2.9%	8.7%	2.8%	7.9%	7.9%	5.2%	–
margin	9.9%	20.6%	12.2%	12.4%	13.3%	15.3%	22.4%	12.0%	12.1%	13.7%	15.9%	16.3%	16.9%	17.5%	18.0%	–
D&A	184	42	42	41	40	165	40	41	40	40	161	160	160	160	160	-0.2%
EBIT	100	152	34	32	63	281	166	40	42	66	324	339	378	420	451	8.6%
growth y/y	–	85.4%	-247.8%	33.3%	216.0%	172.8%	9.2%	17.6%	62.5%	4.5%	15.3%	4.6%	11.7%	11.2%	7.2%	–
margin	3.8%	16.2%	5.5%	5.4%	8.1%	9.6%	18.0%	5.9%	7.7%	8.5%	10.6%	11.0%	11.9%	12.7%	13.2%	–
Music Publishing																
Traditional Revenue	$ 595	$ 151	$ 150	$ 155	$ 131	$ 587	$ 128	$ 125	$ 148	$ 128	$ 525	$ 502	$ 494	$ 486	$ 478	4.2%
growth y/y	–	-4.4%	3.4%	2.6%	-3.1%	-1.3%	-15.6%	-16.7%	-5.8%	-2.5%	-10.5%	-10.9%	-2.0%	-2.0%	-2.0%	–
Digital Revenue	5	4	4	6	8	20	5	4	4	8	19	34	52	73	87	46.2%
growth y/y	NM	NM	NM	NM	200.0%	233.3%	23.0%	0.0%	-33.3%	0.0%	-5.0%	78.9%	52.0%	37.2%	22.0%	–
% of revenue	1.0%	2.6%	2.6%	3.7%	6.4%	3.3%	3.8%	3.1%	2.7%	6.5%	3.5%	6.8%	10.0%	13.0%	18.3%	–
Total Revenue	601	155	154	161	139	607	133	129	150	136	544	536	545	559	565	4.7%
growth y/y	–	-2.5%	3.4%	5.2%	-2.1%	1.0%	-15.5%	-16.2%	-8.8%	-2.4%	-10.4%	13.3%	4.0%	4.0%	4.2%	–
Opexp	457	131	106	131	95	463	110	82	127	102	421	455	508	533	565	7.1%
growth y/y	–	-0.8%	1.9%	4.8%	-1.0%	1.3%	-15.0%	-22.6%	-3.1%	7.5%	-9.0%	15.2%	4.9%	4.9%	6.2%	–
EBITDA	144	24	48	30	42	144	21	47	23	33	123	101	137	144	150	5.2%
growth y/y	–	-11.1%	6.7%	2.1%	-4.5%	0.0%	-12.5%	-2.1%	-23.3%	-21.9%	-14.9%	6.5%	4.0%	4.9%	4.2%	–
margin	24.0%	15.6%	31.2%	18.6%	30.7%	23.7%	15.9%	36.4%	15.3%	23.6%	22.6%	21.3%	21.3%	21.3%	21.3%	–
D&A	63	14	15	16	16	59	16	16	14	14	60	60	60	60	60	-0.9%
EBIT	79	10	33	15	27	85	6	32	9	18	65	75	81	88	94	9.6%
growth y/y	–	66.7%	37.5%	15.4%	-12.9%	10.9%	-40.0%	-2.0%	-40.0%	-34.0%	-24.0%	18.2%	8.0%	8.1%	6.8%	–
margin	31.4%	6.5%	21.4%	9.3%	19.7%	14.0%	4.6%	24.8%	6.0%	13.2%	12.1%	14.0%	14.8%	15.8%	16.6%	–
TOTAL COMPANY																
Traditional Revenue	$ 3,426	$ 1,079	$ 740	$ 705	$ 859	$ 3,374	$ 912	$ 715	$ 736	$ 816	$ 3,249	$ 3,130	$ 2,931	$ 2,830	$ 2,654	-4.5%
growth y/y	–	-9.6%	0.7%	-1.9%	6.9%	-1.5%	-6.2%	-3.4%	4.4%	-5.0%	-3.7%	-3.7%	-4.4%	-3.5%	-6.2%	–
Digital Revenue	39	25	35	44	63	157	69	90	92	89	340	553	841	1,153	1,415	42.8%
growth y/y	NM	NM	NM	NM	211.8%	312.1%	178.0%	157.1%	169.1%	98.3%	116.7%	62.6%	52.0%	37.2%	22.8%	–
% of total revenue	1.1%	2.3%	4.5%	5.9%	6.8%	4.4%	6.6%	11.2%	11.1%	9.9%	9.6%	15.0%	21.0%	28.9%	34.4%	–
Rev Elimination	(23)	(7)	(8)	(7)	(7)	(29)	(7)	(9)	(6)	(7)	(29)	(29)	(29)	(29)	(29)	0.0%
Total Revenue	3,436	1,098	767	742	915	3,502	1,044	796	822	898	3,560	3,654	3,803	3,960	4,078	3.5%
growth y/y	–	-7.6%	4.4%	2.6%	13.1%	1.9%	-4.9%	3.8%	10.8%	-0.8%	1.7%	2.6%	4.1%	4.1%	3.0%	–
Opexp	3,008	870	643	639	760	2,912	817	658	707	760	2,952	3,024	3,128	3,236	3,317	3.0%
growth y/y	–	-14.2%	-3.9%	1.8%	9.7%	-3.2%	-5.1%	3.9%	10.6%	0.1%	1.4%	2.4%	3.4%	3.5%	2.5%	–
Corp. Exp	65	25	27	24	26	103	19	22	25	25	91	100	102	104	106	3.9%
FAS 123	1	2	2	0	2	5	0	2	4	4	10	10	10	10	10	0.0%
EBITDA	342	199	91	70	112	473	202	104	86	109	500	513	551	564	619	6.3%
growth y/y	–	25.8%	88.5%	-2.8%	23.1%	27.8%	8.3%	14.9%	22.9%	-2.5%	4.2%	2.6%	8.5%	2.3%	5.7%	–
margin	10.5%	17.5%	11.8%	9.4%	12.4%	13.2%	19.3%	13.1%	10.5%	12.1%	14.1%	14.1%	14.7%	15.3%	15.1%	–
D&A	227	55	57	56	55	224	55	56	54	54	219	218	218	218	216	-0.3%
Corp. D&A	17	4	4	3	3	14	3	3	4	4	14	15	14	14	13	-1.8%
EBIT	115	130	30	11	54	225	144	45	28	50	267	282	327	374	409	11.2%
growth y/y	–	83.3%	-240.5%	-8.3%	68.8%	90.3%	10.8%	52.5%	154.5%	-0.5%	18.1%	5.5%	15.9%	14.6%	9.4%	–
margin	32.6%	11.9%	3.8%	1.5%	6.0%	6.4%	13.9%	5.7%	3.4%	5.6%	7.5%	7.7%	8.6%	9.5%	10.0%	–

Source: Deutsche Bank Securities, Company Reports

Figure 5: Warner Music Group – Income Statement, Cash Flow (1)

($MM, except per share data)

	FY04a Sep-04	1Q05a Dec-04	2Q05a Mar-05	3Q05a Jun-05	4Q05 Sep-05	FY05a Sep-05	1Q06 Dec-05	2Q06 Mar-06	3Q06 Jun-06	4Q06a Sep-06	FY06e Sep-06	FY07e Sep-07	FY08e Sep-08	FY09e Sep-09	FY10e Sep-10	'06-'10 CAGR
CONSOLIDATED RESULTS																
Revenue	$ 3,436	$ 1,088	$ 767	$ 742	$ 905	$ 3,502	$ 1,044	$ 796	$ 822	$ 898	$ 3,560	$ 3,854	$ 3,803	$ 3,960	$ 4,078	3.5%
growth y/y	—	-7.6%	4.4%	2.6%	13.1%	1.9%	-4.0%	3.8%	10.8%	-0.8%	1.7%	2.0%	4.1%	4.1%	3.0%	—
Opexp	3,074	858	677	672	793	3,040	842	652	736	759	3,059	3,140	3,246	3,356	3,440	3.0%
growth y/y	—	-12.8%	-1.6%	3.2%	11.8%	-1.1%	-1.9%	2.7%	8.8%	-4.5%	0.7%	2.6%	3.4%	3.4%	2.5%	—
EBITDA	362	150	91	70	112	463	202	104	86	104	500	533	557	604	639	6.3%
growth y/y	—	25.8%	83.6%	-2.8%	33.1%	27.9%	6.3%	14.9%	22.0%	-3.2%	8.2%	2.8%	8.5%	8.4%	6.7%	—
D&A	244	80	61	58	58	238	58	59	58	58	233	238	230	230	229	-0.4%
Segment Depreciation	81	30	30	31	31	42	8	8	30	30	36	37	34	30	27	-4.8%
Segment Amortization	178	48	47	45	44	182	47	49	44	41	180	179	182	188	189	0.8%
Corp. D&A	17	4	4	3	3	14	3	3	4	3	14	15	14	14	13	-4.4%
EBIT	118	130	30	11	54	225	144	45	28	50	267	282	327	374	409	11.2%
growth y/y	—	82.1%	-240.5%	-8.3%	68.8%	90.3%	10.9%	52.5%	154.5%	-6.5%	18.7%	6.0%	15.8%	14.6%	9.4%	—
margin	3.4%	11.9%	3.8%	1.5%	6.0%	6.4%	13.8%	5.7%	3.4%	5.6%	7.5%	7.3%	8.6%	9.5%	10.0%	—
Int. Exp	62	35	52	49	42	181	45	45	45	46	181	169	160	145	128	-8.5%
Equity Investments	9	1	-	-	-	1	-	(1)	-	-	(1)	-	-	-	-	—
Other (Inc.)/Costs	1,275	23	(36)	137	35	159	-	(2)	(1)	-	(3)	-	-	-	-	—
PT Income	(1,249)	68	14	(175)	(23)	(117)	99	3	(16)	5	91	114	167	230	283	32.9%
Tax Expense (Benefit)	150	32	10	4	9	55	30	10	(2)	10	48	59	70	83	84	18.4%
Effective Tax Rate	-12.0%	47.1%	71.1%	-2.3%	-38.1%	-47.2%	30.3%	333.3%	12.5%	207.1%	52.8%	51.8%	41.8%	36.2%	33.6%	—
Statutory Tax Rate	37.0%	28.1%	16.5%	-3.1%	42.5%	34.0%	20.5%	19.6%	-7.1%	20.5%	33.4%	20.0%	20.0%	20.0%	20.0%	—
Reported Net Income	(1,422)	36	4	(179)	(32)	(172)	69	(7)	(14)	(5)	43	55	97	147	199	44.9%
growth y/y	—	NM	NM	98.1%	-78.6%	-87.9%	91.7%	-300.0%	-92.2%	-83.8%	-125.0%	28.4%	76.6%	50.9%	35.5%	—
margin	-41.4%	3.3%	0.5%	-24.1%	-3.5%	-4.9%	6.6%	-0.9%	-1.7%	-0.6%	1.2%	1.4%	2.6%	3.7%	4.9%	—
Reported EPS Diluted	$ (13.20)	$ 0.31	$ 0.03	$ (1.41)	$ (0.21)	$ (1.33)	$ 0.46	$ (0.05)	$ (0.10)	$ (0.03)	$ 0.29	$ 0.36	$ 0.63	$ 0.94	$ 1.19	42.5%
NORMALIZED EARNINGS																
Unusual Items	1,276	23	(28)	137	35	159	-	8	(1)	-	7	-	8	13	28	—
Normalized Net Income	(147)	59	(33)	(42)	3	(13)	69	1	(15)	(5)	50	55	103	160	215	44.1%
Normalized EPS Diluted	$ (1.37)	$ 0.51	$ (0.26)	$ (0.33)	$ 0.02	$ (0.06)	$ 0.46	$ 0.01	$ (0.10)	$ (0.03)	$ 0.34	$ 0.36	$ 0.67	$ 1.02	$ 1.36	41.7%
growth y/y	—	NM	NM	71.1%	-109.1%	-62.9%	-10.4%	-102.7%	-68.4%	-270.6%	-448.7%	6.5%	85.8%	53.2%	33.7%	—
Consensus											0.33	0.47				
FREE CASH FLOW																
EBITDA	362	150	91	70	112	463	202	104	86	108	500	533	557	604	639	6.3%
Less: Net Cash Interest	(74)	(42)	(37)	(27)	(22)	(128)	(47)	(24)	(47)	(41)	(159)	(150)	(140)	(123)	(100)	-10.4%
Less: Cash Taxes	(58)	(6)	(12)	(13)	(55)	(86)	(14)	(12)	(23)	(15)	(64)	(67)	(77)	(89)	(98)	11.4%
Less: Other	(73)	(3)	(9)	6	-	1	-	-	-	-	-	-	-	-	-	NM
Less: Net Advances	101	15	(6)	(11)	2	-	(44)	15	(25)	(6)	(60)	(40)	(40)	(40)	(40)	-9.8%
+/- Other Working Capital	133	(108)	260	(45)	(44)	3	(79)	86	(10)	(40)	(53)	9	18	22	18	—
Operating Cash Flow	393	44	215	(21)	33	271	18	169	(27)	8	168	265	318	372	418	25.8%
Less: Capex	(43)	(6)	(8)	(6)	(10)	(30)	(6)	(7)	(6)	(6)	(24)	(25)	(25)	(22)	(21)	-3.1%
Free Cash Flow	350	38	207	(27)	23	241	93	162	(33)	(0)	142	240	293	350	394	23.1%
growth	—	-81.6%	74.1%	-102.9%	109.1%	-31.3%	-45.8%	-21.5%	22.2%	-100.2%	-41.0%	68.3%	22.2%	19.6%	12.7%	—
margin	10.2%	3.5%	26.9%	-3.6%	2.5%	6.9%	9.2%	20.4%	-4.0%	0.0%	4.0%	6.5%	7.7%	8.8%	9.7%	—
FCF Diluted	$ 3.26	$ 0.33	$ 1.67	$ (0.21)	$ 0.15	$ 1.84	$ 0.63	$ 1.14	$ (0.23)	$ (0.00)	$ 0.55	$ 1.57	$ 1.90	$ 2.26	$ 2.50	21.9%
growth	—	-42.6%	59.6%	-120.2%	69.4%	-42.9%	-73.8%	-31.7%	8.0%	-100.2%	-48.4%	63.2%	21.0%	17.7%	11.0%	—
Dividend	—	—	—	-	-	-	20	20	20	20	80	80	80	80	80	—
Dividend/Share	—	—	—	-	$ -	$ -	$ 0.13	$ 0.14	$ 0.14	$ 0.13	$ 0.54	$ 0.52	$ 0.52	$ 0.51	$ 0.51	—
Restructuring/Acq.	—	—	—	89	29	119	10	10	78	10	108	-	-	-	-	—
Available FCF	—	—	—	(126)	3	(123)	(17)	132	(131)	(30)	(45)	160	215	270	314	NM
Basic Shares	107.5	107.5	107.7	127.6	143.2	120.9	141.4	141.9	143.7	148.5	142.9	147.7	151.6	154.7	156.3	2.3%
Fully Diluted Shares	107.5	115.3	123.5	127.9	150.5	129.8	150.5	143.9	143.7	152.8	147.8	153.2	154.7	156.3	157.9	1.7%

(1) Note: historical data generally not available in the quarterly FYE September format shown here and is accordingly estimates not reported actuals.

Source: Deutsche Bank Securities; Company Reports

Source: Deutsche Bank

Figure 6: Industry Recent Weekly and YTD Music Sales Performance

Week of 09/17 -- Domestic Music Sales

	2005	2006	% chg
Physical CDs	9.96	10.05	0.9%

Source: Deutsche Bank, Billboard, Soundscan

Week of 9/10 -- Domestic Music Sales

	2005	2006	% chg
Physical CDs	9.13	8.89	-2.6%
Physical Other AET *	0.06	0.04	-39.6%
Total Physical AET *	9.19	8.93	-2.9%
% total	*84.6%*	*84.5%*	
Digital Albums	0.32	0.60	89.0%
Digital Tracks	13.58	10.35	-23.8%
Digital Track AET *	1.36	1.03	-23.8%
Total Digital AET *	1.68	1.64	-2.4%
% total	*15.4%*	*15.5%*	
Total Music Sales (AET *)	**10.87**	**10.56**	**-2.8%**

** AET - Album Equivalent Total using 10 singles or cassettes per album*

Source: Deutsche Bank, Billboard, Soundscan

YTD 9/10 -- Domestic Music Sales

	2005	2006	% chg
Physical CDs	372.50	341.69	-8.3%
Physical Other AET *	3.10	1.78	-42.6%
Total Physical AET *	375.60	343.47	-8.6%
% total	*92.2%*	*85.4%*	
Digital Albums	9.46	20.34	115.0%
Digital Tracks	223.73	386.08	72.6%
Digital Track AET *	22.37	38.61	72.6%
Total Digital AET *	31.83	58.95	85.2%
% total	*7.8%*	*14.6%*	
Total Music Sales (AET *)	**407.43**	**402.42**	**-1.2%**

** AET - Album Equivalent Total using 10 singles or cassetts per album*

Source: Deutsche Bank, Billboard, Soundscan

Source: Deutsche Bank

Figure 7: Warner Music Group – Discounted Cash Flow Analysis

(Amounts in MMs, Except Per Share Data)	FY06E	FY07E	FY08E	FY09E	FY10E
Consolidated EBITDA	500	513	557	604	639
Less: Capital Expenditures	(24)	(25)	(23)	(22)	(21)
Less: Advances	(60)	(40)	(40)	(40)	(40)
Less: Other	0	0	0	0	0
Less: Income Taxes	(64)	(67)	(77)	(89)	(214)
Unlevered Free Cash Flow	$352	$381	$417	$453	$364

Equity	
Closing Price on 9/21/06	$24.29
Fully Diluted Shares	152.9
Equity Value	$3,715
• Equity Ratio	63.6%

Debt	
End of Year Total Long-Term Debt	$2,127
Debt Adjustments	—
End of Year Cash/Note Receivable	—
Preferred Stock	—
Debt Value	$2,127
• Debt Ratio	36.4%

Risk Free Rate	5.0%
Equity Risk Premium	5.0%
Beta	1.00
Cost of Equity	10.0%

WACC	8.1%

Weighted Avg Interest Rate	7.5%
Cost of Debt	4.9%

2006 PV of FCF discounted at 8.1%	353	356	358	266
2007 PV of FCF discounted at 8.1%		385	388	288
Terminal Value @ 2010				$6,066
• Unlevered After-Tax Free Cash Flow Multiple				16.7x

Sum of Free Cash Flow at PV	$1,334	$1,060
Add: Terminal Value (8.1% discount rate)	4,437	4,797
Enterprise Value	$5,770	$5,858
• Enterprise Value / EBITDA	11.5x	11.4x
Less:		
End of Year Total Net Debt	$1,933	$1,792
Plus cumulative dividends	80	160
Net Asset Value	$3,917	$4,226
Less: Minority Interest	0	0
Plus: Option/Warrant Proceeds	17	17
Total Net Asset Value	$3,933	$4,243
Shares	141.2	142.9
Non-Voting Shares	0.0	0.0
Option Shares	9.2	9.2
Fully Diluted Shares Outstanding	150	152
Private Market Value Per Share	$26.14	$27.88
Target Discount to Net Asset Value	0.0%	0.0%
Target Price Per Share	$26	$28
Closing Price on 9/21/06	$24.29	$24.29
Upside to Target Price Per Share	7.0%	15.3%

2006 Equity Value Per Share

WACC	Terminal Growth 1.5%	2.0%	2.5%
7.6%	25.99	28.59	31.35
8.1%	23.12	25.35	27.90
8.6%	20.75	22.59	24.62

Terminal Value EBITDA Multiple

WACC	Terminal Growth 1.5%	2.0%	2.5%
7.6%	9.7x	10.2x	11.0x
8.1%	8.7x	9.5x	10.4x
8.6%	8.2x	8.8x	9.5x

Terminal Value FCF Multiple

WACC	Terminal Growth 1.5%	2.0%	2.5%
7.6%	16.5x	18.1x	20.0x
8.1%	15.3x	16.6x	18.2x
8.6%	14.2x	15.3x	16.7x

Source: Deutsche Bank Securities Inc. estimates and company information

Figure 8: Warner Music Group – Valuation Multiples

($ in millions, except per share data)

ENTERPRISE VALUE	2005	2006E	2007E	2008E	2009E
Equity Value					
Basic Shares Outstanding	144				
Dilutive Shares In The Money	9.2				
Diluted PF Shares	153				
Stock Price on: 9/21/06	$ 24.29				
Equity Market Cap	$ 3,715	$ 3,715	$ 3,715	$ 3,715	$ 3,715
Pro Forma Debt					
As Reported Gross Debt	2,251				
Cash	(335)				
As Reported Net Debt-6/30/06	1,916				
BOY PF Net Debt	$ 1,916	$ 1,918	$ 1,856	$ 1,626	$ 1,315
CY FCF	$ -	$ (60)	$ (230)	$ (311)	$ (363)
EOY PF Net Debt	$ 1,916	$ 1,856	$ 1,626	$ 1,315	$ 952
Hidden Value @ 80% Of Value					
Option Proceeds	17				
PV Tax Benefit	350				
Total Hidden Value	$ 367	$ 367	$ 367	$ 367	$ 367
Total Enterprise Value	$ 5,264	$ 6,204	$ 4,974	$ 4,664	$ 4,301
VALUATION ANALYSIS					
FY EBITDA	$ 463	$ 500	$ 513	$ 557	$ 604
CY EBITDA	475	485	529	571	615
CY EV/EBITDA	11.1x	10.7x	9.4x	8.2x	7.0x
As Reported FY EPS	$ (0.10)	$ 0.34	$ 0.36	$ 0.67	$ 1.02
As Reported CY EPS	(0.02)	0.27	0.45	0.77	1.12
CY P/E	NM	90.3x	53.5x	31.5x	21.7x
FY FCF	$ 241	$ 142	$ 240	$ 295	$ 350
CY FCF	216	189	230	311	363
FY FCF/Share	$ 1.86	$ 0.96	$ 1.57	$ 1.90	$ 2.24
CY FCF/Share	1.56	1.28	1.49	2.00	2.32
CY P/FCF	15.5x	19.0x	16.3x	12.1x	10.5x

Source: Deutsche Bank Securities estimates; Company reports

Figure 9: Warner Music Group – 3Q05 Releases

Date	Artist	Album	Label	Genre	Notes
7/5/05	Webbie	Savage Life	Atlantic	Rap	Debuted #9
7/5/05	Missy Elliott	Cookbook [DualDisc]	Atlantic	Rap	Debuted #2
7/5/05	Amadou & Mariam	Dimanche a Bamako	Nonesuch	World	
7/5/05	Bill Frisell	EastWest	Nonesuch	Jazz	
7/5/05	Frayser Boy	Me Being Me	Asylum	Rap	
7/5/05	Rupee	1 on 1	Atlantic	R&B	
7/5/05	Stephin Merritt	Two Chinese Operas	Nonesuch	Rock	
7/12/05	Various Artists	Hustle & Flow Soundtrack	Atlantic	Rap	
7/12/05	Gucci Mane	Trap House - Chopped & Screwed	ADA/Big Cat	Rap	
7/19/05	B5	B5	Bad Boy	Rap	
7/25/05	Dane Cook	Retaliation	ADA/Comedy Central	Comedy	Debuted #4, top in genre
7/26/05	Alanis Morissette	Jagged Little Pill Acoustic	Maverick	Rock	Starbucks Exclusive
7/26/05	Brian Setzer	Rockabilly Riot, Vol. 1	ADA	Rock	
7/26/05	Jason Mraz	Mr. A-Z	Atlantic	Rock	Debuted #8, 76k units
7/26/05	Mazella	Soul Holes	Maverick	Rock	
7/26/05	Ray Charles	At the Olympia	WEA Int'l	R&B	
7/26/05	Trey Songz	I Gotta Make It	Atlantic	R&B	
8/2/05	Faith Hill	Fireflies	Warner Brothers	Country	Debuted #1, +184% wk 10
8/2/05	Richard Hell	Spurts: The Best of Richard Hell	Rhino	Rock	
8/2/05	Howard Jones	Ultimate Collection	WEA Int'l	Rock	
8/9/05	Natalie Merchant	Greatest Hits (Import)	WEA/Rhino	Rock	
8/9/05	Staind	Chapter 5 [Dual Disc]	Elektra	Rock	Debuted #1, 189k units
8/9/05	Michael McDonald	Ultimate Collection	Rhino	ROCK	Debuted #70
8/16/05	TapRoot	Blue Sky Research	Atlantic	Rock	Debuted #30
8/16/05	Dirty	Hood Stories	Rap-A-Lot (Wea)	Rap	
8/16/05	The Click Five	Greetings from Imperial House	Atlantic	Rock	Debuted at #15, 52k units
8/16/05	The Ramones	Weird Tales of the Ramones	Rhino	ROCK	
8/16/05	The Stooges	Stooges [Deluxe Edition]	Rhino	Rock	
8/16/05	The Stooges	Fun House [Deluxe Edition]	Rhino	ROCK	
8/16/05	LU	LU	WEA Int'l	Latin	
8/23/05	Trick Pony	R.I.D.E.	Asylum/Curb	Country	
8/23/05	Gram Parsons	The Complete Reprise Sessions	Rhino	Rock	
8/23/05	Rupee	1 on 1	Atlantic	R&B	
8/23/05	Jack's Mannequin	Everything In Transit	Maverick	Rock	
8/23/05	Peter, Paul & Mary	Very Best of Peter, Paul & Mary	Rhino	Folk	
8/23/05	Chicago	Carnegie Hall Vol 3-4 (Chicago IV)	Rhino	Rock	
8/23/05	Gram Parsons	Complete Reprise Sessions	Rhino	Rock	
8/23/05	Jerry Garcia	Jerry Garcia Collection, Vol. 1: Legion of Mary	Rhino	Rock	
8/23/05	Yes	Word Is Live	Rhino	Rock	
8/23/05	Various Artists	Tribal 20th Anniversary Collection	Rhino	World	
8/23/05	Daniel Powter	Daniel Powter	Warner Bros.	ROCK	
8/23/05	Sonny	Asi	WEA Int'l	Latin	
8/30/05	Yolanda Adams	Day by Day	Atlantic	Christian	Debuted at #27
8/30/05	Death Cab for Cutie	Plans	Atlantic	Rock	Debuted at #8, 71k units
8/30/05	Dirty	Hood Story Chopped & Screwed	Rap-A-Lot (Wea)	Rap	
8/30/05	Cold	Different Kind of Pain	Lava	ROCK	
8/30/05	Various Artists	Austin City Limits Festival	Rhino	Rock	
8/30/05	Eric Clapton	Back Home	Warner Bros.	Rock	Debuted #17
8/30/05	Gilberto Gil	Eletroacustico	WEA Int'l	Latin	
9/6/05	Luis Miguel	Mexico en la Piel: Edicion Diamante	WEA Int'l	Latin	
9/6/05	Do or Die	D.O.D. Chopped & Screwed	Atlantic	Rap	
9/9/05	Gabe Dixon Band	Live at World Cafe	Warner Bros.	Rock	
9/9/05	The Ordinary Boys	Brassbound [UK Bonus CD]	WEA Int'l	Rock	
9/9/05	Syria	Non E Peccato	WEA Int'l	World	
9/13/05	Little Brother	Minstrel Show	Atlantic	Rap	
9/13/05	Paul Wall	People's Champ	Atlantic	Rap	Debuted #1, 173k units
9/13/05	Tracy Chapman	Where You Live	Atlantic	ROCK	
9/13/05	Trapt	Someone In Control	Warner Bros.	Rock	Debuted #12
9/13/05	Various Artists	Just Say She Box Set	Rhino	Rock	
9/13/05	Antigone Rising	From the Ground Up	Lava	ROCK	
9/13/05	Little Brother	Minstrel Show	Atlantic	Rap	
9/13/05	Genesis	Platinum Collection	Rhino	Rock	
9/20/05	Ryan Cabrera	You Stand Watching	Atlantic	Rock	Debuted at #20
9/20/05	Disturbed	Ten Thousand Fists	Reprise	Rock	Debuted at #1 233k units
9/20/05	Ray Charles	Genius and Friends	Rhino/WEA	R&B	
9/20/05	P3C	25 to Life	Atlantic	Rap	Debuted at #10
9/27/05	Lil' Kim	Naked Truth	Atlantic	Rap	Debuted at #5
9/27/05	Neil Young	Prairie Wind	Reprise	Rock	Debuted at #11
9/27/05	Wynonna	Her Story: Scenes from Lifetime	Curb	Country	36k units wk 1
9/27/05	Maceo	Straight Out Da Pot	ADA/Big Cat	Rap	
9/27/05	Various Artists	Future Retro	Warner Brothers	Alt Remix	
9/27/05	Sean Paul	The Trinity	Atlantic	Rap	164k units first 2 wks
9/27/05	HIM	Dark Light	Warner Bros/Sire	Rock	55k units in first 2 wks
9/27/05	Lori McKenna	Bittertown	WB Nashville	Country	
9/27/05	8Ball & MJG	TBO	Bad Boy	Rap	

Source: Company Data, Billboard, MTV, VH1

Figure 10: Warner Music Group – 3Q06 Releases and Pipeline

Date	Artist	Album	Label	Genre	Notes
7/11/06	Pimp C	Pimpalation	Asylum/Rap a Lot	Rap	Debuted #2, 87k units
7/11/06	Muse	Black Holes & Revelations	Warner Bros.		debuted #9, 48k units
7/17/06	Rodney Atkins	If You're Going Through Hell	Curb	Country	
7/17/06	Paolo Nutini	These Streets	WEA Int'l	Rock	
7/25/06	Trae	Restless	Asylum/Rap-A-Lot	RAP	
7/25/06	Tom Petty	Highway Companion	American/Warner Bros.	Rock	debuted #4, 112k units
7/25/06	Sammy Hagar	Livin' It Up	Rhino	Rock	
7/25/06	Toby Lightman	Bird on a Wire	Lava	Soul	
7/25/06	Various Artists	Miami Vice Motion Picture Soundtrack	Atlantic	Soundtrack	
8/1/06	Kill Hannah	Until There's Nothing Left of Us	Atlantic/WEA	Alt Rock	
8/8/06	Slayer	Christ Illusion	American/Warner Bros.	Metal	debuted #6, 67k units
8/8/06	Cassie	Cassie	Bad Boy	R&B	debuted at #4 with 100k units
8/15/06	Cham	Ghetto Story	Atlantic/WEA	Dancehall Reggae	debuted at #53 with 15k units
8/22/06	Paris Hilton	Paris	Warner Bros.	Pop	debuted at #6 selling 77k units
8/22/06	Danity Kane	Danity Kane	Bad Boy	R&B/Hip Hop	debuted at #1 and sold 495k in 4 wks
8/22/06	Trillville Mafia	It Goes Without Sayin'	Rap-A-Lot (Wea)	Rap	
8/22/06	Hana	Amor Es Combate	WEA Latina	Latin Rock	debuted at #4 with 87k units
8/22/06	The Casualties	Under Attack	Side One Dummy/ADA	Punk Rock	
8/23/06	Tego Calderon	The Underdog/El Subestimado	Atlantic/Siguiri	Reggaeton	debuted at #43
9/28/06	The Black Crowes	The Lost Crowes	Rhino	Rock	
9/29/06	Dream Theater	Orchestra	Rhino	Rock	
9/29/06	Young Dro	Best Thang Smokin'	Grand Hustle/Atlantic	Rap	debuted #3 with 104k units
9/12/06	The Black Keys	Magic Potion	Nonesuch	Rock	
9/12/06	Kelsey Chambers	Carnival	Warner Bros.	Country Rock	
9/12/06	Everclear	Welcome to the Drama Club	Eleven Seven/ADA	Rock	
9/12/06	Heavens	Patent Pending	Epitaph/ADA	Alt Rock	
9/12/06	Yo La Tengo	I am Not Afraid of You and I will Kick Your Ass	Matadors/ADA	Alt Rock	
9/12/06	Governor	Son of Faith	Atlantic	R&B/Soul	
9/12/06	Mastodon	Blood Mountain	Reprise	Metal	debuted at #32 with 24k units
9/12/06	Sugarcult	Lights Out	V2/Warner Bros.	Rock	
9/19/06	Jane's Addiction	Up from the Catacombs: Best of Jane's Addiction	Rhino	Rock	
9/19/06	Little Feat	The Best of Little Feat	Rhino	Country Rock	
9/19/06	Various Artists	A Life Less Lived: The Gothic Box	Rhino	Rock	four disc box set of Gothic Rock
9/19/06	Lupe Fiasco	Food & Liquor	Atlantic/WEA	Hip Hop	Debut Album, expected to sell 190k in wk 1
9/26/06	Christian Daniel	Christian Daniel	Bad Boy	Latin	
9/26/06	Mute Math	Mute Math	Warner Bros.	Alt Rock	Underground following
9/26/06	Tori Amos	A Piano: The Collection	Rhino	Folk Rock	5 disc Box Set
Sept 2006	Jordan McCoy	TBD	Bad Boy	Pop	

Source: Company Data, Billboard, MTV, VH1

Figure 11: Warner Music Group – 4Q05 Releases

Date	Artist	Album	Label	Genre	Notes
10/4/05	James Blunt	Back to Bedlam	Atlantic	Rock	Debut; Sold 3.5M WW, 9wk #1 UK
10/4/05	O.A.R.	Stories of a Stranger	Atlantic	Rock	Sold 54k units week 1
10/4/05	Simple Plan	MTV Hard Rock Live	Atlantic	Rock	Live follow-up to Platinum Debut
10/4/05	Gerald Levert	Voices	Elektra	R&B	
10/4/05	Inf Noise Conspiracy	Armed Love (US Bonus Tracks)	Reprise	Rock	
10/4/05	Shinedown	Us & Them	Atlantic	Rock	Sold 55k units in week 1
10/4/05	Trina	The Glamorest Life	Atlantic	Rap	Sold 75k units week 1
10/4/05	Twista	The Day After	Atlantic	Rap	Sold 116k units Wk 1
10/4/05	Deftones	B-Sides & Rarities	Maverick	Rock	sold 37k week 1
10/8/05	Talking Heads	Catalog Dual Discs (Remastered + additions)	Rhino	Rock	
10/11/05	Story of the Year	In the Wake of Determination	Maverick	Rock	2003 Page Avenue sold .6M
10/11/05	Wanna G	In the Mid-Nite Hour	Warner Bros.	Rap	2001 release sold 37k units week 1
10/18/05	Bun B	Trill	Rap-A-Lot (Wea)	Rap	Debut Album
10/18/05	Depeche Mode	Playing the Angel	Reprise	Alt	New Studio Album
10/18/05	Black Rob	Rob Report	Bad Boy	Rap	2000 Life Story sold .9M
10/25/05	Yukmouth	Million Dollar Mouth Piece	Asylum/Rap-a-lot	Rap	
11/8/05	D4L	Down For Life	Dee Money/Asylum	Rap	Single Laffy Taffy climbing chart
11/8/05	Loggins & Messina	Live Still Again Santa Barbara Bowl	Rhino / Wea	Rock	Live album from reunion tour
11/8/05	Trillville	Trillville: Reloaded	Warner Brothers	RAP	2004 debut sold 55k wk 1
11/8/05	Alanis Morissette	Collection	Maverick	Rock	
11/15/05	Green Day	Bullet in a Bible - Live	Reprise	Rock	American Idiot Multiplat
11/15/05	Madonna	Confessions on a Dance Floor	Warner Bros.	Dance	Debuted #1 in 25 countries
11/15/05	Big & Rich	Comin' to your City	Warner Bros.	Country	2004 album Multi-Plat
11/22/05	Enya	Amarantine	Reprise	New Age	2000 album multi platinum
11/22/05	Various Artists	Rent Motion Picture Soundtrack	Warner Bros.	Soundtrack	Sold 41k in week 1
11/22/05	Fort Minor	Rising Tide	Machine Shop/ WB	Hip Hop	Linkin Park Side Project
11/22/05	Michael Buble	Michael Buble Live	Reprise/WEA	Jazz	2005 It's Time went Platinum
11/22/05	Michael Buble	Caught in the Act	Reprise/WEA	Jazz	2005 It's Time went Platinum
11/22/05	Ray Scott	My Kind of Music	WB Nashville	Country	
11/22/05	Crune	A Hustler's Love Story	Warner Bros.	R&B	
11/29/05	The Darkness	One Way Ticket to Hell...and Back	Atlantic	Rock	2003 debut multi-plat WW
11/29/05	Laura Pausini	Live in Paris '05	WEA	Latin	
11/29/05	The Everly Brothers	The Golden Years	WEA	Rock	
12/6/05	Veronique Sanson	Olympia 2005	WEA	Rock	
12/6/05	Sin Ward Boys	Gangsta Funk (Chopped/Screwed)	Asylum/Rap a Lot	Rap	
12/6/05	New Order	Singles	Rhino	Alternative	
12/6/05	Sin Ward Boys	Rated G (Chopped/Screwed)	Asylum/Rap a Lot	Rap	
12/13/05	Luis Miguel	Grandes Exitos Deluxe	Warner Bros.	Latin	
12/13/05	Cream	Royal Albert Hall London 2 3 5 6 '05	Reprise/WEA	Rock	
12/13/05	Various Artists	LOTR: Fellowship of the Ring	Reprise	Soundtrack	
12/13/05	Paolo Conte	Live in Arena Di Verona	WEA	Jazz	
12/13/05	Various	The Source Presents Hip Hop Hits 1	Rhino/WEA	Hip Hop	
12/13/05	The Cons	All the Way Home: Live in Genova	WEA	Rock	
12/13/05	Simply Red	Cubal	WEA	Rock	
12/20/05	Notorious B.I.G.	The Notorious B.I.G. Duets	Bad Boy	Rap	Posthumous Duets Album
12/20/05	John Ozzajca	First Sign of Anything	Warner Bros.	Rock	
12/20/05	Various Artists	Invite Them Up	Comedy Central/ADA	Comedy	
12/20/05	Tony Hustle	Sexy Freaky Electric	Reprise/WEA	R&B	
12/20/05	Phish	Live at Madison Square Garden NYE 1995	Rhino/WEA	Rock	

Source: Company Data, Billboard, MTV, VH1

Figure 12: Warner Music Group – 4Q06 Release Pipeline

Date	Artist	Album	Label	Genre	Notes
10/3/06	Lindsey Buckingham	Under the Skin	Warner Bros.	Pop Rock	Fleetwood Mac frontman, first album in 14 years
10/3/06	Jet	Shine On	Atlantic	Rock	2003 Get Born sold 1.6M copies in US
10/3/06	Skillet	Comatose	Atlantic/WEA	Rock	
10/3/06	Pepper	No Shame	East West/Atlantic	Rock	
10/17/06	P Diddy	Press Play	Bad Boy	Hip Hop	
10/24/06	My Chemical Romance	The Black Parade	Reprise	Rock	2004 Release sold 2M WW
10/24/06	Wilco	Sunken Treasure: Jeff Tweedy Live	Nonesuch	Rock	
10/31/06	The Deftones	Saturday Night Wrist	Maverick	Rock	
Oct 2006	Federation	It's Whatever	Warner Bros.	Rap	
Oct 2006	Eightball & MJG	TBD	Bad Boy	Rap	
11/7/06	Talib Kweli	Ear Drum	Blacksmith/WB	Hip Hop	
11/7/06	Josh Groban	Awake	Reprise/WEA	Classical	2003's Closer sold 5M copies in US
Dec 2006	Paul Wall	Get Money Stay True	Atlantic	Rap	2005 release debuted #1, 173k units

Source: Company Data, Billboard, MTV, VH1

EXHIBIT CO 0958

Company Focus

Europe United Kingdom
Media Publishing

Deutsche Bank

4 April 2005

EMI

Reuters: EMI.L Bloomberg: EMI LN Exchange: LSE Ticker: EMI.L

Going digital - upgrading to Buy

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Upgrading to Buy and raising target price to 310p
The music industry is undergoing a fundamental transformation: digital music revenues are opening up incremental revenue streams leading to margin benefits that should underpin significant revenue and profit growth. On 11.5x CY2007E earnings the stock is trading on an unwarranted 15% discount to the sector.

Digital drives fundamental industry transformation
Digital distribution marks a fundamental and irreversible transformation in the economics of the music industry. The emergence of a viable commercial retail model for downloads, increasing broadband penetration and advances in mobile phone technology increase the potential consumer base for recorded music and all provide significant incremental revenue opportunities.

Return to revenue growth and peak margins
Incremental revenues and the substantial margin benefits of digital music sales should bring EMI's recorded music division back to revenue growth and peak margins. We forecast FY2005-10E revenue CAGR of 3%, and 16.4% EBITA margins for recorded music by FY2010. Our sensitivity analysis of consumer behaviour indicates that the market is currently discounting too bearish a view of the substitutional effects of digital music; and we see further potential upside should our digital revenue growth assumptions prove conservative. We upgrade our mid-term forecasts, which are now at the upper end of consensus.

Attractive valuation – we see 31% upside potential
In our view, EMI is attractively valued, trading on 11.5x 2007E P/E versus a sector median of 13.5x, a 15% discount, which we regard as unwarranted. Historical P/E analysis suggests that the shares should trade at 17.5x forward earnings, implying a target price of 310p. Our DCF target is 323p. Key risks are loss of market share, key artists or management, a further decline in global music sales and adverse currency movements.

Forecasts and ratios

Year End Mar 31	2003A	2004A	2005E	2006E	2007E
Revenue (GBP)	2,175	2,121	1,917	1,942	1,980
EBITA (GBP)	297	284	253	302	331
PBT OB (GBP)	177	153	135	186	219
EPS consensus	NA	NA	12.40	14.60	16.00
DB EPS (GBP)	15.54	14.24	12.30	16.32	18.58
OLD DB EPS (GBP)	15.54	14.24	12.25	15.08	16.73
% Change	0.0%	0.0%	0.4%	8.2%	11.0%
DB EPS growth (%)	14.4	-8.4	-13.7	32.7	13.8
P/E (DB EPS) (x)	12.5	11.7	19.0	14.3	12.6
EV/EBITDA (x)	8.0	7.2	10.6	8.8	7.9
DPS (GBP)	8.00	8.00	8.00	8.00	8.00

Source: Company data, Deutsche Bank estimates

Emerging Themes

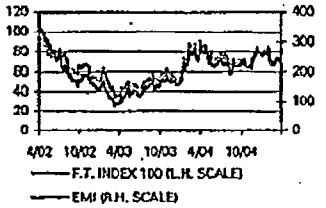
Buy

Price at 4 Apr 2005 (GBP)	236.75
Price Target (GBP)	310.00
52-week range (GBP)	281.25-191.00

Key Statistics

Rating	Hold to Buy ↑	
Target Price	215.00 to 310.00 ↑	44.2%

Price/Price Relative



Performance(%)	1m	3m	12m
Absolute	4.7	-8.9	-11.6
F.T. INDEX 100	-1.7	2.1	11.4

Stock Data

Market cap (GBP)	1,908.3
Shares outstanding (m)	872
Free float (%)	100
F.T. INDEX 100	4,914.9

Upcoming Events

	Date
FY2005 results	24 May 2005
AGM	14 July 2005

Deutsche Bank AG

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DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1

Model updated: 23 March 2005

Equity Research

Europe

UK

Publishing

EMI

Reuters: EMI.L Bloomberg: EMI LN

Buy

Price as of 30 March	GBp 233.75
Target price	GBp 310.00

Company website

http://www.emigroup.com

Company description

EMI Group plc is the world's largest music publisher and 3rd largest recorded music company. The company records, manufactures and markets recorded music from more than 1,500 artists. EMI is also the world's largest music publisher and owns the copyrights to more than 1 million compositions.

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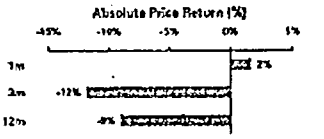
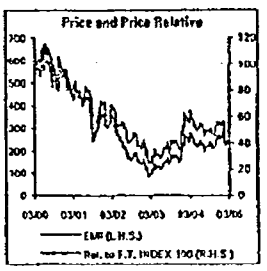
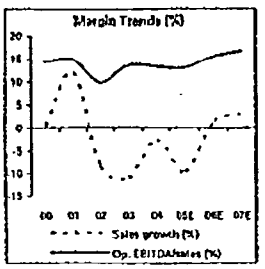


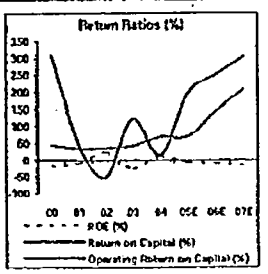
52-week Range:	GBp 191.00 - 281.25
Market Cap (m)	GBP 1,836
	USD 3,457

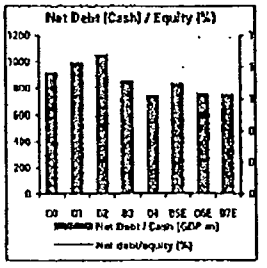
Company Identifiers	
Cusip	NA
SEDOL	0044473

Year Ending 31 March	2000	2001	2002	2003	2004	2005E	2006E	2007E
SUMMARY								
Headline EPS (GBp)	18.95	22.50	13.59	15.54	14.24	12.30	16.92	18.58
P/E ratio Headline (x)	29.0	25.4	27.2	12.5	11.7	19.0	14.3	12.6
Headline EPS growth (%)	1.7	18.7	-39.6	14.4	-8.4	-13.7	32.7	13.8
EPS FD (GBp)	19.06	10.15	-25.43	28.76	-9.07	6.00	10.93	13.18
P/E ratio FD (x)	27.5	56.2	nm	8.7	nm	33.9	21.4	17.7
Operating CFPS (GBp)	11.43	19.71	16.20	8.65	22.90	11.09	16.38	20.68
Free CFPS (GBp)	4.70	15.42	10.88	-1.06	15.85	4.72	10.65	14.95
P/CFPS (x)	48.1	28.9	22.8	22.4	7.3	21.1	14.3	11.3
DPS (GBp)	16.00	16.00	10.30	8.00	8.00	8.00	8.00	8.00
Dividend Yield (%)	2.8	2.8	2.7	4.1	4.8	3.4	3.4	3.4
BV/Share (GBp)	-93.41	-99.65	-131.60	-88.41	-99.95	-105.06	-101.88	-95.19
Price/BV (x)	nm	nm	nm	nm	nm	nm	nm	nm
Weighted average shares (m)	779	779	783	784	784	785	785	785
Average market cap (GBP m)	4,260	4,443	2,050	1,518	1,311	1,836	1,838	1,838
Enterprise value (GBP m)	5,200	5,437	3,049	2,378	2,048	2,678	2,648	2,599
EV/Sales	2.18	2.03	1.51	1.09	0.97	1.40	1.36	1.30
EV/EBITDA	15.0	13.6	16.3	8.0	7.2	10.6	8.8	7.9
EV/EBIT	21.0	18.5	28.3	11.3	10.3	15.3	11.8	10.1
EV/Operating Capital	10.0	11.6	11.5	5.8	11.7	18.6	40.9	26.8
INCOME STATEMENT (GBP m)								
Sales revenue	2,383	2,672	2,446	2,175	2,121	1,917	1,942	1,959
Operating EBITDA	346	399	242	297	284	253	302	331
Depreciation	59	67	51	43	35	30	29	28
Amortisation	39	54	51	43	51	47	47	47
EBIT	248	279	139	211	198	175	225	256
Net interest income(expense)	-50	-74	-60	-76	-96	-87	-66	-64
Associates/affiliates	4	1	23	-1	0	0	0	0
Investment/other income(expense)	0	0	0	0	0	0	0	0
Exceptionals/extraordinaries	47	-43	-254	185	-155	0	0	0
Income tax expense	71	71	38	84	20	32	47	59
Minorities/preference dividends	22	13	9	10	7	4	5	6
Net income	156	79	-199	226	-79	53	88	107
CASH FLOW (GBP m)								
Cash flow from operations	89	154	127	68	180	87	129	162
Movement in net working capital	-88	-15	89	-104	60	38	-12	-16
Capex	-52	-33	-42	-76	-65	-50	-45	-45
Free cash flow	37	120	85	-8	124	37	84	117
Other investing activities	-69	-15	-24	221	-11	-35	15	0
Equity raised(bought back)	4	1	0	0	0	0	0	0
Dividends paid	-158	-125	-126	-29	-63	-64	-63	-63
Net inc(dec) in borrowings	0	0	0	0	0	0	0	0
Other financing cash flows	11	-53	-1	16	60	0	0	0
Total cash flows from financing	-143	-177	-126	-13	-3	-64	-63	-63
Net cash flow	-196	-72	-65	199	111	-62	36	55
Movement in net debt(cash)	196	72	65	-199	-111	62	-38	-55
BALANCE SHEET (GBP m)								
Cash and other liquid assets	260	137	86	100	345	345	345	345
Tangible fixed assets	337	307	277	289	203	195	184	189
Goodwill	27	61	34	56	32	28	24	20
Other intangible assets	521	547	518	451	449	468	437	406
Associates/investments	0	0	0	0	0	0	0	0
Other assets	1,012	1,115	1,001	1,036	958	795	784	814
Total assets	2,164	2,168	1,916	1,933	1,887	1,821	1,783	1,774
Interest bearing debt	1,189	1,130	1,144	961	1,094	1,186	1,104	1,095
Other liabilities	1,703	1,676	1,661	1,533	1,509	1,389	1,403	1,352
Total liabilities	2,892	2,806	2,805	2,494	2,603	2,575	2,507	2,447
Shareholders' equity	-728	-776	-1,030	-693	-784	-825	-800	-755
Minorities	0	138	141	133	68	71	76	82
Total shareholders' equity	-728	-640	-889	-560	-716	-754	-724	-674
Net working capital	-247	-307	-339	-358	-515	-553	-566	-524
Net debt(cash)	921	994	1,059	860	749	840	759	750
Capital	194	354	170	300	92	86	35	76
RATIO ANALYSIS								
Sales growth (%)	0.4	12.1	-8.5	-11.1	-2.5	-9.6	1.3	2.9
Op. EBITDA/sales (%)	14.5	14.9	9.9	13.7	13.4	13.2	15.5	16.6
EBIT/sales (%)	10.4	10.4	5.7	9.7	9.4	9.2	11.6	12.8
Payout ratio (%)	78.9	156.8	nm	27.6	nm	119.1	71.5	58.4
ROE (%)	-20.5	-10.6	22.1	-26.2	10.2	-7.5	-11.7	-14.8
Return on Capital (%)	306.9	44.4	-53.1	120.0	12.7	195.4	261.0	305.2
Operating Return on Capital (%)	45.0	31.8	34.3	41.5	67.8	70.2	143.4	207.7
Capex/sales (%)	2.2	1.3	1.7	3.5	2.6	2.6	2.3	2.3
Capex/depreciation (x)	0.9	0.5	0.8	1.8	1.6	1.6	1.5	1.5
Net debt/equity (%)	nm	nm	nm	nm	nm	nm	nm	nm
Net interest cover (x)	5.0	3.8	2.3	2.8	2.1	2.0	2.6	3.1









Source: Company data, Deutsche Bank estimates

Investment thesis

Digital music to drive top line and margin recovery

The recorded music market is entering a new growth phase driven by a stabilisation of physical format and dramatic growth in digital music sales. Legal music downloads and master tone downloads for mobile devices should bring about substantial revenue and margin benefits for the music industry: these include incremental revenue streams, a more profitable catalogue mix, negligible manufacturing and distribution costs as well as working capital benefits. On our raised forecasts, we see EMI growing recorded music revenues by 3% CAGR FY2005-10E. We forecast the company to generate 27.5% of recorded music revenues from digital by FY2010E, leading to a divisional EBITA margin pre-overhead of 16.4% up from 9.3% in FY2005E.

Figure 1: Revenue and margin outlook summary for recorded music

Revenue stream from ...	Mid-term revenue outlook	Margin impact
Physical album sales	-	0
Music DVDs	+	0
Downloads	++	++
Master tones	+++	++

Source: Deutsche Bank

Our analysis of the substitutional effects of digital music sales indicates that the market is currently discounting 75%/50% of download/master tone revenues cannibalising physical format sales by 2010, which we feel is an overly bearish scenario. Our base case assumes that 100% of master tone revenue and 75% of download revenues are initially incremental, dropping to 90% and 65% by FY2010 respectively. This scenario implies -3% 2005-10E CAGR for physical formats more than offset by 71% growth in digital music revenues, resulting in overall recorded music CAGR of 3% for the division. If we left our assumptions on the substitutional impact unchanged but raised our FY2005-10E digital revenue growth CAGR from 71% to 77% this would raise the fair value of the shares from 310p to 390p.

Valuation

In our view, EMI is attractively valued, trading on 11.5x calendar 2007E earnings against a sector median of 13.6x, a 15% discount, which we believe is unwarranted. Historical P/E analysis suggests that the shares would be more fairly valued at around 17.5x forward earnings, implying a target price of 310p. Our DCF, using terminal growth rates of 2% for music publishing and 3% for recorded music, generates a 323p target. The 3.4% dividend yield should also support the share price around current levels. Our detailed valuation of EMI's music publishing business using four different valuation techniques gives us a fair value for the business of £1.04bn equal to 10.1x 2006E EV/EBITA or 5.7x 2006E NPS. On our 310p target price the implied valuation of the rump recorded music business would be 11.2x 2006E EV/EBITA, which we see as fair given the improving margin profile and revenue growth going forward and a sector average of 11.5x.

Risks

Potential risks to our estimates and Buy case would be a deterioration in global music sales and adverse currency movements and, more specific to EMI, loss of market share, key artists and/or management.

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Valuation

Upgrading medium-term estimates

We upgrade our mid-term revenue and margin assumptions for EMI on a group level driven by an improving outlook for recorded music from growing digital music sales. We upgrade our FY2006-07E EPS forecasts by 8-11% and raise our EBITA margin forecasts from 13.3% and 14.2% to 14.0% and 15.2% respectively. For FY2005 we forecast £135m of adjusted PTP in line with recent management guidance of *"around £138m"*. Below we set out the key changes to our estimates for EMI.

Figure 2: EMI Group forecast changes

FY ending March 31	2006E old	2006E new	% change	2007E old	2007E new	% change
Turnover	1962	1,942	-0.5	1991	1,999	0.4
y-o-y growth (%)	1.1	1.3		2.0	2.9	
EBITA	259	272	5.1	282	303	7.5
Margin (%)	13.3	14.0		14.2	15.2	
Normalised PTP	172	186	8.3	198	219	10.8
Normalised EPS	15.1	16.3	8.1	16.7	18.6	11.1

Source: Deutsche Bank

Recorded Music: Raising mid-term forecasts

Our positive stance on the growth prospects of digital music causes us to factor in a more vigorous top line recovery than we have previously forecast. We now expect EMI to start showing positive top-line growth in FY2006, mainly driven by expected market share gains from the delayed Coldplay and Gorillaz releases in H106. We note that FY2006 should be the first year of positive revenue growth for EMI since FY2001. For FY2007 we increase our revenue growth rate from 2 to 3%, which compares to global recorded music industry growth rates from 2001-04 of -8.9%, -7.0%, -7.4% and -1.4%. We are also raising our EBITA margin forecasts substantially, mainly due to the margin benefits of digital sales representing a higher proportion of the mix. For FY2005 we are looking for an 8% pre-currency revenue decline in line with recent company guidance of -8-9%.

Figure 3: Recorded Music division forecast changes

FY ending March 31	2006E old	2006E new	% change	2007E old	2007E new	% change
Turnover	1,554	1,545	-0.6	1,583	1,590	0.5
y-o-y growth (%)	1.1	1.2		1.9	3.0	
EBITA	158	172	9.0	179	200	11.7
Margin (%)	10.2	11.1		11.3	12.6	

Source: Deutsche Bank

Music Publishing: Tweaking

We also fine-tune our Music Publishing forecasts to take into account currency movements in FY2005, which slightly lowers the base for FY2005 and hence also affects 2006/07E forecasts.

Figure 4: EMI Music publishing division forecast changes

FY ending March 31	2006E old	2006E new	% change	2007E old	2007E new	% change
Turnover	398	397	-0.2	408	408	0.0
y-o-y growth (%)	-1.9	1.8		2.4	2.7	
EBITA	101	100	-0.9	103	103	0.
Margin (%)	25.4	25.2		25.2	25.3	

Source: Deutsche Bank

Attractive on multiples

On our revised estimates, EMI shares look attractively valued relative to the sector on multiples. As Figure 5 shows, on P/E and EV/EBITDA the stock trades at 15% and 3% discounts on calendarised 2007E multiples. We believe these discounts to be unjustified due to the improving long-term growth outlook for recorded music and the margin benefits that digital music revenues bring about. Our new target price implies 15x our calendarised 2007E earnings, which would put the shares at a slight premium to the sector. We are comfortable with this, given that our forecast EPS and EBITDA 2005-07E CAGR for EMI are significantly higher than those for the sector: EMI's EPS growth of 23% compares to the sector at 11% and its EBITDA growth rate of 14% is also more than 50% higher than the sector's at 9%.

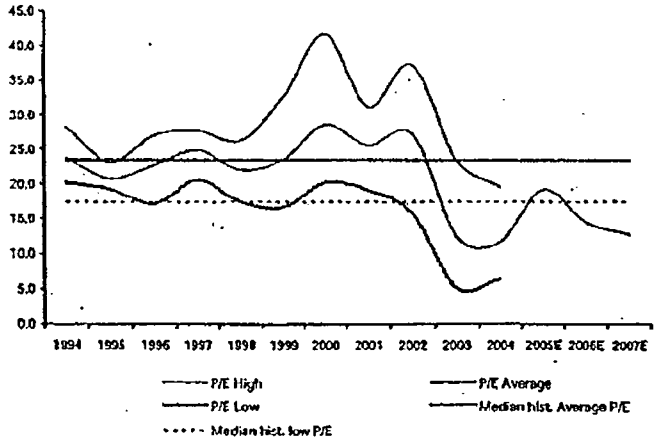
Figure 5: EMI multiples vs. the Media sector (calendarised)

	2005E	2006E	2007E
EMI P/E	15.6	13.3	11.5
Media sector median P/E	15.9	14.5	13.5
EMI Premium/(Discount) to sector (%)	-2.0	-8.6	-15.1
EMI 2005-07E EPS CAGR (%)	22.9		
Media sector 2005-07E EPS CAGR (%)	11.1		
EMI EV/EBITDA	10.1	8.9	7.8
Media sector median P/E	8.8	8.8	8.1
EMI Premium/(Discount) to sector (%)	3.1	1.6	-3.2
EMI 2005-07E EBITDA CAGR (%)	14.4		
Media sector 2005-07E EBITDA CAGR (%)	9.1		

Source: Deutsche Bank

Looking at where EMI has historically traded on a P/E basis, we see that the current P/E valuation is close to historical lows. As Figure 6 shows, the median historic low for EMI's P/E is 17.5x forward earnings, against the current 13x on our calendarised 2006E forecasts. With the recorded music market likely to return to growth next year, the stock should re-rate back to its historic median, which also equals our new 310p target price on our calendarised 2006E EPS estimates.

Figure 6: EMI Group historical P/E multiples



Source: Datastream, company data, Deutsche Bank estimates

DCF highlights long-term value

Our DCF calculation underpins the long-term value accretion that the transformation of the industry should bring about for EMI. Assuming a conservative terminal growth rate of 2% for music publishing and 3% for recorded music and applying a WACC of 8.6% our DCF calculation suggests fair value at 323p, which is above our new target price and supports our positive view on the stock. Were we to increase the terminal growth rates to 4% in recorded music this would increase our DCF target to 369p.

Key DCF assumptions

Our key assumptions are set out below. Our 6.5% cost of debt is derived from EMI's market cost of debt implied by current bond prices. We have also assumed a normalized tax rate of 32% (against FY2005E forecast 24%), because we believe that the current rate is artificially low due to tax loss carryforwards in the US and estimated low profitability in Japan, which we expect to normalise going forward.

Figure 7: EMI DCF assumptions

Risk free rate (%)	4.7
Equity risk premium (%)	5.0
Beta	1.0
Cost of Equity (%)	9.7
Nominal cost of debt (%)	6.5
Tax rate (%)	32
Post-tax cost of debt (%)	4.4
Debt as % EV	20
WACC (%)	8.6

Source: Deutsche Bank

Below we set out our divisional mid-term forecasts.

Figure 8: EMI DCF (£ m)

FY ending 31 March	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E
Music Publishing								
EBITA	98	100	103	107	114	118	121	124
Margin (%)	25.0	25.2	25.3	25.5	25.9	26.1	26.1	26.2
Depreciation	5	5	5	5	5	5	5	5
Utilisation Of Provisions	-1	-1	0	0	0	0	0	0
Working Capital	12	-4	-5	-8	-6	-3	-3	-2
Capex	-5	-5	-5	-5	-5	-5	-5	-5
Tax charge	-23	-25	-28	-32	-35	-38	-39	-40
Other cash items	-2	-2	-2	0	0	0	0	0
Unlevered FCF	83	69	69	67	72	78	79	82
Recorded Music								
EBITA	125	172	200	238	264	271	281	283
Margin (%)	8.2	11.1	12.6	14.1	15.1	15.4	15.6	15.6
Depreciation	25	24	23	23	24	40	40	40
Utilisation Of Provisions	-4	-3	0	0	0	0	0	0
Working Capital	27	-9	-11	-20	-16	-7	-7	-5
Capex	-45	-40	-40	-40	-40	-40	-40	-40
Tax charge	-29	-43	-54	-71	-82	-87	-90	-91
Other cash items	-8	-7	-7	0	0	0	0	0
Unlevered FCF	91	94	110	130	151	178	184	188
Discount factor	0.99	0.91	0.84	0.77	0.71	0.66	0.60	0.55
Combined NPV of FCF	173	149	160	153	150	167	159	150
Sum	1,260							

Source: Deutsche Bank

Long-term growth profile for music shifting up

With digital distribution opening up new revenue streams from downloads and mobile music, we believe that it would be unduly conservative to assume a terminal decline or flat growth outlook for music. Given that both recorded music and music publishing divisions for EMI will benefit from the migration towards digital, we believe that a more bullish outlook for terminal growth rates is warranted. Our base case currently assumes 3% for RM and 2% for music publishing resulting in a valuation of 323p per share or 36% upside potential from current levels. Should our medium-term growth outlook in recorded music be too conservative, then we could justify upgrading growth rates to 3 and 4% respectively, which would increase our target price to 383p.

Figure 9: Terminal growth rate sensitivity (share price in £)

	Recorded Music (%)						
Music Publishing (%)	-2	-1	0	1	2	3	4
-2	1.94	2.06	2.20	2.38	2.62	2.94	3.39
-1	1.99	2.11	2.25	2.43	2.67	2.99	3.44
0	2.05	2.17	2.31	2.50	2.73	3.06	3.51
1	2.13	2.25	2.39	2.57	2.81	3.13	3.59
2	2.24	2.35	2.50	2.68	2.91	3.23	3.69
3	2.38	2.49	2.64	2.82	3.05	3.37	3.83

Source: Deutsche Bank

Sensitivity to substitutional effects of digital shows upside

The market is at the moment uncertain about the potential cannibalisation effects of digital music sales on physical formats given the early stage of transition. We have separately modelled download and master tone revenues and have then run a sensitivity analysis on the potential share price impact of revenue cannibalisation. Our modelling suggests that EMI's current share price discounts too pessimistic a view on the substitutional effects.

At 237p, the market is allowing only around 25% of download revenues and 50% of master tone revenues to be incremental to physical sales based on our forecasts. We think this is too bearish a view because we believe all current master tone sales to be incremental and 75% of download revenues. Our base case scenario analysis ties in with our new price target of 310p, implying 31% price upside. If we left our assumptions on the substitutional impact unchanged but raised our FY2005-10E digital revenue growth CAGR from 71% to 77% this would increase the fair value of the shares from 310p to 390p. We explain our modelling here in more detail in the recorded music section of this report.

Figure 10: EMI share price sensitivity to consumer behaviour in digital

Price on 15x 12mth fwd FY 2009 P/E	250	300	350	400	420	450	500
Required FY 2009 EPS	16.7	20.0	23.3	26.7	28.0	30.0	33.3
PV share price	195	234	273	312	328	351	390
Up/(Down) side from current price (%)	-17	0	17	34	40	50	67
Assumptions to get to required FY 2009 EPS							
Incremental % share of total download revenues (%)	10	25	50	75	100	75	75
Incremental % share of total mastertone revenues (%)	15	50	75	100	100	100	100
Output & implied growth rates							
Digital sales % of total RM sales by FY 2010 (%)	34.6	31.7	29.4	27.4	26.6	35.0	38.8
Digital sales growth CAGR FY2005-10 (%)	71.0	71.0	71.0	71.0	71.0	73.0	77.0
Physical sales growth CAGR FY2005-10 (%)	-9.2	-6.5	-4.5	-3.0	-2.1	-3.9	-4.4
Total RM sales growth CAGR FY2005-10 (%)	-1.7	0.0	1.5	3.0	3.7	4.1	4.9

Source: Deutsche Bank

How much is Music Publishing worth?

Our analysis of the fair value of EMI's music publishing division takes into account how much capital has been invested in the business over time, the respective returns and the market multiples of comparable businesses. Our final blended valuation of EMI's music publishing division using DB's CROCI methodology, multiples and DCF valuation approaches, values the business at an EV of around £1.1bn, equal to 10.1x 2006E EV/EBITA or 5.7x 2006E NPS. We explain our valuation approaches and outcomes in more detail later in the note.

Dividend sustainable

EMI is currently paying an 8p dividend per share or around £63m pa, offering investors a yield of 3.4%. We feel that this level of dividend is sustainable going forward despite three liabilities (£67m, £325m and £270m) maturing over the next four to five years. Below we set out our free cash flow forecasts taking into account EMI's debt maturity profile.

Figure 11: EMI free cash flow and bond redemption profile (£ m)

FY 31 March	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E
Free cash flow pre-dividends	37	84	117	143	194	244	259	269
Dividends @ 8p per share	-63	-63	-63	-63	-63	-63	-63	-63
Free Cash Flow post dividends	-26	21	55	80	131	181	196	206
Bond redemption	0	0	0	-67	-325	-270	0	0
Free cash flow post dividends and bond redemption	-26	21	55	13	-194	-89	196	206

Source: Deutsche Bank & company data

Note the following:

- EMI should be able to pay back the £67m privately placed bond in FY2008 and still generate positive Free Cash Flow post the redemption on our estimates.
- EMI's two largest bonds that mature in FY2009/10 (£325m and £270m respectively), within our FY2005-12 time horizon, affect free cash flow post dividends in both years. We would at this stage not anticipate any problems with EMI refinancing some of this debt at the time of repayment, should this be necessary. At end FY08 net debt to EBITDA would be around 1.9x on our estimates. Given the above Free Cash Flow profile and what we expect to be an improved industry outlook, EMI should be able to refinance the amounts needed at lower rates than the current 8.6% and 9.3% coupons. Taking into account that EMI's current market-based cost of debt is around 6.5% for 7-year maturity, we would expect lower refinancing rates in FY 2009/10, which should lead to overall lower interest costs.
- We assume full conversion of the 2010 convertible bond (strike 191p), where the conversion does not affect cash flow.
- We would expect EMI to be able to renegotiate/effectively extend the £250m revolving credit line post 2007 and have hence not included it in our debt repayment schedule.

Recorded Music: The return to growth

Recorded Music – bring on the delta!

EMI consists of two divisions: Music Publishing (MP) and Recorded Music (RM). Recorded Music is the record sales business (ie specific songs) and the music company records revenue whenever a particular song is sold. Music Publishing owns and exploits the copyrights to *compositions* of songs and receives royalties every time that composition is used in a commercial way (ie sold on CD, played on the radio, performed on stage or shown in advertising etc.).

Both divisions have in the past shown significant differences in performance. Of the two divisions, Recorded Music has been responsible for most of the delta in terms of the group's profitability in absolute and relative terms. As the figure below shows, the divisional EBITA swings here have been significant and range from y-o-y growth rates of -64% to +81%. The corresponding EBITA share of total group EBITA has swung between 44% and 69%.

The main reason for these performance swings is the high operational gearing in RM due a relatively high fixed cost base, particularly prior to the outsourcing of manufacturing that will be completed in FY2006. In contrast, EMI's Music Publishing division is a business with high margins (25-27% EBITA margin) and relatively stable absolute revenue and profit figures due to its broader revenue base and higher variable costs. It is hence a much more predictable business in nature. From the market's perspective, EMI's recorded music (RM) division is the focus of analysis and the reason why we concentrate on it in this report. Note that we have included revenue benefits from digital distribution in our MP forecasts.

Figure 12: EMI divisional revenue and EBITA breakdown (£ m)

FY 31 March	2000	2001	2002	2003	2004	2005E	2006E	2007E
Revenues								
Recorded Music revenues	2,029	2,278	2,029	1,774	1,723	1,527	1,545	1,500
Reported y-o-y growth (%)	-1.4	12.3	-10.9	-12.6	-2.9	-11.4	1.2	3.0
Share of group revenues (%)	85	85	83	82	81	80	80	80
Music Publishing revenues	354	391	417	401	398	390	397	408
Reported y-o-y growth (%)	11.9	10.3	6.6	-3.7	-0.6	-1.9	1.8	2.7
Share of group revenues (%)	15	15	17	18	19	20	20	20
EBITA								
Recorded Music EBITA	192	230	83	151	147	125	172	200
Reported y-o-y growth (%)	5.4	19.9	-63.9	81.2	-2.1	-15.4	38.0	16.1
Margin (%)	9.5	10.1	4.1	8.5	8.6	8.2	11.1	12.8
Share of group EBITA (%)	67	69	44	59	59	56	63	66
Music Publishing EBITA	95	105	108	104	102	98	100	103
Reported y-o-y growth (%)	8.4	10.7	2.8	-3.9	-1.6	-4.0	2.4	3.3
Margin (%)	26.8	26.9	25.9	25.8	25.6	25.0	25.2	25.3
Share of group EBITA (%)	33	32	56	41	41	44	37	34

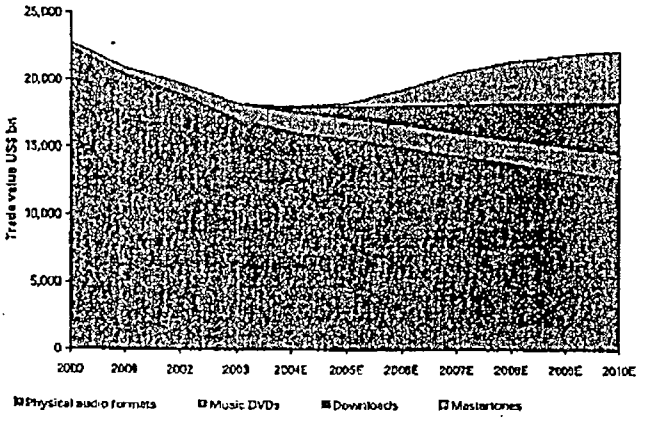
Source: Company data, Deutsche Bank estimates

Top line recovery around the corner ...

We believe that the global music industry is about to enter a new growth p
expect further negative value growth of physical format sales going forward.
mobile master tone sales open up incremental and sizeable revenue streams for the industry and will be the main drivers of growth going forward. We forecast that EMI's top line in recorded Music (RM) will grow 1.2% in FY2006 and 3.0% in FY2007 as CD sales declines bottom out in key markets. Music DVD's continue to post solid growth rates, and digital sales see triple-digit growth rates.

Recently released IFPI figures show that the industry is close to reaching the bottom with a value decline of only -1.4% which follows three years of decline in global music revenues from 2001-03 of 9%, 7% and 7.5% respectively. IFPI expects a bottoming out of the market for 2005, underpinning our view that the industry has reached the bottom and is poised for a new growth stage. We forecast 3% FY2005-10 CAGR for EMI's recorded music division.

Figure 13: Global music market forecast



Source: Deutsche Bank & IFPI

...Driven by downloads ...

The strong take-up of MP3 players and subsequent emergence of viable business models for legal music downloads represents an inflection point for the industry. Incremental download revenues will in our view be a key driver in terms of helping to put recorded music revenue growth back into the black beyond 2005.

MP3 player uptake drives legal download surge

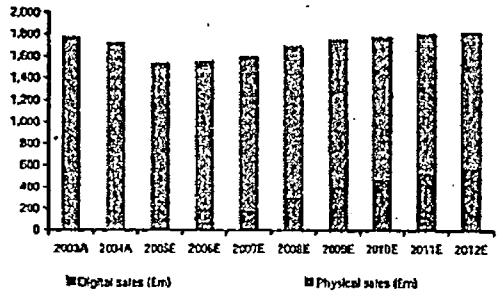
Downloaded music sales have taken off since Apple's launch of iTunes, its online music portal in 2003. The main driver of the immediate success of iTunes was the phenomenal take-up of the iPOD hardware and other portable MP3 players. Since its launch in 2001, Apple has sold more than 10m iPODs of which 4.6m in Q404 alone. This implies an almost doubling of the installed player base in the last reported quarter alone where 4.6m newly shipped units in Q404 compare with an accumulated total at the end of Q304 of 5.7m.

The dramatic increase in the installed MP3 player base has fed through to download sales. Driven by the increased iPOD penetration, Apple has so far sold a total 300m songs via its iTunes download retail websites in North America and Europe. In 2004 in the US alone, 131m single tracks have been sold and the current run-rate for January-February 2005 sales is

running at around 200% y-o-y growth. We estimate that download revenues made up around 2.2% of global recorded music revenues in 2004. With iTunes now live in fifteen countries, which together represent more than 70 percent of the global music market, we are confident of further significant growth opportunities for the industry here.

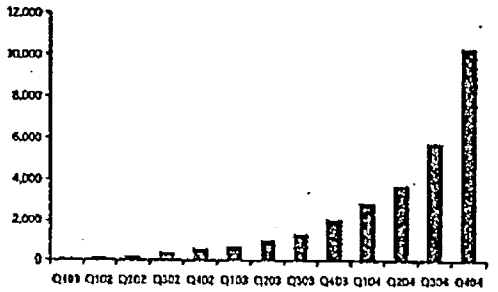
Nielsen Soundscan and BPI data both highlight the last week of December as a record week for the industry with 6.7m and 312k single track downloads in the US and the UK respectively. For the US, by far the largest single download market globally, this equals an implied annual run-rate of close to 350m tracks and Apple recently stated that it is currently selling around 1.25m downloads a day, equalling an annual run-rate of 456m songs; both rates compare against 2004 downloads of 150m or growth rates of 200+%.

Figure 14: EMI recorded music revenue split



Source: Deutsche Bank & Company data

Figure 15: Installed iPOD base (cumulative k units)



Source: Apple & Deutsche Bank

To quantify the revenue opportunities from legal music downloads on a mid-term basis, we have developed a top-down model that is presented in Figure 14. The main outcomes and our assumptions are as follows:

- We expect total download revenues to grow by 44% CAGR from an estimated $650m in 2004 to $5.9bn by 2010. Subscription service based revenue should make up around 50% of total download revenues by 2010.
- The equivalent implied album consumption per user is below three albums pa going forward against a current average album consumption of 11 in the physical world.
- Due to the current skew of download sales towards the US, where EMI has lower market share, we assume EMI's market share in the download market will rise from the current 10% back up to its current global average of 13% as downloads catch up in other regions.
- We assume steady retail pricing of around $1 per song, which we deem reasonable, as we discuss later in the note in our section on pricing. The record label's share of music downloads is 65c per track ie, around 65% of the retail price, which is equivalent to current wholesale margins for physical formats and has been confirmed by the trade press and industry sources.

Figure 16: DB legal download model

Music downloads (US $ m)	2004E	2005E	2006E	2007E	2008E	2009E	2010E	Comments
Installed MP3 player base (m)	12	22	37	61	90	147	176	
Growth (%)		81	67	65	49	63	20	
Non-MP3 player users	2	3	4	5	7	8	9	Just downloading/listening via PC
Growth (%)		50	40	30	20	20	20	
Total legal online users (m)	14	25	41	66	97	155	186	
Growth (%)		77	64	62	46	60	20	
US single track downloads	143	257	412	577	750	899	1,034	
Growth (%)		80	60	40	30	20	15	
Non-US single track downloads	7	14	25	40	56	73	88	
Growth (%)		100	80	60	40	30	20	Assuming 12 month time lag in growth between Europe and US
Total single track downloads (m)	150	271	437	617	806	973	1,122	2004-2010 CAGR 40%
Growth (%)		81	61	41	31	21	15	
Album downloads (m)	38	68	109	154	201	243	281	Currently around a third of single track downloads, slower growth than single tracks due to pricing in line with physical albums
Growth (%)		81	61	41	31	21	15	
Total track downloads (m)	525	950	1,530	2,159	2,821	3,405	3,929	Assuming 10 tracks per album. Launch of iTunes and Napster in Europe on country by country basis in H2 2004
Growth (%)		81	61	41	31	21	15	
Equivalent album consumption p.a./user	3.7	3.8	3.7	3.3	2.9	2.2	2.1	Current album consumption 11.3 p.a.
Price per download (US$)	1.00	1.00	1.00	1.00	1.00	1.00	1.00	
Retail download value (US$ m)	525	950	1,530	2,159	2,821	3,405	3,929	
Growth (%)		81	61	41	31	21	15	
Subscription-revenues (US $ m)	131	332	688	1,080	1,410	1,702	1,964	DB estimates it to be around 50% of download revenue
% share of download revenues (%)	25	35	45	50	50	50	50	
Growth (%)		153	107	57	31	21	15	
Total retail download revenue	656	1,282	2,218	3,239	4,231	5,107	5,893	
Recorded Music share of retail value (%)	65	65	65	65	65	65	65	Based on 99c download, with 65c going to the labels
Total RM download revenues	427	834	1,442	2,105	2,750	3,320	3,830	
EMI market share of downloads (%)	10	10	11	12	13	13	13	
EMI revenues US$m	43	83	159	253	358	432	498	
£/$	1.9	1.9	1.9	1.9	1.9	1.9	1.9	
EMI CY download revenues £m	23	44	84	134	190	230	265	
Growth (%)		95	90	59	42	21	15	

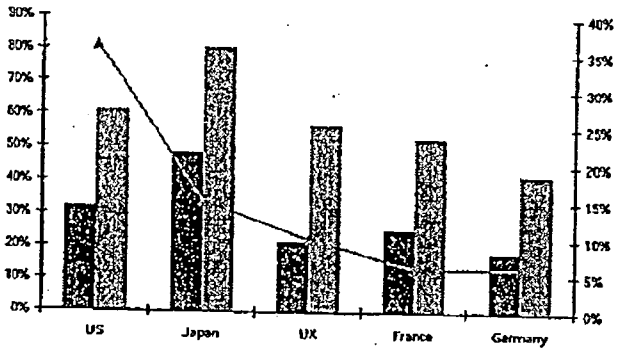
Source: Deutsche Bank

Broadband penetration another driver

Increasing broadband penetration is another key driver of legal music download growth. In recent years we have seen striking increases in broadband penetration rates, enabling music consumers to download digital music at ease. The charts below show that the US and Japan are ahead of most of Europe's major economies in terms of broadband penetration. France, Germany and the UK, the 3rd, 4th and 5th largest music markets globally, lag Japanese and US broadband penetration significantly at the moment but penetration rates should more than double in these markets within the next five years. The relatively high data requirements that come with downloading a song (MP3 coded songs have a size of around 3-5MB in the highest quality level) make broadband effectively a prerequisite to downloading music. The

rise in broadband penetration will hence grow the potential customer- and revenue base for the music industry.

Figure 17: Broadband penetration forecasts for key music markets (%)



Source: Screen Digest, Broadband Intelligence, IDC, IFPI & Deutsche Bank

One main driver of European broadband rates over the next five years should be that the European telecom incumbents continue to aggressively market DSL broadband access lines because they need growing broadband revenues to offset their declining fixed line voice revenues. Recapitalized cable companies are also starting to market high-speed Internet accesses, often as part of "triple-play" (telephone, broadband & TV) product offerings. This will increase the competitive pressure in European broadband and should lead to falling prices and thus a quicker take-up of broadband services by consumers.

Download retail model here to stay

Major technology and retail players have positioned themselves for the distribution of legal downloads, which underpins the faith of the electronics and retail industries in the business model. Since its launch, Apple has been able to maintain a sizeable 75% market share, but other players in the market such as the relaunched (and now legal) Napster, Rhapsody, and Musicmatch, are also gaining scale. A number of third-party retailers and consumer goods companies, such as Wal-Mart and Sony, have also launched similar services.

Digital music distributors typically operate one of two possible pricing models:

- Pay-per-download: Consumers pay for each track that they download and then "own" it. This usually includes the right to make a certain amount of digital copies of the track.
- Subscription-based: Consumers have unlimited access to a large library of tracks as long as they subscribe to the service. These services usually also offer the option to purchase tracks on a pay-per-download basis. On leaving the service, the consumer usually loses the right to content access.

Figure 18: Major online retailers of digital music

Retailer	Owner	Pricing model
Musicmatch	Yahoo	Pay-per-download
iTunes	Apple	Pay-per-download
Connect	Sony	Pay-per-download
Rhapsody	RealNetworks	Subscription-based/Pay-per-download
MSN Music	Microsoft	Pay-per-download
Emusic	Independent	Pay-per-download
Wal-Mart Music	Wal-Mart	Pay-per-download
Napster	Roxio	Subscription-based/Pay-per-download

Source: Company data, Deutsche Bank

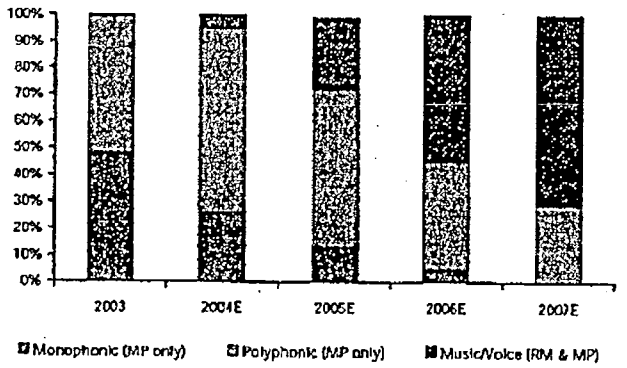
... and mobile music revenues ...

While we believe that the market is slowly beginning to capture the revenue potential from downloads it does not seem to be capturing the revenue benefits from mobile phones. Technological change of handsets/mobile devices will become an additional growth driver of digital revenue streams for EMI. On our estimates, master tone revenues for the recorded music industry will reach $3.8bn by 2010, implying a market roughly similar in size to legal downloads by then for the labels. We highlight that this forecast implies a conservative $12 annual average spend per mobile phone user on master tones by 2010.

Mobile Music – The next growth story...

The migration of mobile phone capability from playing ring tones (compositions of songs re-recorded by a third party and then sold on to mobile phone users) to Master tones (actual songs sold to mobile phone users) means a significant expansion of mobile revenues from EMI's Music Publishing (MP) division (currently collecting royalties from ring tones) into Recorded Music. A large share of new handset releases, are already capable of employing Master tones and we expect penetration here to pick up fast. Figure 19 illustrates the expected technological shift in the US:

Figure 19: US handset market breakdown by ring tone type



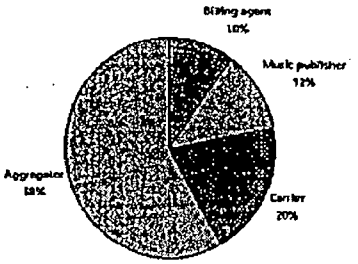
Source: Jupiter Research

With the technological evolution of handsets, EMI's revenue opportunity will expand into its recorded music division:

- For Master tones, EMI can expand its revenue potential from collecting copyright royalties only via its music publishing division to recorded music royalties from selling the actual songs.

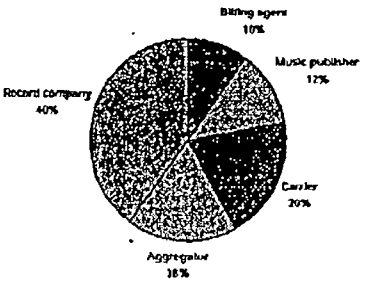
- The share of revenues on a per-song-basis from Master tones is significantly higher than that for ring tones. As the below charts show, on a group level, EMI should be able to increase its revenue share of Mobile music sales from 12% for ring tones to 50-55% for Master tones. We expect record labels and Telecom carriers increasingly to try to squeeze out the middlemen (ie, billing agents & aggregators) so we expect to see further revenue share expansion here going forward.

Figure 20: Ring tone revenue split



Source: Billboard (typical industry split)

Figure 21: Master tone revenue split



Source: Billboard (typical industry split)

Recent news flow and data points support our bullish view

In light of our positive view on master tone revenues, we briefly summarize some encouraging data points that underpin our positive stance:

- In Japan and South Korea, where 3G phones capable of playing master tones have significant market share, sales from mobile music outsold online downloads in 2004 (source: IFPI)
- Ring tone and Master tone revenues in the UK were more than double those of CD singles in 2004 with £120m of mobile revenues against CD singles with £55m.
- China's leading provider of mobile phone services Kongzhong has signed licence agreements with all major labels on music distribution. According to the Chinese telecom regulator MII, there were around 334m mobile phone users in China in 2004. This is expected to grow to 400m+ in 2005.
- EMI has struck a number of deals to provide its music content to third-party retailers and carriers in the UK such as Carphone Warehouse, Three, Orange,
- Vodafone is expecting to offer mobile phones with built-in 1GB hard drives to enter the market within two years, effectively making them mini-iPODs with music storage capability. This should further support acceptance of mobile phones as music playing devices.

Altogether the prospects for Master tone revenues for the industry and EMI are more than healthy and we have modelled this accordingly, again using what we believe to be conservative assumptions.

Our Master tone forecast

Our DB Master tone model is based on the handset forecasts of our technology analysts and assumptions on the penetration of master tone-enabled phones. The outcome and our assumptions are as follows:

- Global sales of master tone-enabled handsets should grow from 70m units in 2004 to around 566m in 2010. By 2010, 71% of all sold handsets should be master tone enabled.
- The recorded music revenue CAGR from master tones for 2005-10E is 111%, significantly outgrowing legal downloads (44% CAGR) over that time period.
- We assume 12 single-track downloads per year by 2010 per master tone phone sold, equivalent to one download per month.
- We see prices for master tones falling from the current $2.5 per track to $1 by 2010, implying the same price point for master tones to single track internet downloads. We believe that in the long run, music companies & operators will struggle to justify charging a premium in mobile music against downloads.

Figure 22: DB master tone revenue model

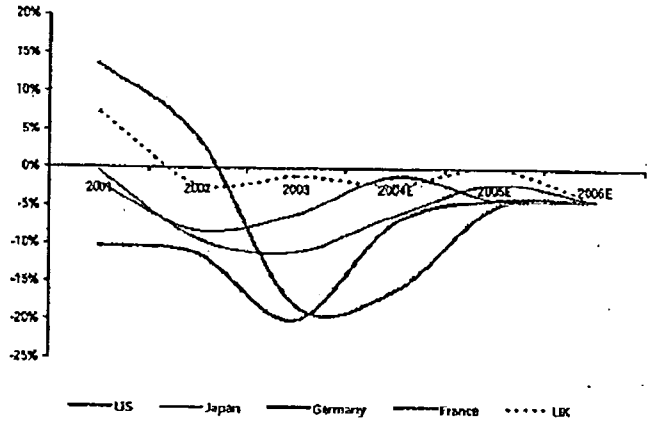
Master tones (US $ m)	2004E	2005E	2006E	2007E	2008E	2009E	2010E
Master tone phone % share of total (%)	11	26	40	57	63	68	71
Global Master tone mobile phone sales (m units)	69	176	284	421	483	533	566
Downloads per mobile phone user p.a.	0.5	1.0	4.0	6.0	8.0	10.0	12.0
Price per download (US$)	2.5	2.5	2.0	1.8	1.5	1.2	1.0
Retail download value (US$ m)	86	439	2,274	4,423	5,800	6,396	6,797
Growth (%)		410	418	95	31	10	6
Billing agent & Aggregator revenues	26	123	591	1,062	1,276	1,279	1,223
% of retail value	30	28	26	24	22	20	18
Carrier revenues	17	92	500	1,017	1,392	1,599	1,767
% of retail value	20	21	22	23	24	25	26
Recorded Music revenues (US$ m)	43	224	1,183	2,344	3,132	3,618	3,806
% of retail value	50	51	52	53	54	55	56
Growth (%)		420	428	98	34	12	8
EMI RM market share of master tones (%)	10	11	12	13	13	13	13
EMI RM revenues (US$ m)	4	25	142	305	407	457	495
£/$	1.9	1.9	1.9	1.9	1.9	1.9	1.9
EMI CY Master tone revenues £m	2	13	75	162	217	243	263
Growth (%)		472	476	115	34	12	8

Source: Deutsche Bank

... while physical music formats stabilise ...

On top of the significant growth potential that we see for digital sales, physical format sales (ie CDs and CD-Singles) have also started to recover in key markets. After three years of decline, 2004 was the first year with a noticeable pick-up in physical album volumes in the US and the UK. Even though this was somewhat offset by price declines leading to only flattish value growth, we expect other key markets to follow suit within the next 12-18 months.

Figure 23: Y-O-Y value growth of physical audio formats in key music markets



Source: IFPI, BPI & Deutsche Bank

US and UK stabilising, other markets to follow

Physical music format sales in the US and the UK have bottomed in 2003 with 2004 showing slight growth in both markets in volume terms. We believe that this development is paving the way for a similar market development in the other key markets. Here Japan, France and Germany are showing early signs of stabilisation.

Japan & Germany are posting dramatic slowdowns in decline rates of around -2% and -4% respectively for 2004. Only France is still witnessing the full force of the downturn with a -15% growth rate in 2004. We believe this to be largely timing related, as the late start into recession in France caused a time delay of around 12-18 months relative to Japan and Germany.

Overall we view developments in the US/UK markets as an 'early cycle' indicator for the remaining markets to bottom out; we expect stabilisation of physical format sales in all of the main markets within the next 12-18 months. Despite significant differences in timing and amplitude of growth, the similar shape of the growth curves for each individual market underpins our view.

The upside: Consumer behaviour in digital key

We believe that the stock market is currently in a state of uncertainty about how consumer behaviour in the digital world will affect the long-term growth potential of the industry. We identify two key questions for investors at the moment:

- How much of digital revenues will be incremental to physical format sales and how much will be substitutional ie what are the cannibalisation effects of digital music sales?
- What effect will unbundling of albums have on the long-term revenue potential?

We conclude that the current share price discounts too bearish a scenario on the substitutional effects of music sales and is overly concerned with the unbundling threat.

Cannibalisation sensitivity shows upside

The first concern in the market is the potential cannibalisation effect of digital music sales on physical formats. Even though current indications are for the bulk of digital sales at this stage in the cycle to be incremental (ie, in addition to physical format sales) we think that once

digital revenues have grown their share to more meaningful amounts, this will certainly affect sales of physical formats.

While we do not claim to have the magic ball and so quantify the exact split in, say, three years time, our modelling suggests that EMI's current share price discounts too grim a view on the substitutional effects. At 237p, we estimate that the market is discounting only 25% of download revenues and only 50% of master tone revenues as incremental (based on our forecasts). We think this is too bearish of a view as we believe all current master tone sales to be incremental and 75% of download revenues. We set out our modelling assumptions below:

- Our base case assumption is for 75% of download revenues and 100% of master tone revenues to be incremental to physical format sales. We prudently assume this will drop to 65% and 90% by 2010 respectively as the increasing consumer spend on music leads to increased cannibalisation effects.
- We continue to anticipate price erosion in physical formats and factor in 2% pricing pressure on physical formats in FY2006 and 2007 and 1% thereafter. Our pricing assumptions for downloads are as follows: We see flat pricing for downloads going forward at $1 per track and master tone prices dropping form $2.5 per download this year to $1 in 2010.
- Physical format growth: We assume underlying stabilization of physical format volumes excluding any substitutional effects from digital music mid-term ie flat volume growth with 2% pricing pressure in FY2006&07 and -1% thereafter. Based on this base case assumption for physical format sales we have then subtracted all assumed substitutional digital revenues from physical format sales. We use 100%/75% incremental revenue shares for master tones and downloads as our 2006-07 assumption, with these figures dropping to 90% and 65% respectively by 2010. The corresponding physical format CAGR 2005-10E including the substitutional effects from digital is -3.0% p.a.
- Digital revenues: Our base case digital revenue scenario uses our separately modelled download and master tone revenues as we lay out above in this section. The implied digital revenue 2005-10E CAGR for combined download/master tone revenues is 71%.
- Our digital and physical format sales forecasts combine for 2005-10E recorded music revenue growth CAGR of 3%.
- The implied revenue share of digital music for EMI's Recorded Music division by FY2010 is 27.5%, broadly in line with company guidance of 25%.
- We have assumed that the shares trade on an undemanding 12m forward earnings multiple of 15x at the end of March 2008 and discounted the implied share price to present value using EMI's WACC of 8.6%.

Our base case price target is 312p or 33% upside potential, in line with our new 310p target price (previously 215p).

Figure 24: EMI share price sensitivity to consumer behaviour in digital

Price on 15x fwd 2009 EPS	250	300	350	400	420	450	500
Required FY 2009E EPS	16.7	20.0	23.3	26.7	28.0	30.0	33.3
FV share price discounted at EMI WACC	**195**	**234**	**273**	**312**	**328**	**351**	**390**
Up/(Down)side from current price	-17	0	17	34	40	50	67
Assumptions to get to required FY 2009 EPS							
Incremental % share of total download revenues (%)	10	25	50	75	100	75	75
Incremental % share of total master tone revenues (%)	15	50	75	100	100	100	100
Output & implied growth rates							
Digital sales % of total RM sales by FY 2010 E(%)	34.6	31.7	29.4	27.4	26.5	35.0	38.8
Digital sales growth CAGR FY2005-10 (%)	71.0	71.0	71.0	71.0	71.0	73.0	77.0
Physical sales growth CAGR FY2005-10 (%)	-9.2	-0.6	-4.6	-3.0	-2.1	-3.0	-4.4
Total RM sales growth CAGR FY2005-10 (%)	-1.7	0.0	1.6	3.0	3.7	4.1	4.9

Source: Deutsche Bank

The key takeaways from our sensitivity modelling are:

- Under our current base case assumptions, fair value for EMI shares is at the 310p level. If we assume that all digital and master tone sales are incremental at the moment, then we can easily see another 6% upside to our new price target
- If we were to leave our assumptions on the substitutional impact unchanged but raise our FY2005-10 digital revenue growth CAGR forecast from 71% to 77% this would raise the fair value of the shares from 310p to 390p.
- Our resulting base case 2005-10E CAGR for physical format sales of -3% might be too bearish if the industry stimulates sales through adding further value to physical formats. This could be done via enhanced packaging (dual discs ie, combining albums with bonus/Music DVDs, release of value-added artist packages etc.)

Unbundling: threat or opportunity?

Another oft-cited uncertainty on consumer behaviour in the digital world is unbundling. The fear in the market is based on the possibility of 'unbundling' or filleting albums into single tracks in the digital world; ie, consumers can cherry-pick three or four songs from an album and buy them individually for the price of a single track ($0.99) instead of buying the album for $12-14. With albums accounting for the lion's share of profits for the industry (singles are usually loss-making) the fear is that the unbundling possibilities in the digital world will harm the industry's main revenue and profit stream, particularly on new releases.

Our main argument for seeing unbundling as an overstated threat is as follows: unlike movies, we think that the consumption value (joy) of music lies in repeated consumption. Most of the time, consumers need to listen to an album a number of times before they take a view on the quality of it. In the digital world, however, it is currently not possible to listen to an album track repeatedly before buying it. All consumers can do is to 'preview' album tracks online, which usually means that they can listen to a 20 or 30 second excerpt of each track.

Frankly, with the way that music is consumed, we do not think that consumers will base their decision whether to 'unbundle' a new album into single tracks or not on a 20-second snippet of each song. Also, we note that consumers are already able to unbundle albums in the physical world via buying singles. With the single format having fallen by 90% from peak volumes in 1992 to 2003 in the US, we do not feel that consumers will find unbundling of new releases particularly attractive (singles are almost exclusively released/available on new releases). The risk of incremental unbundling in the digital world is hence low and in our view is an overstated fear in the market.

Taking the thought process on unbundling further, we believe that it can have benefits for the industry. The possibility of downloading a song for $1 lowers the barriers for consumers to consider back catalogue purchases, which in turn will drive incremental back catalogue sales. A large and growing share of online music covers the industry's back catalogue and the ease of use inherent to online music stores enhances the value proposition to consumers. Clearly, the appeal of buy just one or two songs off an old album which consumers otherwise would have had to purchase in full (and might have been reluctant or unable to) will in our view lead to incremental back catalogue sales. This increases the value of EMI's back catalogue immediately and hence represents a main beneficial side-effect for the industry from the perceived unbundling threat.

Market focus should shift away from album-only

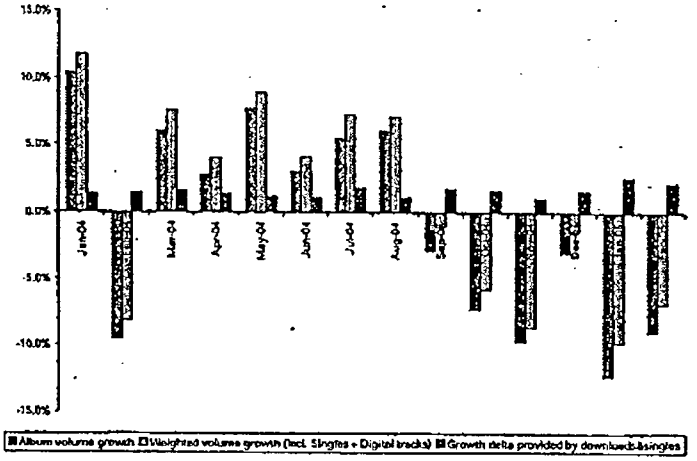
The market has recently become somewhat 'obsessed' with analyzing weekly album volumes coming out of the US (Nielsen Soundscan). While we generally do not argue the advantage of having weekly data points, we would highlight a few points about the weekly sales data:

- Looking at album sales only ignores the revenue benefits from digital downloads and Music DVDs (and also excludes singles sales). Hence when analyzing weekly shipment data, numbers should be adjusted for downloads as they become a driving factor of market growth.
- Short-term data points on y-o-y growth can be distorted by the timing of record releases as well as specific factors affecting buying behaviour such as the timing of public holidays etc. One example here would be that 2004 had 53 selling weeks and the 53rd week was a relatively important one: If we add it to the 4Q04 data, volumes increased 2.9% y-o-y; if we exclude it, volumes were down 5.1%. Additionally, such a big 53rd week will also impact sequential sales growth ie, January sales would naturally be relatively weak.
- Pricing of music, which has been volatile over the last few years, is ignored. We address this issue in a separate section.

As a consequence of our bullish view on the revenue opportunities from digital music we advocate looking at a weighted volume figure that captures the growth delta that single sales and, more crucially, digital downloads, bring about to the industry's top line.

Figure 25 shows that the growth difference provided from including downloads and singles as opposed to just CD albums is recognizable: for 2004, album sales were up 1.7% but when we adjust the figures for downloads and singles then the number increases to 2.9%. Given that singles sales were also down in 2004, this implies that downloads provided a growth delta for the market of 1.3+%. We also note that the growth delta provided by digital sales has recently been increasing, as Figure 25 below shows.

Figure 25: US music volume growth y-o-y



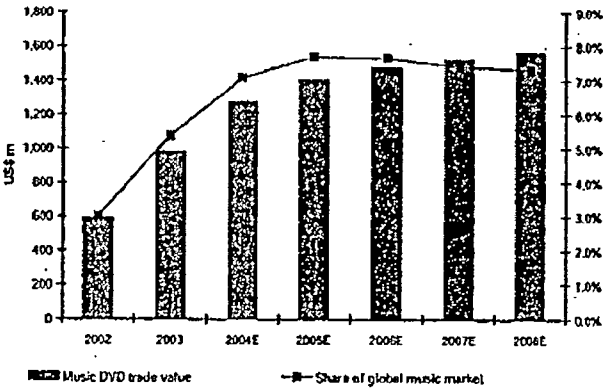
Source: Nielsen Soundscan

Music DVDs – the icing on the cake

In addition to digital music revenues, Music DVDs have also been a clear success story over the years and these also are not being captured by album sales. The dramatic increase in DVD player penetration has opened up an opportunity for the majors to exploit the format. Music DVDs have now firmly established themselves as a value-added product within physical music formats.

Music DVD growth has been impressive with growth rates of 66% in 2003 and 23% in 2004. In this time period Music DVDs have doubled their share of total music sales from 3% in 2002 to 8% in 2004. Unfortunately there currently is no tracking system in place for Music DVDs, so that the revenue benefits of sales are not captured. However, we would remind investors that this is a significant growth story within physical sales that should enhance top line growth and is not being captured in album volumes.

Figure 26: Global Music DVD market growth



Source: Deutsche Bank & IFPI

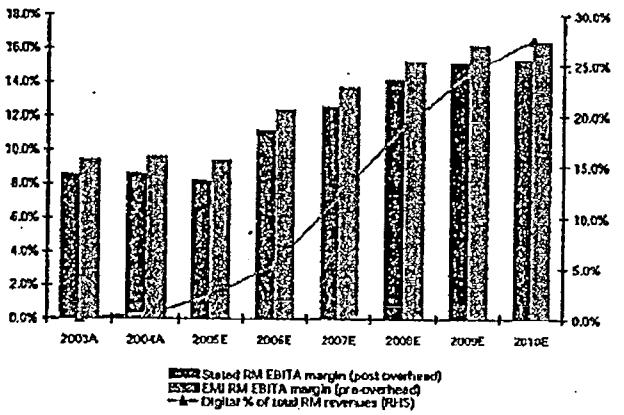
Digital drives margin recovery

Digital music should be a key driver for long-term margin expansion at EMI. The margin benefits of digital music are compelling and include an initial 15-16% margin advantage from the falling away of distribution and manufacturing costs. Further long-term benefits are a more profitable catalogue mix (65% back catalogue /35% new releases split compared to 45%/55% currently) as well as cash flow benefits. By FY2010, we expect digital music to provide around 27.5% of recorded music sales driving divisional margin from the current 9.3% to 16.4% (pre-overhead) by FY2010, in line with the company's guidance of returning to 15-16% peak margins within five years. On a group level, this will drive EBITA margin expansion by 52% from the current FY05E margin of 11.6% to 17.6% by FY2010E.

Digital drives significant long-term margin expansion ...

The margin implications of the industry transition from physical to digital distribution are profound and we forecast a long-term recovery of EMI's recorded music margins. Ever since its digital investor day held in summer 2004 EMI has been guiding that the margin benefits of digital sales should lead to EMI's recorded music division returning to peak margins of 15-16% (pre-overhead, last achieved in 1997) within the next five years and for revenues from digital music to make up to 25% of recorded music sales by 2010. This is in line with our analysis and forecasts as laid out above.

Figure 27: EMI Recorded Music margin and revenue profile



Source: Deutsche Bank & Company data

Digital sales high-margin

In the long run, we identify a number of reasons as to why distributing music digitally will drive margin growth and should be beneficial for expanding cash flow generation in EMI's recorded music division:

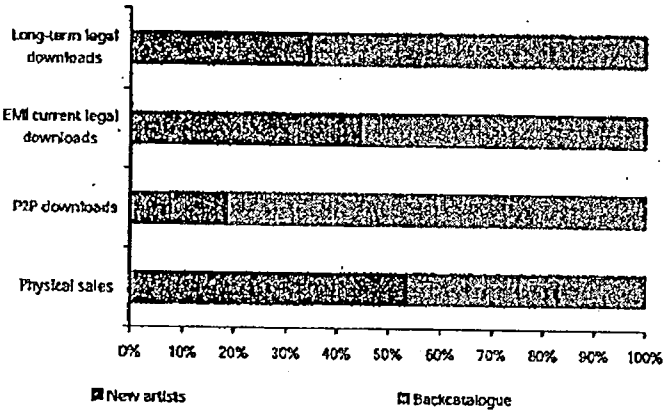
- A changing revenue mix towards the more profitable back catalogue
- As manufacturing and distribution costs fall away, digital music sales should gain an immediate estimated 15% margin edge over physical product
- Negligible working capital requirements due to the non-physical nature of distribution and manufacturing process

More profitable catalogue mix

Research into illegal P2P networks as well as data on current consumption patterns show that digital downloaders are much more likely to acquire the more profitable back catalogue tracks than is the case in the physical world. The main reason for this skew is likely to be found in the wide availability of older music online as well as the ease of finding it there. This contrasts with the 'classic' physical music retail outlets which mainly stock recent releases and have only a limited back catalogue available in-store.

Altogether, research houses estimate the long-term split between front and back catalogue in the digital world will increase favourably to 65% back catalogue /35% new releases sales, which represents a roughly 20% shift from the current 45%/55%purchase pattern in the physical world.

Figure 28: Digital revenue split by catalogue type



Source: NPD/Ipsos Digital, Nielsen Soundscan, EMI & Deutsche Bank

From EMI's perspective, back catalogue sales are more profitable than new releases because they involve less direct costs per unit sold. We estimate that EMI recovers the lion's share of launch costs after 12-18 months following the initial release of an album/artist. If EMI sells a back catalogue artist/song in the digital world for which it already has incurred origination, promotion/marketing and Artist & Repertoire (A&R) costs years ago, then its back catalogue is a much more profitable part of its roster on a unit cost basis than new releases ever will be. We estimate that altogether, origination, marketing promotion and A&R costs represent roughly 25% of physical sales. As Figure 29 below shows, every incremental 10% shift towards back catalogue sales in digital music will bring about an uplift of up to 4.5% to recorded music EBITA. As the shift relates only to digital sales, the uplift is inevitably greater in the out-years.

Figure 29: EBITA sensitivity to incremental 10% shift towards back catalogue in digital

	2005E	2006E	2007E	2008E	2009E	2010E
Recorded Music base case EBITA	125	172	200	238	264	271
Incremental £BITA contribution from additional 10% shift towards back catalogue	0.9	2.1	4.8	8.0	10.6	12.1
Recorded Music EBITA uplift (%)	0.7	1.2	2.4	3.4	4.0	4.5

Source: Deutsche Bank

Production & distribution costs fall away

We estimate that digital tracks & master tones have an initial 15% margin edge over physical formats due to manufacturing & distribution costs falling away. The main direct cost

associated with distributing and producing music in digital form is the digitalisation of EMI's back and front catalogues, which is already covered by its current IT initiatives. In our view an estimated £15m of accumulated IT spend in FY 2003 and 2004 already covers the spend needed to beef up EMI's infrastructure and internal workflow for digitalisation. Altogether, the costs of digitalisation are low to negligible in the long term and have been incurred by the company already at the time of writing, which implies that every £ of digital revenues from 2005 on has an estimated 15% margin edge over physical formats.

Figure 30: Typical recorded music key cost breakdown (% of sales)

	(%)
Artist Advances & Royalties	28
Overhead	24
Marketing promotion	18
Distribution & Manufacturing	15
Origination	5

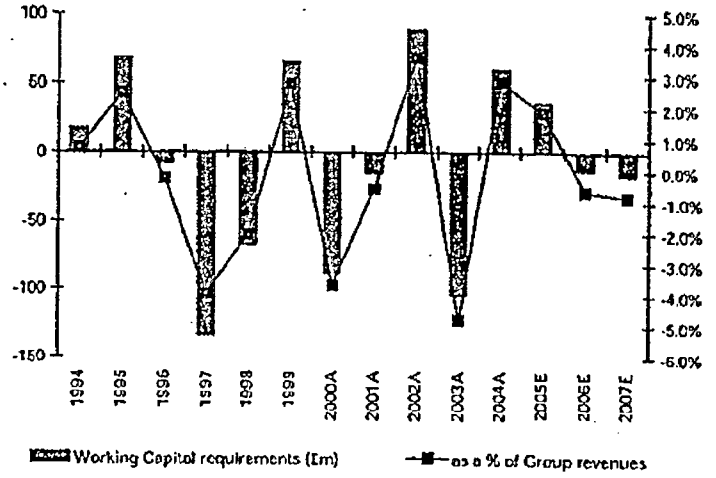
Source: Deutsche Bank

Working capital benefits improve cash generation

EMI will be able to further improve its cash flow profile because the working capital requirements of digital music are significantly lower than for physical formats. Because 'classic' manufacturing and procurement processes are not involved in the creation of a digital track or album, there are a number of working capital intensive processes such as the physical stocking of the product as well as handling returns from retailers that are omitted. In contrast to physical formats, digital inventory will only be available virtually (ie stored on a central server) and the music company is not affected by customer returns.

In conjunction with EMI's outsourcing activities in the physical recorded music business, we estimate a sustainable working capital benefit of around £20m pa for the group. This will hence contribute to reducing the absolute level as well as the volatility of cash flows and improves the overall cash generation of the group.

Figure 31: EMI historical and forecast working capital inflows/outflows



Source: Deutsche Bank & Company data

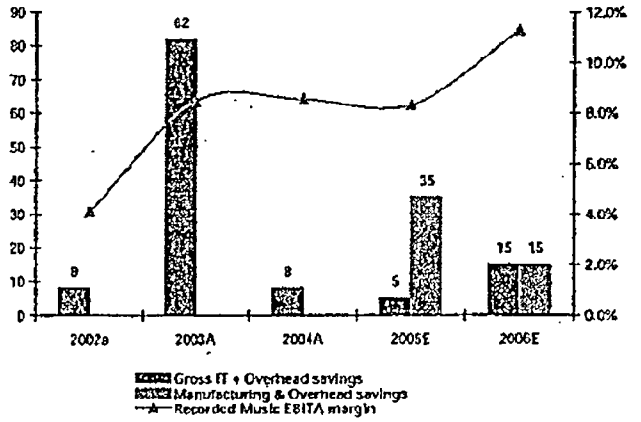
Cost measures further drive margin boost

During the downturn in global music sales, EMI's management has done an excellent job in adjusting its cost base to market realities. Over the last three years, EMI has announced around £170m (or around US$300m) of accumulated cost savings, which we estimate represent some 10% of its recorded music cost base. Cost savings have been mainly achieved in the following areas:

- Outsourced manufacturing operations in Europe and the US: We estimate that this should lead to annualised costs savings of £30m. After implementation of this outsourcing agreement, EMI will still retain a joint venture manufacturing operation in Japan. In addition to the £30m of annualised P&L savings, these measures should also enhance EMI's cash flow profile by freeing up to £20m of working capital permanently.
- Overhead: We estimate overhead savings of around £100m in FY2002-06. These savings were achieved mainly through salary cuts, redundancies, artist and roster restructuring and through the consolidation of offices and labels.
- IT: The IT savings programme relates mainly to the upgrading and expansion of EMI's IT equipment and systems. We estimate that the IT initiatives will generate annualized savings of around £20m.

The above restructuring efforts have led to significant EBITA margin improvement. As we can see in Figure 32, we expect EMI's physical margins to approach the mid-point of its 11-13% mid term EBITA margin target by FY2006 (see Figure 32).

Figure 32: EMI announced cost savings FY 2002-2006E (£m)



Source: Deutsche Bank & Company data

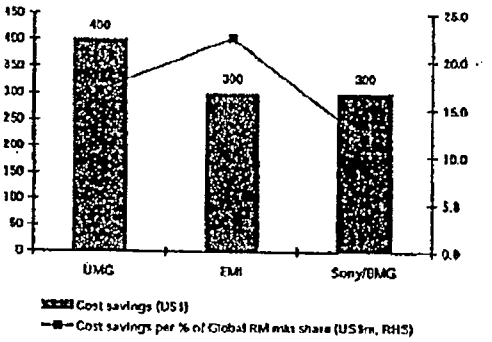
EMI's costs savings best in class

Of the big four major labels, EMI has been the quickest to implement and execute the above cost measures. Over the last 12-18 months all other major labels have followed suit and announced cost measures worth a combined $1.1bn that they have targeted by end-2005. This time lag in cost measures will lead to EMI maintaining its roughly 12-month time advantage over the other majors, so that it should enjoy the highest margins in the industry for at least the next 24 months.

EMI not only leads the industry in the timing of its cost savings but also in relative size. EMI's cost savings of around US$300m even rival those of Sony/BMG on an absolute basis, a business which has almost twice EMI's market share. EMI's cost savings equal $22.4m per

global market share point, against only $12m targeted at Sony/BMG and $17m at UMG. While we would not rule out any of the other labels overshooting here, this shows that EMI's restructuring efforts go beyond those of its competitors.

Figure 33: Major labels cost savings overview



Source: Deutsche Bank & Company data

Piracy: the heretical view

We have a heretical view on piracy. While piracy has undoubtedly served to amplify the decline in music sales over the past four years, we think that its impact on music sales is generally overestimated. Without aiming to play down its relevance, we believe that the market's current focus on short-term piracy data points adds little to an analysis of EMI. According to our own analysis and third-party research the impact of piracy and particularly P2P file sharing on music revenues is very ambiguous. Consequently we believe that, while containing physical and digital piracy is of course a sensible goal for the industry, changes in piracy levels do not materially affect short-to mid-term forecasts.

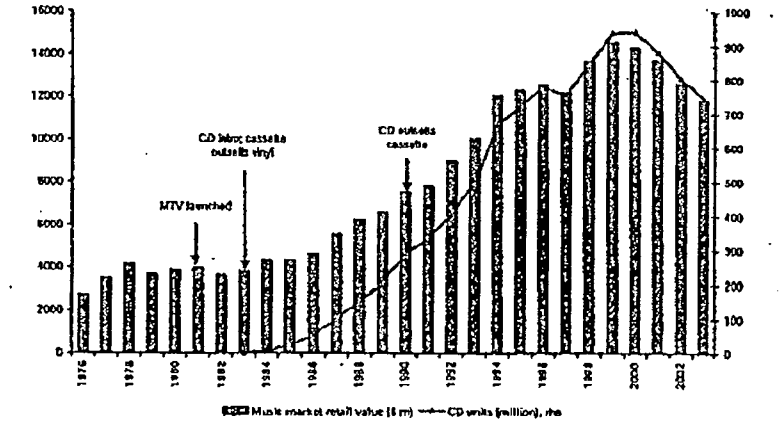
Piracy – just a scapegoat?

The music industry consensus view is that much of the blame for the slump in recorded music sales from 2000 onwards is due to increasing physical and digital piracy levels. However, we believe that when examining how consumer preferences and the entertainment industry have changed over the last few years, this argument oversimplifies a complex mix of issues. We argue that there are at least four additional reasons that have contributed to the decline of music revenues, out of which we believe two to have more or less played out in revenue terms:

Format replacement

A format replacement cycle for the CD artificially over stimulated demand in the 80s up to the mid 90s as consumers replaced their vinyl and tape collections with CDs. We believe the pullback effect of this replacement cycle to be largely over now and see the potential for a back catalogue-driven download replacement cycle resulting in incremental revenues for the industry (as we have analysed previously).

Figure 34: US recorded music market (US$ m LHS, units m RHS)



Source: RIAA, Jupiter Research & Deutsche Bank

Content supply

Lower supply of music content – Official data here are patchy, but annual new releases in the US, for example, have dropped from 38,900 in 1999 to 27,000 in 2001 according to RIAA. This represents a 30% decline in new releases, over which the corresponding value decline for the music market was a quite modest 6%. We think that the relative outperformance of sales vs. new releases is mainly due to replacement buying.

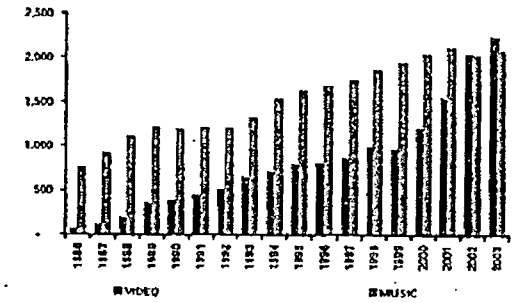
The latest IFPI figure (33,000 releases in the US in 2004) shows that post the recent roster restructurings at all major labels the supply of new releases has in fact picked up again. This should pave the way for the anticipated stabilisation of physical format sales and incremental download and master tone sales growing the overall revenue base of the industry.

Entertainment competition

Other entertainment forms competing for consumer spend – since the mid- to late 90s, price deceleration in DVD equipment and movies as well as video games have meant that both entertainment forms can now compete with music on price as price differentials for entry point hardware and content have narrowed dramatically. This is also felt at the retail level as retailers devote more shelf space to those entertainment forms.

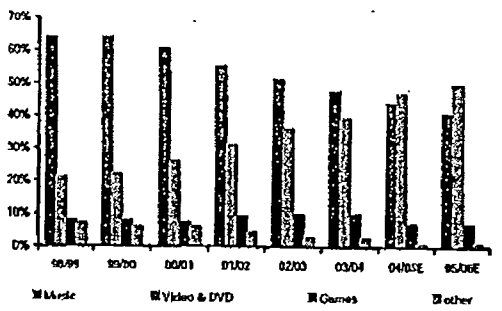
While we expect this trend to continue, online retailers represent 'free', unlimited and incremental promotion and distribution points for music. For master tones, mobile phones are an entirely new promotion platform with carriers being incentivised to market music downloads to promote 3G uptake. We believe the increased 3G penetration will halt the trend of music's declining share of consumer spend going forward.

Figure 35: UK retail sales of Video and Music (£m)



Source: BPI

Figure 36: HMV LFL sales split evolution



Source: Deutsche Bank and company data, UK & Ireland data

Radio consolidation

Radio consolidation reduces breadth and depth of airplay – as a result of more and more stations becoming part of larger radio groups, radio programming is becoming increasingly commercial in order to attract higher audiences. To achieve this, radio stations have started to focus on playing fewer but better-selling artists/tracks and are playing those artists/tracks more frequently across their schedules ultimately leading to a homogenization of radio programming. Consequently, this results in less variety on the airwaves, which dilutes the value of radio as a promotional platform for the music industry.

We think that radio consolidation will generally continue because most radio markets are still highly fragmented. However, increasing multi-channel penetration from the digitalization of radio will lead to a re-emergence of specialized niche/theme stations that should in part reverse this trend in the medium term.

Market focus on piracy levels overdone

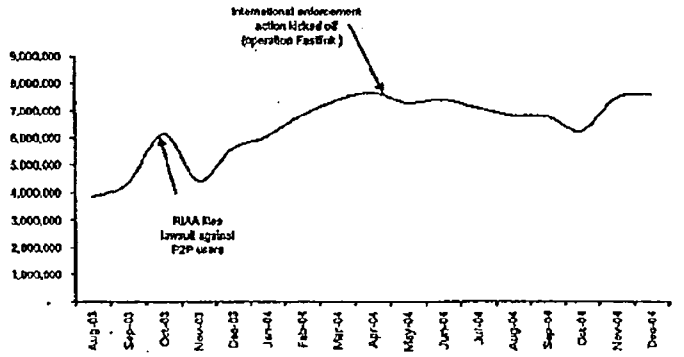
Based on the above analysis, we think that the impact of piracy on music sales is generally overestimated and should at best impact investor sentiment while having practically no impact on short-term forecasts. The main reason for our view is that we do not believe that anyone (not even music executives themselves) can give a reasonable assessment of the

single most important variable in the exercise of quantifying the impact of piracy: How much of the pirated content would have been legally purchased had it not been pirated?

P2P effect on buying behaviour still unclear ...

Following an improvement in market sentiment that followed a period of falling P2P usership due to legal action by the industry, recent market worries for EMI stem from a rebound in levels of P2P file-sharing as shown below.

Figure 37: Global P2P users



Source: Big Champagne & Deutsche Bank

However, we argue that the sentiment effect on EMI's share price is likely overdone. The actual effect that illegal file sharing has on consumer behaviour is debatable and most data points that we have uncovered on the subject are contradictory: Some research suggests that illegal downloads can have promotional benefits for legal music purchases, others that they actually affect legal music purchases. On balance we believe that the importance of changes in P2P usage is generally overestimated by the market, when considering the below points:

- An empirical study by students of the Harvard Business School (*The Effect of File Sharing on Record Sales – An Empirical Analysis*, March 2004) tracked file-sharing network activity and music buying over time and argues that file sharing is not hurting record sales. The study supports an oft-heard argument – that most illegal downloaders would not have bought the downloaded music even in the absence of file sharing. The report even argues that illegal downloading can boost record sales under certain conditions.
- A survey carried out by Jupiter Research in August 2003 questioning online music users saw 33% of them admitting that file-sharing led them to decrease their music spend while 16% said that they had actually increased music spend since they started file sharing. So overall a net 16% of file sharers admitted to spending less money on music because of P2P, a less sensational number than 33%.
- Jupiter Research estimates that 75% of music spending is by 25% of buyers. On a crude back-of-the-envelope calculation, this implies that out of the heavy music buyers' group every 1% of the population is responsible for 3% of the music market. Looking at actual penetration rates of P2P networks shows that less than 1% of the total population logs on to P2P networks and that music downloads only cover half of P2P activity. Assuming that only music aficionados (ie, out of the 25% group) download music illegally, then Figure 38 shows that this would in theory affect less than 1.5% of global

music sales. Adding then that P2P networks are mostly used by lower income consumers such as students and kids, the impact of P2P networks on music consumption appears much less dramatic in this light.

Figure 38: Estimated P2P impact on music sales

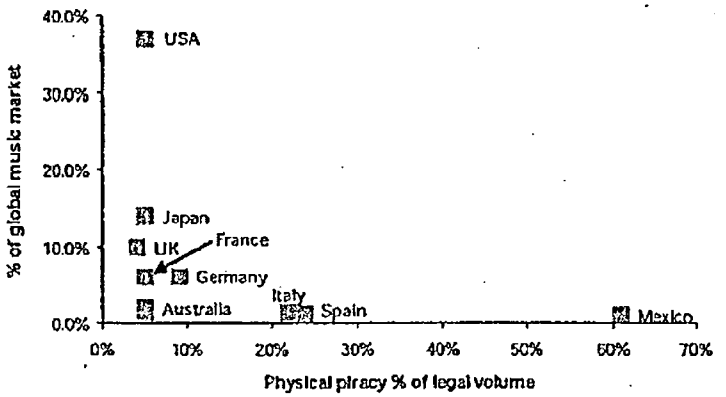
	P2P users as % of total population	Audio share of total P2P activity in %	Estimated % of total population downloading music from P2P networks	Each % of music aficionados responsible for what multiple % of music sales (x)	Potential revenue share at risk assuming P2P users stop buying music
US	0.9	49	0.4	3	1.3
UK	0.4	49	0.2	3	0.6
France	0.6	49	0.3	3	0.9
Germany	0.6	49	0.3	3	0.9

Source: IFPI, OECD, Big Champagne & Deutsche Bank

... and physical piracy mostly affects lower value markets anyway

Another point underpinning our view on piracy is that physical piracy (ie burning of CDs at home or on CD replication lines) affects mostly the lower-value music markets in Asia, Latin America and Eastern Europe. The five major markets, which together account for 75% of global sales, all have piracy levels of below 10%, which we believe to be a threshold level for the industry. We would not expect the industry to be able to push piracy rates any further in these markets given the availability and relative price attractiveness of CD burners etc.

Figure 39: Physical piracy levels in major music markets



Source: IFPI

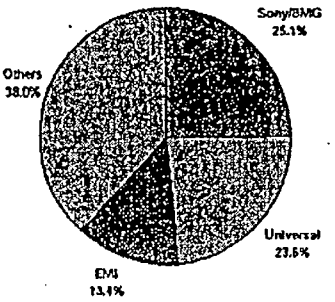
Other industries such as Software and Luxury Goods cope with counterfeited products yet manage to grow revenues. Overall we are comfortable that physical piracy should not stand in the way of our revenue recovery view and will remain a fact of life as well as a soft and unquantifiable factor for the recorded music industry. The impact on our short-term forecasts and investment case on revenue and margin recovery is hence fairly limited.

Market share analysis

Big Five down to Four post Sony/BMG merger

With the approval of the Sony/BMG merger in 2004, the global music landscape has consolidated from five to four major players. Sony/BMG is now the global leader in market share terms with just above 25%, closely followed by UMG. EMI has around 13% of the market with the rest left to other players.

Figure 40: Global recorded music market shares 2003

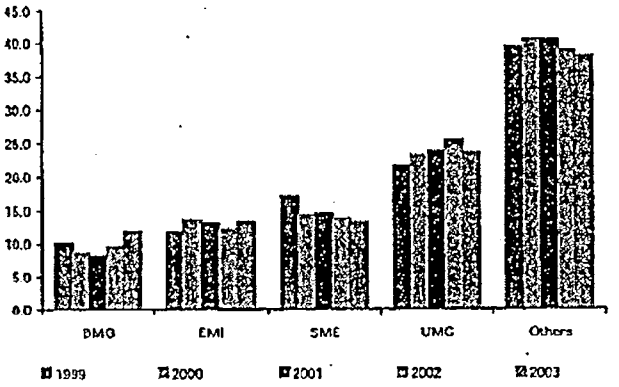


Source: IFPI

No clear trends in historical market share ...

Looking back at recent trends in global market shares suggests that the majors' market shares have generally been volatile y-o-y and have not shown consistent or sustainable patterns. In fact, from 1999-2003 we saw few significant market share shifts between the majors, even though on balance all majors managed to gain share from the independents, with Sony being the only exception.

Figure 41: Global market shares 1999-2003



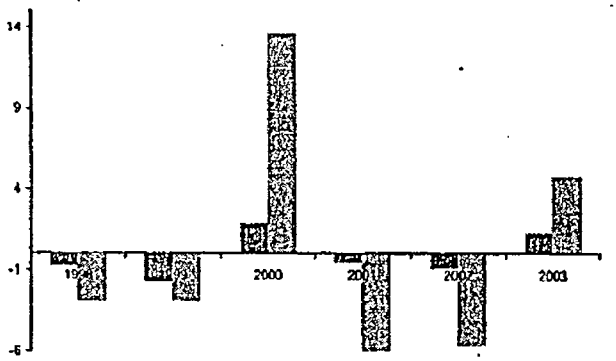
Source: IFPI

... but shifts in market shares have significant top-line impact

Generally, we agree with EMI management's view that market share as a standalone measure of success is outdated and that profitable growth around long term artist development is much more important. However, EMI's recent revenue and profit warning highlighted again that short-term shifts/delays in album releases and subsequently market share can significantly affect top line and profits.

The obvious implications of swings in market share (particularly when close to cut-off dates such as financial year ends) show that that the significant directional correlation between y-o-y market share changes and relative revenue performance in recorded music should not be underestimated. Mathematically, for EMI with around 13% global market share, a 1% share change in a stable market will lead to 8% turnover growth/decline. Historically, we have seen EMI gain and lose market share on a frequent and changing basis, with large impacts on the top line and relative revenue performance.

Figure 42: Impact of market share changes on EMI's revenue performance



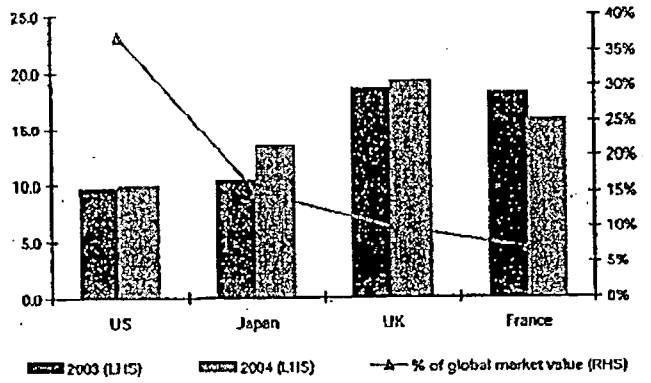
Source: Deutsche Bank, Company data & IFPI; years refer to calendar years i.e. 2003 is CY2003 market growth against EMI's FY2004 (ending March 31) revenue performance

Mid-term market share should bounce back

Following the recent warning on market share phasing we expect EMI to regain in FY2006 most of its market share losses of FY2005. The two album delays that were cited as the main reasons behind the warning (Coldplay and Gorillaz) will be released in FY1H06 and should hence lead to EMI making up some of its market share losses in FY05.

While we do not have a detailed release schedule for FY2006, we do not think that EMI faces an underlying market share risk mid-term. As Figure 43 shows, EMI's market share in CY2004 was pretty much flat across the main markets, which underpins our view that EMI is not facing market share issues and that the current weakness is temporary and largely tied to the phasing of releases.

Figure 43: EMI market share development 2004



Source: Nielsen Soundscan, SNEP, The Official UK charts company, Music & Copyright

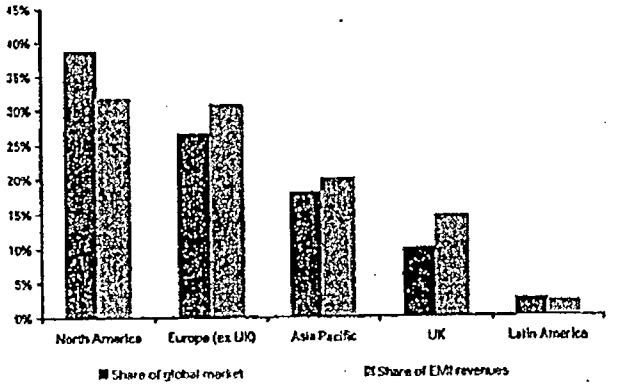
EMI regional share analysis

When looking at global market shares it is certainly worth examining the relative exposure that EMI has to different markets. Given the varied growth profiles and stages in the cycle of each individual market, it makes sense to draw conclusions from EMI's relative market exposure to revenue growth.

EMI strong in Europe and Asia ...

As Figure 44 shows, EMI has an exceptionally strong position in the UK (15% of revenues vs. 10% global market share) and is strong in the rest of Europe (31% of revenues vs. 27% of global market). EMI's position in the Asia Pacific region is also disproportionately strong.

Figure 44: Market revenue share vs. EMI's recorded music revenue share



Source: Deutsche Bank, Company data & IFPI

... but US position shows room for improvement ...

Against this, EMI has a slight underexposure to the US market. While North America (US 37%, Canada 1.7%) accounts for almost 40% of the Global retail market, we estimate that EMI's recorded music division generates around 32% of revenues in that region.

What does this tell us? In terms of growth, EMI's market position is more heavily skewed towards markets that are currently showing a slower growth profile. As we have shown in a previous part of this note, the US is currently recovering but EMI is slightly underexposed to the region. This is partly offset by EMI's strength in the UK, which in 2004 has also recovered to show flat growth. However, the company's relative overexposure to continental Europe and Asia, both markets that are still in moderate decline, means that EMI could slightly underperform the global market this year, which was highlighted by the recent revenue downgrades.

Having said that, we would add the following points:

- Once the continental European and Asian markets pick up again, EMI should disproportionately benefit from the recovery here, ie, should show revenue outperformance versus the global market. If investors are going to invest in music, then they may as well be geared into a high growth recovery story.
- As we have shown above, EMI does not seem to have lost market share in the US in 2004.
- EMI's overexposure to Asia should position the company well for master tone take-up as mobile phone and network technology is currently most advanced in this region.

... and is key to driving market share and profitability

We think that the main reason for EMI's underexposure to the US market is EMI's difficulty in breaking into local acts. While EMI has a decent US roster of established US artists, once we exclude Norah Jones from the catalogue, the company's share of the heavily commercially successful US acts is lower than that of its competitors.

This has an impact not just on EMI's revenue exposure to the US market but also its profitability. We believe that breaking into US acts and gaining market share in the US is crucial for profitability for two reasons:

- Successful US acts can usually be marketed around the world, giving majors higher operational leverage in terms of recovering A&R and other fixed costs. Against this, local artists in say the Japanese, French or German markets are almost impossible to market outside of their respective home countries.
- Looked at it the other way around, US music consumers continue to prefer US artists; 'importing' artists into the US from other continents is a hard exercise in the music business. EMI has tried the latter with its 'flagship' Anglophone non-US artists Kylie Minogue and Robbie Williams but, once Coldplay is excluded, this has thus far had limited success.

Altogether we think that gaining a better foothold in the US will be the key strategic challenge for EMI going forward if it wants to further expand its global market share and profitability on a sustained basis.

The pricing conundrum

The current pricing environment

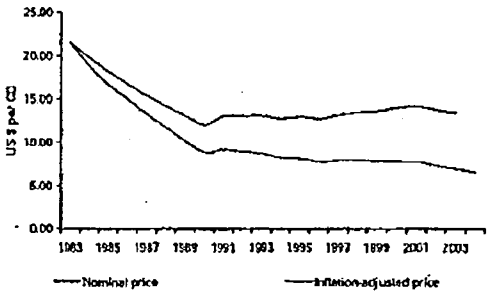
Recent data on retail prices have been somewhat bleak, as structural changes within the retail landscape have brought down retail prices of physical formats. Our analysis indicates, however, that most of the pricing pressure that we are currently witnessing is predominantly happening at the retail level, whereas we estimate a slightly more benign pricing environment in wholesale revenues (ie, EMI's revenue base). While our forecasts account for further pricing pressure on physical music formats going forward, early signs of pricing in the digital world are encouraging for the industry.

Retail prices: real cost of music is falling

Price has been an important driver of the decline in music markets on a retail level lately, as we illustrate below:

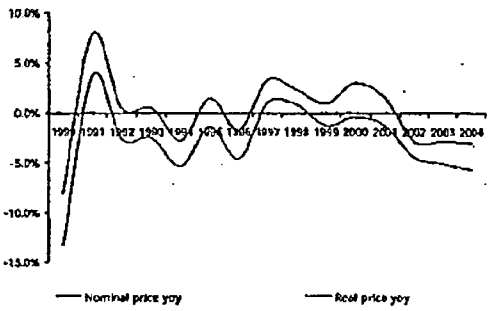
- In 2002 and 2003 we estimate that the average retail price of a CD in the US has fallen by around 5% in each year, and by almost 4% in 2004.
- Over the past 15 years, CD prices in the US have hardly moved in absolute terms. The current average CD price of $12.95 is similar to that in the early 90s. In real terms, prices have fallen by some 29% on our estimates from 1991 to 2004.
- There was upward pressure on nominal CD prices as the market showed good growth throughout the 90s and downward pressure since 2001, showing that there is a correlation between pricing power and demand in the industry.
- When adjusted for annual inflation, the real price per CD has shown a gradual decline from the early 90s, with only three years (1991/97/98) of real price increases in between.

Figure 45: Average retail price of a CD in the US



Source: RIAA, NPD, US department of Labor and Deutsche Bank

Figure 46: Average CD price % growth y-o-y

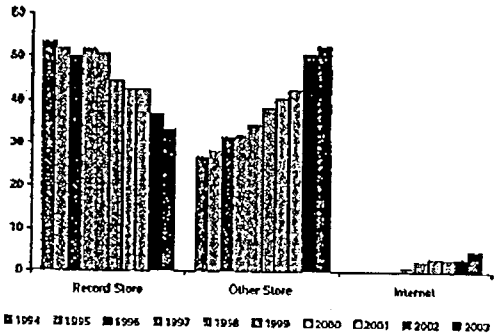


Source: RIAA, NPD, US department of Labor and Deutsche Bank

Discount retailer's gaining share

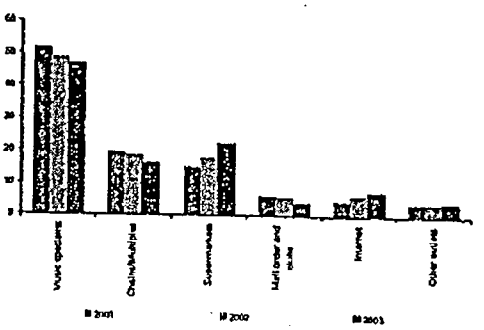
A look at the retailing structure of music explains recent pressure on music retail prices. As Figure 47 and Figure 48 show, the share of non-specialist retailers selling music has significantly increased over the last few years, bringing down retail prices. In the US from 1994 to 2003, record stores lost 20% of market share to 'other retailers', of which we believe supermarkets/mass merchants (such as Wal-Mart) to have been the main beneficiaries. In the UK, supermarkets have grown their market share by 50% (from 15% to 22.4%) in just the last three years.

Figure 47: US soundcarrier purchases by outlet



Source: RIAA

Figure 48: UK soundcarrier % purchases by outlet



Source: EPI, Taylor Nelson Sofres & Deutsche Bank

Due to the share gains of supermarkets/mass merchants and online distributors, which both have more aggressive pricing strategies than specialist retailers, retail prices for music will by definition come down, even if wholesale prices remained flat. Because from EMI's perspective only wholesale pricing actually matters, we think that the pricing environment here should be slightly more benign:

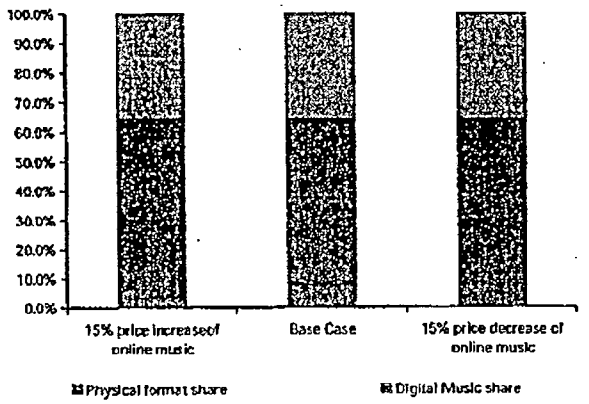
- The lean cost structure of online retailers of physical formats enables them to price CDs much more aggressively than specialist retailers without giving up gross profit. Hence we are unlikely to see substantial wholesale price pressure here.
- Supermarkets often use CDs as loss leaders to draw specific demographics into their stores. We believe that there is some acceptance among supermarkets that music will remain a loss leader/break-even scenario for them because of the demographic benefits they achieve.
- As a consequence of the discounters gaining share, specialist retailers had to react to those competitive pressures and are seen lowering prices, too. For example in the UK market, specialist retailers have undoubtedly seen margin pressure in the declining music market, although there is limited disclosure to back this up. Our retail analysts estimate that WH Smith's gross margins in music fell to below 20% in 2004. HMV, which arguably enjoys more pricing power and label support, says that HMV UK's overall gross margins have remained robust, but it is likely that better DVD margins have offset weaker music margins. Declining music gross margins for CDs could support our initial view that specialist retailers have not been able to share pricing pressure with the majors much.

So while supermarkets will likely exert their pricing power on the labels to some degree, we believe this to be on a smaller scale than current retail price declines suggest. In any case, we have factored 2% price declines into our EMI forecasts for physical music formats for FY2006-07 and believe this to be a prudent assumption.

Scope for pricing power in the digital world?

With digital music sales seeing significant growth, we believe that the novelty value of the product and current high demand for digital music will initially lead to consumers showing little price sensitivity on their digital music purchases. This is backed up by some early research that shows that the share of digital music sales would show very little sensitivity to a 15% price increase/decrease (Figure 49)

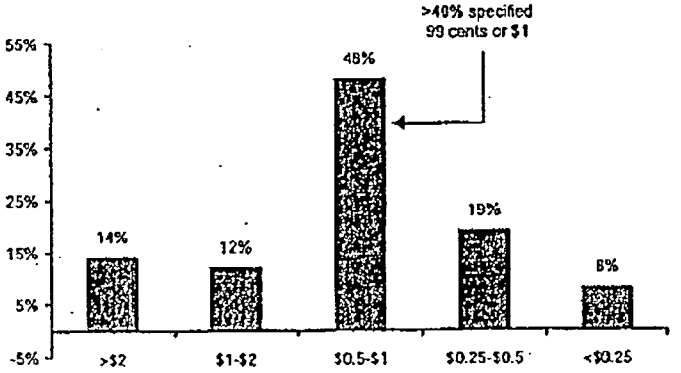
Figure 49: Price elasticity of digital downloads



Source: IFPI Europe & Deutsche Bank

We believe that the current $0.99/Euro 0.99 per song represents a good value proposition for consumers as well as for the bigger online retailers. A survey undertaken by Jupiter Research & Ipsos underpins this view as it shows that the industry has managed to establish a sustainable pricing point for digital music at 99c per song. When asked how much they would be willing to pay for a single download of their favourite artist, more than 40% of consumers specified 99c or $1. Altogether, 66% of those surveyed do not mind paying $0.99 or more per track.

Figure 50: Preferred pricing for a downloaded song



Source: Jupiter Research/Ipsos All online adults

Pricing – a potential volume driver?

One positive aspect of deteriorating retail prices for physical formats is that this can ultimately stimulate demand for the product. At the same time, the fragmentation of music tastes and the pressure on customers' wallets mean that a one-size-fits-all price for music is no longer valid. So a viable option here for record labels would be to steer demand and ultimately drive volume growth through pricing strategies that are similar to demand-based pricing models in the travel and airline industry. Below we set out an example of a recent pricing initiative by BMG that is supportive of new future pricing models for the industry.

BMG's three-tier pricing strategy

BMG Germany recently launched a trial version of a new three-tier pricing strategy. BMG is launching a select number of new releases under a strategy where CDs are being sold in three different versions:

- Basic version (RRP Euro 9.99), which effectively is only the CD in a case without a booklet or any further extras.
- Standard version (RRP Euro 12.99), which is a CD including the booklet and some extras such as interviews or video tracks etc. Effectively the same as the "normal" CDs that are currently on sale.
- Premium version (RRP Euro 16.99), which offers a broad spectrum of extras in addition to the CD. Extras include thick songbooks, integrated multimedia offerings and bonus tracks. Likely to be bought by the core fan base of an artist.

If the first launch under the new pricing structure (artist: 2Raumwohnung, Album name: Es Wird Morgen) is anything to judge by then consumers have shown a roughly even buying pattern between all three versions. Figure 51 shows that with this split of sales, the effect on the average selling price is pretty much neutral, with the likely sales stimulation offsetting this.

Figure 51: BMG average selling price under old and trial pricing strategy

	RRP (EUR)	Share of sales (%)	Average weighted selling price (EUR)
Regular CD price under old strategy	13.99	100	13.99
Trial pricing strategy band			
Premium	16.99	30	5.10
Basic	9.99	35	3.50
Standard	12.99	35	4.55
Blended total			**13.14**

Source: BMG & Deutsche Bank estimates

Should BMG's pricing model establish itself, we could well see an increase in volumes while average selling prices could be more or less maintained according to our rough analysis above. With 65% of buyers either trading up or down, we think that this is proof of additionally created interest in the product that will feed through to volumes. Even though there are no comparable figures as to how much volume growth the new strategy has actually achieved over the old one-price-fits-all strategy, BMG has already sold more albums after the first two weeks of release than it sold of the artist's preceding album in total.

How much is Music Publishing worth?

We believe that the market has generally regarded EMI's Music Publishing division as a high-margin business, with stable cash flows but relatively predictable in nature due to the lack of upside surprises relative to forecasts. Altogether, we believe that it is widely perceived to be more of a "utility type" business with much less delta than the recorded music division.

In this context we aim to shed light on the fair value of EMI's music publishing division. We take four valuation approaches to see how much capital has been invested in the business over time, what the respective returns are and what market multiples comparable businesses trade on. Our final blended valuation of EMI's music publishing division values the business at an EV of around £1.1bn, equal to 10.1x 2006E EV/EBITA or 5.7x 2006E NPS.

Profitability – diminishing returns

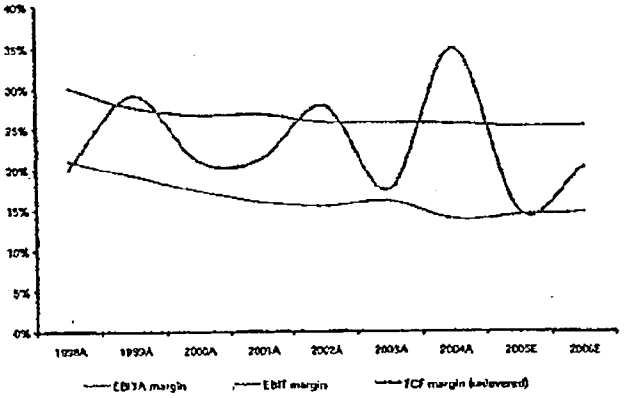
The profitability of EMI's music publishing business has steadily declined over the last five years. EBITA margins have gone from 28% in FY1999 to an estimated 25% in FY2005. Looking at the absolute level of EBIT generated (post music copyright amortization) it is currently below 1999 levels, despite revenues being 23% higher than in FY1999. We think that the declining profitability is due to a number of factors:

- The underlying revenue decline in mechanical royalties on the back of weak recorded music sales
- Possible (initial) margin dilution from acquired companies pre-synergy extraction

When we look at EBIT margins, Figure 52 shows that they have declined much more steeply than EBITA margins. This is mainly due to the increased amortization charge that hit EMI's P&L after capitalising the catalogues of acquisitions. As a consequence of the two most sizeable acquisitions, Jobete (capitalised in FY1998) and Windswept in FY2000, EMI's music copyright amortisation charge almost doubled from 1998 (£27m) to 2004 (£51m). On top of these two acquisitions, EMI has selectively bought smaller music publishing catalogues over the years, the value of which ranged from £5-12m.

For the record, EMI only generates an amortization charge on acquired music publishing rights. Organically generated intangibles are not capitalized and hence do not trigger an amortisation charge. The music copyright amortisation can hence be seen as being comparable to goodwill amortisation.

Figure 52: EMI music publishing margin profile

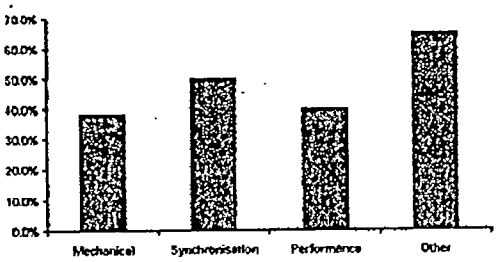


Source: Deutsche Bank & Company data

Underlying margin decline

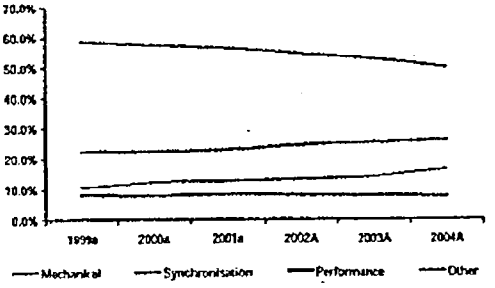
However, even when ignoring the effect of acquisitions on margins, the underlying EBITA margin decline is more so noticeable. It moves particularly into focus, when we consider that the share of relatively low-NPS (Net Publishers Share = Music Publishing gross profit post paying the song writer) mechanical revenue streams has declined over time while higher-NPS revenues such as Synchronisation have grown their share of overall revenues.

Figure 53: Estimated NPS for MP revenue streams



Source: Deutsche Bank & Company data

Figure 54: Share of total MP revenues



Source: Deutsche Bank & Company data

This implies that the underlying margin decline is worse than the headline figures initially suggest. We see this as pointing towards an increase in the cost base. We believe that one of the reasons for this could be that artists gained material leverage during the late 90s in negotiating their contracts with publishers.

- With a booming music market in the late nineties, particularly high profile artists had higher negotiating leverage and commanded increasingly favourable conditions, which pushed down NPS for the publishers.
- Competition between the major publishers for artists has pushed up the songwriters' share of publishing revenues.
- Negative reported revenue growth in FY2003/04 has had a negative margin impact in covering the fixed cost base of the business

Unfavourable writer contracts that were signed recently only started to feed through to margins with a time lag, which is mainly due to the 12-18 month collection cycle for most royalties hence leading to an underlying decline in NPS across the board. EMI's Music Publishing margins are laid out below:

Figure 55: EMI Music Publishing division operating profitability (£m)

P&L	1998	1999	2000	2001	2002	2003	2004	2005E	2006E
Revenues	298	317	354	391	417	401	398	395	402
Growth (%)		6.1	11.9	10.3	6.6	-3.7	-0.8	-0.6	1.8
EBITDA	95	93	100	110	113	109	107	105	107
Margin (%)	31.8	29.2	28.2	28.2	27.1	27.0	26.8	26.5	26.6
Depreciation	5	5	5	5	5	5	5	5	5
EBITA	90	88	95	105	108	104	102	100	102
Margin (%)	30.1	27.6	26.8	26.9	25.9	25.8	25.6	25.2	25.4
Intangible amortisation	27	27	34	43	44	39	47	43	43
EBIT	63	61	61	62	64	65	55	57	59
Margin (%)	21.0	19.1	17.3	16.0	15.4	16.1	13.8	14.3	14.7

Source: Deutsche Bank & Company data

Cash flow impacted by working capital swings

In terms of cash flow, music publishing is generally a very cash generative business because revenues are booked on a cash basis and there is very little capex required – tangible assets usually consist of an office with a chair and PC. However, due to the nature of music publishing contracts with advances, royalty payments and cash collections from music publishing societies all having different timing cycles, working capital can have a significant impact on cash flow generation. This can be further amplified by the quality (high expected revenue streams = high advances) and quantity of signings, so that cash flow can and will show large swings y-o-y.

Based on the information given in EMI's annual report we have estimated the cash flow profile of EMI's Music Publishing division before debt servicing. This shows that the FCF margins fluctuate quite significantly y-o-y, mainly driven by working capital.

Figure 56: EMI's Music Publishing cash flow profile

Cash Flow (£m)	1998	1999	2000	2001	2002	2003	2004	2005E	2006E
EBITDA	95	93	100	110	113	109	107	105	107
Tax (assumed at Group rate)	-30	-29	-29	-30	-28	-28	-23	-25	-26
Working Capital		34	9	8	37	-6	60	-17	5
Capex	-5	-5	-5	-5	-5	-5	-5	-5	-5
FCF (unlevered)	60	92	74	83	116	70	139	58	81
Margin (%)	20.0	29.1	21.0	21.3	27.9	17.4	34.9	14.8	20.3
Conversion (FCF/EBITDA) (%)	63	100	75	75	103	64	130	56	76
Net acquisitions	-148	-5	-165	1	-7	-6	1	0	0
Net FCF (unlevered, post acquisitions)	-88	87	-91	84	109	64	140	58	81

Source: Deutsche Bank & Company data

Method 1: CROCI analysis

Based on our assumptions for the music publishing division, we have assembled an individual asset profile for EMI's Music Publishing division and compared the cash returns to the asset base based on DB's proprietary CROCI methodology. The outcome can be summarised as follows:

EMI's music publishing cash business returns a little above its cost of capital. We believe that the returns of the business are mainly impacted by relatively pricey acquisitions in music publishing, most notably Jobete and Windswept, both of which are mentioned above. These were done at high multiples and hence have inflated the invested capital base of the business without giving adequately high returns.

Figure 57: EMI Music copyrights development (incl. acquisitions, £ m)

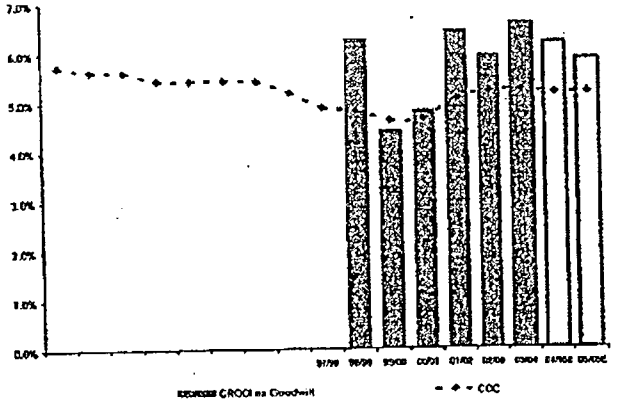
YE March 31	1998	1999	2000	2001	2002	2003	2004	2005E	2006E
Cost at start of year	397	529	563	748	848	864	811	784	784
Currency	-16	19	2	82	-2	-67	-97	0	0
Acquisitions	148	5	165	-1	7	9	0	0	0
Additions	0	10	16	6	11	8	5	0	0
Disposals	0	0	0	0	0	-3	-1	0	0
Reclassification	0	0	0	15	0	1	66	0	0
Cost at end of year (A)	529	563	748	848	864	811	784	784	784
Amortisation start of year	130	157	190	225	302	346	360	335	378
Currency	0	6	2	29	0	-30	-43	0	0
Charge for the period	27	27	34	43	44	39	47	43	43
Disposals	0	0	0	0	0	-2	-1	0	0
Write-downs	0	0	0	0	0	7	5	0	0
Reclassification	0	0	0	5	1	1	-33	0	0
Accc. amortisation at end of year (B)	157	190	225	302	346	360	335	378	421
Net value (A-B)	372	374	521	547	518	451	449	468	437

Source: Deutsche Bank & Company data

At the same time the decline in the core revenue stream from mechanical royalties has weighed down returns over the last few years. Were the business a listed company then we believe the market would probably value it on an EV/NCI (Enterprise Value/Net Capital Invested) multiple of around 1.2x, based on CROCI of 5.9% and cost of capital of 5.1%. This represents an EV of around £700m according to CROCI.

The Cash Return on Capital Invested is the real inflation adjusted economic return on a company's assets, that is, actual economic profitability. The bars show the level of CROCI calculated according to three asset life assumptions. The dotted line shown is the real cost of capital (COC), 5.1% at the moment. A CROCI above the line illustrates that the company is creating value for shareholders; below the line implies value destruction. As Figure 58 shows, EMI's music publishing division is, according to our estimates, comfortably exceeding the global Cost of Capital of our CROCI team (ex. 1999).

Figure 58: EMI Music Publishing CROCI ex goodwill



Source: Deutsche Bank

Below we set out the calculation of Capital Invested as per our CROCI team.

Figure 59: EMI Music Publishing CROCI & NCI calculation

	1998	1999	2000	2001	2002	2003	2004	2005E	2006E
Inflation Adjusted Gross Capital Invested	653	866	1131	1229	1207	1131	1079	1114	1122
Inflation Adjusted Net Capital Invested	536	457	617	677	662	626	572	592	596
Cash Flow (Post Tax, Pre-Exceptionals)	71	77	85	96	108	97	98	98	97
Avg. Life of Tangible Assets – Depreciation:	0.5 y	0.5 y	0.5 y	0.5 y	0.5 y	0.5 y	0.5 y	0.5 y	0.5 y
	(7.2 y. old)	(4.9 y. old)	(4.7 y. old)	(5.3 y. old)	(5.3 y. old)	(4.6 y. old)	(1.9 y. old)	(1.4 y. old)	(1.3 y. old)
Avg. Life of Intangible Assets (Music Copyrights)	20.0 y	20.0 y	20.0 y	20.0 y	20.0 y	20.0 y	20.0 y	20.0 y	20.0 y
	(9.0 y. old)	(9.0 y. old)	(9.0 y. old)	(9.0 y. old)	(9.0 y. old)	(9.0 y. old)	(9.0 y. old)	(9.0 y. old)	(9.0 y. old)
Avg. Life of Tangible Assets – Maintenance Capex:	0.3 y	0.3 y	0.3 y	0.3 y	0.3 y	0.3 y	0.3 y	0.3 y	0.3 y
	(4.6 y. old)	(3.2 y. old)	(3.0 y. old)	(3.4 y. old)	(3.4 y. old)	(3.0 y. old)	(1.2 y. old)	(0.9 y. old)	(0.9 y. old)
CROCI ex Goodwill – based on Method 2 (%)		6.3	4.4	4.8	6.5	6.0	6.6	6.2	5.9

Source: Company data, Deutsche Bank
Net Capital Invested is a measure of the totality of investments that have been made to generate the economic returns. This includes gross tangible fixed assets and intangible assets such as R&D, leased assets, other depreciable intangibles such as brands less accumulated depreciation and plus non-depreciable capital invested such as net working capital, land.

We note that the CROCI EV is highly sensitive to changes in the assumed average life of the music publishing copyrights, which effectively form the asset base of the Music Publishing division. While music copyrights do generate royalties up to 70 years after the death of the writer, we believe that on average (i.e. considering peak and trough revenues on any given copyright) the potential for sustained royalty/cash generation on a constant level is in reality shorter than that and have hence assumed 20 years as our base case asset life here. Below we have set out the sensitivity of the CROCI EV of music publishing to changes in the assumed average asset life. Changing this assumption from say 20 to 25 years gives a roughly £130m uplift to our implied value up to £830m.

Figure 60: EMI MP EV sensitivity to Average Asset life for Music copyrights

	Assumed average life of Music copyrights (years)				
	15	20	25	30	35
EMI MP CROCI (%)	3.4	5.9	7.0	7.7	8.0
COC (%)	6.1	5.1	5.1	5.1	5.1
CROCI/COC	0.7	1.2	1.4	1.5	1.6
Inflation-Adjusted NCI	587	600	605	614	623
Implied EMI MP EV (£m)	391	694	830	927	977

Source: Deutsche Bank

Suggested valuation

According to our CROCI methodology, the implied fair value for EMI's music publishing EV is around £700m based on a 20yr asset life. We assume that EMI can potentially leverage its Music Publishing business with around 4-4.5x EBITDA given its stable earnings profile, while the equivalent ratio would be sub-2x for recorded music. Based on this attribution of EMI's group debt, the implied equity value for EMI's Music Publishing based on our CROCI analysis is approximately £240m. On our 2006E forecasts our CROCI valuation implies a fair value multiple of around 6.8x EV/EBITA.

We would also like to add that our derived EV of £700m initially looks like a very low absolute valuation, and we note that the CROCI methodology assumes the same level of returns (i.e. 5.9%) into perpetuity. In our view however, music publishing returns are likely to improve from these levels going forward, driven by a pick-up in mechanical royalties and mobile phone revenues. We would hence see this CROCI-derived value as a worst-case valuation floor for EMI's Music Publishing division.

Figure 61: Music Publishing implied CROCI valuation

	Value (£m)	Comment
Implied MP EV	700	Given CROCI profile, market would likely value the business at around 1.2xEV/NCI or £700m
Net debt share	460	Assuming that 55% of group net debt could be attributed to MP, which is equal to 4-4.5xEBITDA leverage against sub- 2x for the RM division
Implied MP Equity value	240	
Implied 2006E EV/EBITA multiple	6.8	Based on our 2006 forecasts for MP division

Source: Deutsche Bank & Company data

Method 2: Directories multiples?

When looking for other quoted media sub-sectors that could be indicative of the valuation the market would attribute to music publishing, directories spring to mind. Directories companies have a number of similarities in terms of their returns and growth profile that supports a comparative valuation analysis.

- Stable nature of revenue streams – Most directories businesses have organic growth rates of between 0 and 5%, which is pretty similar to music publishing.
- High margins – Directories businesses in Europe typically have EBITA margins of between 30%, which compares to our current 25% forecast for music publishing.
- Strong cash generation because of low capex requirements. Capex requirements for directories are relatively low (typically <2% of sales), which compares favourably to music publishing, where we estimate underlying capex to be in the region of 1-2% of sales.

Looking at where listed directories are currently trading, we derive a median valuation of 10.5x 2006E EV/EBITA for our blended Music Publishing valuation.

Figure 62: Directories EV/EBITA multiples as at 31 March 2005

	Price	Rec.	2004E	2005E	2006E
TPI	Euro 7.0	Hold	14.3	12.3	11.5
Yell	466p	Sell	11.9	10.8	10.1
Pages Jaunes	Euro 18.8	Buy	12.8	11.4	10.5
Directories median			12.6	11.4	10.5

Source: Deutsche Bank

Method 3: Consumer publishing multiples?

Another alternative sub-sector to look at is consumer publishers. The main argument for music publishing valuations somewhat resembling a consumer publishing business is that circulation revenues at consumer publishers largely depend on the commercial success of its magazine and newspaper titles. Even though most consumer publishers are partly advertising-funded, EMI's pure exposure to consumer tastes in recorded music, concerts and radio warrants at least taking a look at the multiples at which consumer publishers currently trade. On our current estimates, consumer publishers trade at around 9.5x 2006E EV/EBITA, which we include in our blended music publishing valuation.

Figure 63: Consumer publisher EV/EBITA multiples as at 31 March 2005

	Price	Rec.	2004E	2005E	2006E
Johnston Press	536p	Hold	10.4	10.3	9.8
Trinity Mirror	682p	Sell	9.7	9.7	9.5
Daily Mail	723p	Hold	12.3	11.4	7.9
EMAP	838p	Buy	11.0	10.0	9.0
RCS Mediagroup	Euro 4.2	Buy	18.5	14.3	11.9
L'Espresso	Euro 4.6	Buy	11.5	11.0	9.5
Mondadori	Euro 8.4	Buy	10.8	9.9	9.4
Prisa	Euro 15.7	Hold	20.9	16.8	14.3
Consumer publishers median			11.3	10.7	9.5

Source: Deutsche Bank

Method 4: DCF

As our final sense check on the valuation of EMI's Music publishing business we use DCF. We use our long-term Music Publishing forecasts as laid out in the valuation section of this report and have then made the following standalone assumptions for our divisional valuation:

Figure 64: Music Publishing standalone DCF assumptions

	(%)
Cost of Equity:	8.7
Nominal cost of debt:	5.5
Tax:	32
Post-tax cost of debt:	3.7
Debt as % of EV:	40
WACC:	7.3

Source: Deutsche Bank

In line with our assumed 2% terminal growth for music publishing in the valuation section of this report, we see fair value at the music publishing business at an EV of £1.4bn, giving us an implied 2006E EV/EBITA multiple of 13.6x.

Figure 65: Music Publishing standalone DCF terminal growth sensitivity

(%)	-2.0	-1.0	0.0	1.0	2.0	3.0	4.0
Sum NPV	598	598	598	598	598	598	598
Terminal value	442	500	574	672	806	1,002	1,317
Combined NPV	1,040	1,098	1,172	1,270	1,404	1,600	1,915
Implied 2006E EV/EBITA multiple	10.1	10.6	11.3	12.3	13.6	15.5	18.5

Source: Deutsche Bank

Historical deal multiples: far-fetched

Another valuation approach would be to look at historic deal multiples. In the recent past we have seen music publishing deals executed at high headline multiples. The average multiple for the most recent four transactions in the sector has been a high 18.4x NPS (Net Publisher Share).

Figure 66: Music Publishing deal multiples

Date	Buyer	Asset	Price (US$m)	NPS multiple (x)
August-00	Vivendi	Rondor	400	18.0
March-01	Chrysalis	Securitisation	251	18.8
July-02	Sony	Acuff Rose	157	16.0
April-03	EMI	Jobete	109	20.0

Source: Deutsche Bank

We believe that there are a number of reasons for the relatively high multiples being paid for smaller publishing catalogues:

- A larger acquirer can easily integrate the business and leverage its own sales, distribution and collection network to generate incremental revenues.
- Cost savings can easily be achieved by eliminating overheads if small catalogues are integrated into the existing platform of a major.
- Finally, the scarcity of music publishing assets that are available for sale has pushed up prices whenever assets were up for sale.

We do not believe that a major music publishing catalogue such as EMI's should be valued anywhere near historical transaction multiples, because the relative revenue and cost benefits from acquiring such a large catalogue would be substantially less than in smaller deals. Payment of these kind of multiples would require a trade buyer that can extract substantial cost savings. However, a deal involving any of the other major music publishers would raise regulatory issues so that we do not see historical transaction multiples as materially impacting our valuation of EMI's music publishing business.

Implications for EMI valuation

Taking our four different valuation approaches into account, our blended fair value multiple for music publishing comes out at £1.04bn or 10.1x FY2007E EV/EBITA. This is again based on a suggested CROCI multiple of 6.8x, with directories and consumer publisher peer group multiples suggesting a range between 10.5x and 9.5x and an implied DCF multiple of 13.6x. Our blended valuation for EMI's music publishing business implies an NPS multiple of 5.7x, compares with a historical transaction multiple of 18.4x NPS for smaller catalogues.

Figure 67: Music Publishing valuation

	2006E Multiple	Comment
Consumer Publisher EV/EBITA median (2006E)	9.5	Current market value
Directories EV/EBITA median (2006E)	10.5	Current market value
CROCI implied EV/EBITA multiple (2006E)	6.8	According to DB CROCI methodology
DCF implied EV/EBITA multiple	13.6	According to DCF
Blended EV/EBITA multiple (2006E)	10.1	Average of above
Implied MP equity value	580	On blended EV/EBITA multiple
Assumed MP net debt share	462	Assuming MP can leverage up to 4x EBITA and RM up to 2x results in 55% share of net debt
Implied MP EV (£ m)	1,042	On blended EV/EBITA multiple
Implied NPS multiple	5.7	On blended EV/EBITA multiple

Source: Deutsche Bank

Implied RM valuation

Having set a market- and return-driven valuation for music publishing, we have isolated EMI's recorded music multiples so that we can assess the multiple the market should be attributing to EMI's recorded music business. On our 310p target price the market would value EMI's recorded music business at 11.2x 2006E EV/EBITA, which we see as fair given the improving margin profile and revenue growth going forward. This compares favourably to the media sector, which is currently trading on a 11.8x average.

Figure 68: Implied RM and MP multiples on 310p target price

Implied RM multiples on 310p	FY2005E	FY2006E	FY2007E
EV/EBITA	17.9	13.0	11.2
EV/Sales	1.5	1.4	1.4
EBITA margin (%)	8.2	11.1	12.6

MP multiples on £1.04bn EV	FY2005E	FY2006E	FY2007E
EV/EBITA	10.7	10.4	10.1
EV/Sales	2.7	2.6	2.6
EV/NPS	6.0	5.9	5.7

Source: Deutsche Bank

Appendix: Music Publishing explained

Introduction

Music companies create and exploit copyright related to sound recordings. **Recorded Music** is the business of acquiring and developing rights to the recordings of performances by artists and exploiting these performances through record sales. Music Publishing is the business of acquiring, administering and exploiting music rights. As a distinct activity, **Music Publishing** is the business of acquiring, administering and exploiting rights in musical compositions on behalf of both the composer of the score and the writer of the lyrics. Simply put, recorded music sells songs by an artist, whereas music publishing sells compositions. Revenues in music publishing typically break down as follows:

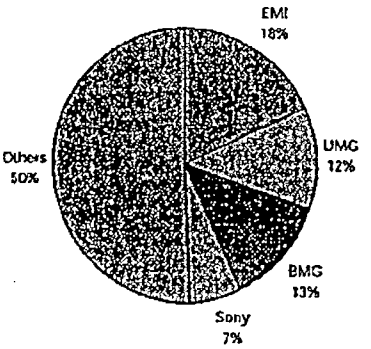
Figure 69: EMI's music publishing divisions

Division	Revenue share of music publishing division (%)	Revenue from...
Mechanical	55-65	Single and album sales, Master tones
Performing	20-25	Radio, Music Videos, Cinema, Internet, Concerts
Synchronisation	10	Advertising spots, ring tones, Film sound tracks, musicals etc.
Other income	05-10	Stage, paper based scores

Source: Vivendi Universal, EMI and Deutsche Bank

Through select acquisitions, EMI has become the global market leader in music publishing, followed by Universal and BMG.

Figure 70: Global music publishing market shares 2003



Source: Music & Copyright

Revenue generation

Music publishers earn revenue from licensing the right to use their songs. Every time a song is used or performed, the owner of the copyright must grant permission, a licence must be issued and a payment must be made. That is the theory, anyway. In practice, there is

considerable leakage in this process. However, the premise holds good that the more a song is performed or used the more income is generated for the publisher and songwriter.

Copyright conveys the exclusive legal right of song writers to be compensated for the use of their songs. Generally, the right to receive copyright royalties extends for the life of the writer plus between 50 and 70 years following their death, depending on jurisdiction. Income generated by the use of a song is split between the writer and publisher, with the publisher in most instances responsible for collecting income on behalf of the writer and for distributing their share.

Commonly, the publisher will sign up to use intellectual property of the writers for several albums plus a retention period, following which the rights will revert to the writer to cut new deals or sell the rights. Hence, typically deals will be for 10-15 years given each album cycle is typically 2-3 years.

Although music publishing grew out of the sheet music publishing business of the last century, the vast majority of publishing revenues today come from three sources – mechanical, performance and synchronisation royalties.

Mechanical royalties

The term mechanical evolved out of the practice of converting sheet music into piano rolls that mechanically played the song – hence the name. It was a direct path from piano rolls to recordings. Each time a record is sold, the publisher gets paid. The pace of growth of mechanical royalties is driven by the growth rate of the overall recorded music market.

Rates

In general, the average mechanical royalty across the world is about 8.5% of the retail price of a record. In the US it is a fixed rate of 7.6 cents per song. Hence a typical album with 10 songs will generate a publisher royalty of 76 cents. Deducting sales tax and retailer margin, the average revenue generated from a CD sale by a record company is $8 therefore the 76 cents represents almost 10% of revenues. Out of that 8.5% or 76 cents, the writer/composers have to be paid their share.

Growth

Fundamentally, the revenue growth of mechanical revenues is linked to the top line of the global music market. It is directly related to album volumes – rather than to price – as the royalty is paid on a per copy shipped basis.

Collection

The responsibility for collecting the monies from the record companies that ship the albums lies with collection societies (CS). These are essentially non-commercial organizations that are independent of record companies. There are typically a small handful of major collection societies in each market. With international-selling artists, it is the publisher's role to chase down the payment of royalties due from the CSs, who in turn have the responsibility to audit the record company's wholesale soundcarrier shipments.

It is worth highlighting that most publishers (including for example EMI) only record revenues once the cash has been received – ie, does not record revenues on an accrual basis. Also, there is a delay in the payment of the monies to the publishers by territory. Payments from certain markets (such as Italy, Latin America) can lag the respective record sales by up to two years. In the UK, by contrast, payments are typically made within three months. Nevertheless, the stated financial performance lags what is occurring in the real market place and as such, the mechanical performance of a single FY may have obscured the real picture – where revenue actually generated in that year might be slowing more sharply.

Margins

The gross margin on mechanical revenues for the publisher is around 25%. The writers receive around 75% of the net publisher share. We believe this margin is slowly getting squeezed as the negotiating leverage of the artists grows and contracts to re-license become shorter after the initial licensing period when a writer is largely unknown. Certain deals have always existed in the industry where publishers essentially accept very low margins on mechanical revenues – as low as 5-10% – in exchange for better margins on the more variable synchronisation revenues.

Synchronisation Royalties

This has been a growing source of revenue for music publishers lately. It involves the marrying of a song (words and music) with visuals such as television programmes, advertisements, videogames and films. Revenues from ring tones are also predominantly booked in this division, eve though this varies by country. Synchronisation revenues are ad hoc contracts signed with, say, an advertiser, their agency or a movie studio that wishes to use a piece of music.

Margins in this division are highly variable in a way that mechanical and performance are not. Once the synchronisation deal is signed, it is likely that the publisher will also receive revenues from either performance (if the ad is played on TV or radio) or mechanical revenues if it forms part of a music soundtrack.

Revenues are determined by a number of factors such as:

- likely play levels
- status of the track (current or back catalogue)
- the track's prominence (title music, background),
- geographic coverage
- time of year
- length of exploitation and
- most importantly gut feel – as to whether the client wants the piece of music desperately and hence is prepared to pay well for it.

Cash flow is immediate, with the cheque sent directly from the client to the publisher with generally no intermediaries involved.

Growth rate

Synchronisation has been the fastest-growing revenue stream in the recent past. Revenue has been buoyed by the stellar performance of the film industry – with record box office success and profitability recorded across the market – as well as the boom in adspend from the mid 1990s to 2000. A recovery in the economy and the advertising market will generally spur growth going forward.

Margins

Revenue on average is agreed at anywhere between 30-45% for the publisher. As such, it is the highest-margin stream for the publisher. As it is the area where the publisher has the greatest opportunity to influence the promotion and exploitation of the content, we expect margins here to remain high. The high margin levels of synchronisation effectively act as an incentive for the publisher to drum up business from greater utilisation of its catalogue.

Performance royalties

Historically performance income was generated when a song was performed live on stage or played in a public place. Now it covers a wide range of uses including when a song is broadcast on radio, television, in a cinema (except in the US), a lift, a pub jukebox or over the Internet. Performance represents the second high-growth revenue stream for music publishers.

Revenue generation

Radio revenues are generated on two bases: commercial channels (the vast majority) pay the publisher a percentage of advertising revenues. Non-commercial channels (such as the BBC stations in the UK) pay a percentage of audience reach. As such, this revenue stream is actually cyclically geared.

TV revenue generation is complex: to simplify, it is related to audience share, which determines how many viewers saw an advert or program and conditions how much revenue the publisher is due.

Collection

Taking the example of the UK, here the Performing Rights Society (PRS) collects revenues. The PRS in particular is a much criticised body given its perceived inefficiency in pursuing its near impossible mandate of tracking down and enforcing payment for licence abuse. Licence abuse could encompass the following vivid examples:

- a pub music quiz failing to pay for music clips for its punters to guess at
- websites playing background music
- a street vendor of wind-up toys illegally using a well known tune
- a teleconference company subjecting financial analysts to 99 Red Balloons while on hold, awaiting the start of a quarterly results conference call.

It is clear that there is considerable leakage in this area – much of which will never be eradicated, as it would be cost inefficient to even attempt to do so.

The trail of cash payments is generally not transparent and is the most working capital-intensive of all revenue streams.

Growth

Performance revenues have flourished with the growth in the number of TV channels and radio stations. The strong advertising cycle of the late 1990s-2000 has also buoyed radio and some TV revenue streams that were linked to advertising revenues. The advent of digital radio in various markets may provide additional revenue stimulus, but it is likely to be limited as we expect digital radio to capture only limited incremental radio adspend.

Margins

Gross margins end up in the 25% region. In most territories, there is an agreed formula under which the writer gets 50% of the performing royalties from the PRS up front and the balance is then paid to the publisher by the PRS. Of the 50% received by the publisher, 50% (ie, 25% of the original amount) is then forwarded to the writer.

Financials

Figure 71: EMI Profit & Loss account (£ m, UK GAAP)

FY to 31 March	2003	2004	2005E	2006E	2007E
Total Revenue	2,175	2,121	1,917	1,942	1,999
Reported Growth (%)	-11.1	-2.5	-9.6	1.3	2.9
EBITDA	297	284	253	302	331
Growth (%)	22.8	-4.3	-11.1	19.3	9.7
Margin (%)	13.7	13.4	13.2	15.5	16.6
Depreciation	-43	-35	-30	-29	-28
Operating Costs	-1,921	-1,872	-1,694	-1,670	-1,696
Annual Growth (%)	-14.8	-2.6	-9.5	-1.4	1.5
EBITA (pre music amortisation)	254	249	222	272	303
Reported Growth (%)	33.2	-1.9	-10.8	22.4	11.4
Operating Margin (%)	11.7	11.8	11.6	14.0	15.2
Net Interest	-76	-96	-87	-86	-84
Interest Cover (x)	3.3	2.6	2.5	3.2	3.6
Copyright & Goodwill Amortisation	-43	-51	-47	-47	-47
Exceptional	-25	-184	0	0	0
Gains/losses on disposals)	210	29			
Reported pre-tax profit (FRS10)	319	-53	68	139	172
Normalised PTP (pre amortisation)	177	153	135	186	219
Reported Growth (%)	15.8	-13.7	-11.8	38.0	17.8
Margin (%)	8.2	7.2	7.0	9.6	11.0
Taxation	-45	-33	-32	-47	-59
Underlying Tax Rate (%)	25.4	21.2	23.5	25.0	27.0
Minorities	-10	-7	-4	-5	-6
Normalised attributable profit	122	114	100	135	154
Dividends	-63	-63	-63	-63	-63
Average Number Of Shares (m)	784.0	784.4	785.3	785.3	785.3
Average Number Of FD Shares (m)	784.4	826.5	871.6	871.6	871.6
Normalised Earnings Per Share (p)	15.5	14.2	12.3	16.3	18.6
Reported Growth (%)	14.4	-8.4	-13.7	32.7	13.0
Net Dividend Per Share (p)	8.0	8.0	8.0	8.0	8.0
Reported Growth (%)	-20.8	0.0	0.0	0.0	0.0
Dividend Payout (%)	51.5	56.2	65.1	49.0	43.1
P&L Dividend Cover (x)	1.9	1.8	1.5	2.0	2.3

Source: Company data, Deutsche Bank

Figure 72: EMI cash flow statement (£ m)

FY to 31 March	2002	2003	2004	2005E	2006E	2007E
Operating Profit	-101	188	133	175	225	256
Music Copyright & goodwill amortisation	44	49	61	43	43	43
Depreciation	57	43	35	30	29	28
Goodwill	29	12	22	4	4	4
Utilisation Of Provisions	-29	-85	-36	-5	-4	0
Cash exceptionals				-70	-15	
Working Capital	89	-104	60	38	-12	-18
Other cash items	124	16	43	-10	-9	-9
Operating Cash Flow	212	117	309	206	261	305
Co defn conversion (%)			109	109	92	82
Interest, dividends to minorities	-62	-11	-99	-87	-86	-84
Taxation	-22	-39	-31	-32	-47	-59
Capital Expenditure/Music copyrights net	-42	-76	-55	-50	-45	-45
Free Cash Flow	85	-8	124	37	84	117
Growth (%)	-29.4	n/m	n/m	-70.2	125.5	40.5
Free Cash Flow Margin (%)	3.6	-0.4	5.9	1.9	4.3	5.9
Earnings Conversion (%)	80.0	-6.7	109.0	37.2	62.0	76.0
Dividends	-125	-29	-63	-63	-63	-63
Net Operating Funds	-40	-38	62	-57	21	55
Acquisitions	-24	-22	-89	-50	0	0
Disposals	0	243	78	16	15	0
Net Cashflow	-64	183	51	-92	36	55
Other items	-1	16	60	0	0	0
Change in Net Debt	-65	199	111	-92	36	55

Source: Company data, Deutsche Bank

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist			
Company	Ticker	Recent price	Disclosure
EMI	EMI.L	241.64 (GBp)	2,6,8,9,13,14,15

2. Deutsche Bank and/or its affiliate(s) makes a market in securities issued by this company.
6. Deutsche Bank and/or its affiliate(s) owns one percent or more of any class of common equity securities of this company calculated under computational methods required by US law.
8. Deutsche Bank and/or its affiliate(s) expects to receive, or intends to seek, compensation for investment banking services from this company in the next three months.
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EXHIBIT CO 0959

July 16, 2006

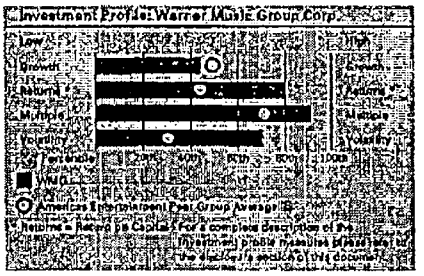
COMPANY UPDATE

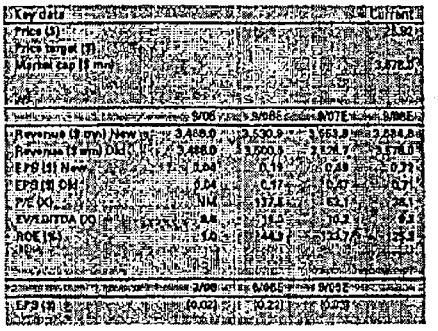
Warner Music Group Corp. (WMG)

Outlook: Increasing 3QFY06 revenue and EBITDA by 4% and 6%

What's changed

We are raising our 3QFY06 revenue, EBITDA, and EPS estimates to $815 mn (+11.1% yoy), $86 mn (+22.2%), and ($0.22) from $784 mn/$81 mn/($0.24), respectively, given our view that Warner Music gained 300+ basis points in domestic market share to 19.3% in the June quarter, driving 4% upside to expected revenue.. Revenue benefited from releases by T.I., Red Hot Chili Peppers, and Daniel Powter, as well as spillover from Madonna and James Blunt among others. Given the strong physical performance, we are lowering our aggressive digital sales estimate to $82 mn (+86% yoy and -9% qoq), from $92 mn, which still represents significant growth. Our estimates also incorporate 100 bps of yoy EBITDA margin expansion. We believe the stock should continue to benefit from another quarter of outperformance and consistent fundamental trends, reinforcing our thesis that digital growth can offset physical declines and Warner has made sufficient A&R investment to drive new release performance. Warner Music's market share gains to date have reinforced our view that 2006 will likely be the 1st year that digital increases outpace physical declines, something WMG experienced for the 2nd time last quarter in Recorded Music (excluding FX). Warner Music Group is Not Rated.



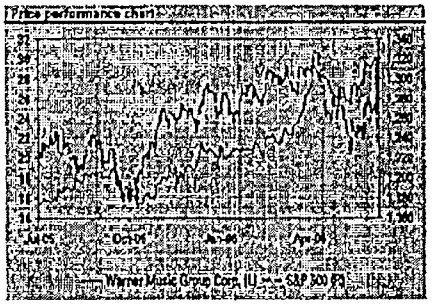


Implications

Warner Music shares should benefit from another quarter of outperformance. With the Sony/BMG merger uncertainty, WMG is likely to continue to trade without an M&A premium. Thus, we believe that WMG should be trading closer to the implied value we discussed in our note dated April 27, 2006, before our shift to Not Rated.

Valuation

Warner Music is trading at 10x CY2007 EV/EBITDA. We do not have a price target given our Not rated status. Prior to going NR, our year-end implied value was $26 without an M&A premium.



Key risks

The biggest risk to our thesis is that physical music declines exceed digital growth by a great enough magnitude to offset the margin benefit of digital. Company-specific risks: (1) lack of transparency into release data; (2) acceleration in piracy; (3) cost reductions that may have been too deep; (4) underdevelopment in the urban genre; (5) digital royalties litigation; and (6) leverage.

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Warner Music Group Corp.: Summary financials

Profit model ($ mn)	9/05	9/06E	9/07E	9/08E
Total revenue	3,468.0	3,630.5	3,553.9	3,584.0
Cost of goods sold	(1,650.0)	(1,842.5)	(1,825.5)	(1,830.1)
SG&A	(1,301.0)	(1,268.4)	(1,213.6)	(1,215.5)
R&D				
Other operating profit (expense)	164.0	107.2	134.1	136.0
ESO expense	(25.0)	(16.0)	(10.0)	(10.0)
EBITDA	450.0	511.7	638.9	668.9
Depreciation & amortization	(238.0)	(228.7)	(209.5)	(186.2)
EBIT	222.0	283.0	327.4	381.7
Net interest income/(expense)	(182.0)	(178.8)	(164.5)	(159.2)
Income/(loss) from associates	0.0	0.0	0.0	0.0
Other	19.0	12.0	5.5	8.0
Pretax profits	59.0	116.2	168.4	211.6
Provision for taxes	(57.7)	(87.7)	(93.1)	(97.9)
Minority interest	0.0	0.0	0.0	0.0
Net income pre-preferred dividends	1.3	30.5	75.3	113.7
Preferred dividends	0.0	0.0	0.0	0.0
Net income (pre-exceptionals)	1.3	30.5	75.3	113.7
Post tax exceptionals	(893.0)	0.0	0.0	0.0
Net income (post-exceptionals)	(891.7)	30.5	75.3	113.7
EPS (basic, pre-except) ($)	0.01	0.22	0.53	0.77
EPS (diluted, pre-except) ($)	0.04	0.19	0.49	0.72
EPS (basic, post-except) ($)	0.01	0.22	0.53	0.77
EPS (diluted, post-except) ($)	0.04	0.19	0.49	0.72
Common dividends paid ($)	(764.0)	0.0	0.0	0.0
DPS ($)	6.92	0.00	0.00	0.00
Dividend payout ratio (%)	8,650.8	0.0	0.0	0.0

Balance sheet ($ mn)	9/05	9/06E	9/07E	9/08E
Cash & equivalents	298.0	262.4	549.2	839.5
Accounts receivable	607.0	635.5	648.2	637.7
Inventory	57.0	42.0	61.8	60.3
Other current assets	265.0	145.0	245.0	245.0
Total current assets	1,227.0	1,084.9	1,504.2	1,780.5
Net PP&E	167.0	142.1	134.1	128.6
Net intangibles	2,784.0	2,618.1	2,441.8	2,276.9
Total investments	21.0	39.0	72.2	105.7
Other long-term assets	234.0	322.0	372.0	422.0
Total assets	4,499.0	4,468.1	4,624.9	4,713.7
Accounts payable	247.0	212.7	209.2	301.5
Short-term debt	17.0	17.0	17.0	17.0
Other current liabilities	1,484.0	1,527.3	1,690.5	1,836.4
Total current liabilities	1,748.0	1,757.0	1,907.7	2,154.9
Long-term debt	2,229.0	2,128.8	2,211.8	2,195.6
Other long-term liabilities	432.0	431.7	441.7	451.7
Total long-term liabilities	2,661.0	2,560.5	2,653.5	2,647.3
Total liabilities	4,409.0	4,417.4	4,560.9	4,802.1
Preferred shares	0.0	0.0	0.0	0.0
Common stock	548.0	556.0	556.0	556.0
Retained earnings	(459.0)	(507.3)	(492.0)	(438.4)
Other common equity	0.0	0.0	0.0	0.0
Total common equity	89.0	48.7	64.0	117.6
Minority interest	0.0	0.0	0.0	0.0
Total liabilities & equity	4,498.0	4,468.1	4,624.9	4,719.7

Growth & margins (%)	9/05	9/06E	9/07E	9/08E
Sales growth	2.4	1.8	0.7	0.9
EBITDA growth	18.1	11.2	4.9	4.3
EBIT growth	67.6	27.5	15.7	10.5
Net income growth	35.5	103.8	147.1	50.8
EPS growth		225.7	139.0	47.1
EBITDA margin	13.0	14.1	18.1	18.6
EBIT margin	6.4	8.0	9.2	10.7
Gross margin	44.7	47.8	48.5	48.9

Additional financials	9/05	9/06E	9/07E	9/08E
Net debt/equity (%)	2,200.0	2,669.7	2,825.3	2,117.3
Interest cover (X)	1.2	1.6	1.9	2.1
Inventory days	11.5	9.3	10.4	12.8
Receivable days	63.6	63.7	63.9	60.4
BVPS ($)	0.74	0.34	0.44	0.78
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
ROA (%)	0.0	0.7	1.7	2.4
CFOCI (%)	11.9	26.7	19.4	32.7
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Dupont ROE (%)	2.0	62.5	117.7	96.8
Margin (%)	0.1	0.9	2.1	3.2
Turnover (X)	0.8	0.8	0.8	0.8
Leverage (X)	50.5	91.8	72.3	30.1
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Free cash flow yield (%)	17.8	8.8	7.7	16.3

Cash flow statement ($ mn)	9/05	9/06E	9/07E	9/08E
Net income	(189.0)	26.7	75.3	113.7
D&A add-back (incl. ESO)	239.0	228.7	209.5	186.2
Minority interest add-back	0.0	0.0	0.0	0.0
Net (inc/dec) working capital	(51.0)	24.4	64.8	162.9
Other operating cash flow	188.0	(3.8)	2.5	(10.1)
Cash flow from operations	204.0	275.3	352.0	454.8
Capital expenditures	(30.0)	(24.0)	(26.0)	(25.0)
Acquisitions	0.0	0.0	0.0	0.0
Divestitures	0.0	0.0	0.0	0.0
Other	(24.0)	(94.0)	(33.2)	(33.5)
Cash flow from investing	(54.0)	(118.0)	(59.2)	(58.5)
Dividends paid (common & pref)	(926.0)	(177.0)	(90.0)	(90.0)
Inc/(dec) in debt	(591.0)	(14.0)	(36.0)	(36.0)
Other financing cash flows	1,101.0	8.7	10.0	10.0
Cash flow from financing	(416.0)	(182.3)	(106.0)	(106.0)
Total cash flow	(266.0)	74.4	186.8	290.3

Note: Last actual year may include reported and estimated data.

Source: Company data, Goldman Sachs Research estimates.

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Estimate changes: We are raising our revenue and EBITDA estimates for 3QFY06 by approximately 4% and 6% respectively, while maintaining our estimates for the September quarter of fiscal 2006 so that our full year fiscal 2006 EPS estimate increases from $0.17 to $0.19 (all estimates are post-FAS123R and pro forma for print business sale). We have increased our revenue and EBITDA for 3QFY06 to $815 mn (+11.1% yoy) and $86 mn (+22.2% yoy), respectively, from $784 mn (+7.1% yoy) and $81 mn (+16.4% yoy) previously, given the better-than-expected performance of several acts that drove an increase in Warner Music Group's domestic market share performance despite a decline in physical music unit sales for the overall market. Please see key data points below that lead to our increased estimates. Our estimates incorporate 100 bps of yoy EBITDA margin expansion after yoy increases of 170 bps and 220 bps in 1QFY06 and 2QFY06, respectively. Warner Music's 3QFY06 release schedule included releases by T.I., Red Hot Chili Peppers, and Daniel Powter, as well as continuing sales from Madonna and Enya among others (see Exhibit 2).

Exhibit 1: Estimate changes
$ millions, except per-share data

	F3Q06E	F4Q06E	F2006E	F2007E	F2008E
Revenue (new)	$815	$876	$3,531	$3,554	$3,585
% change yoy	11.1%	(3.2%)	1.8%	0.7%	0.9%
Revenue (old)	$784	$876	$3,500	$3,527	$3,576
% change yoy	7.1%	(3.2%)	1.0%	0.8%	1.4%
Total EBITDA excluding FAS 123 (new)	$90	$116	$528	$547	$570
% change yoy	13.3%	(2.4%)	8.8%	3.6%	4.2%
Total EBITDA excluding FAS 123 (old)	$85	$116	$524	$543	$568
% change yoy	8.2%	(2.4%)	8.0%	3.6%	4.6%
Total EBITDA including FAS 123 (new)	$86	$112	$512	$537	$560
% change yoy	22.2%	0.1%	11.2%	4.9%	4.3%
Total EBITDA including FAS 123 (old)	$81	$112	$508	$533	$558
% change yoy	16.4%	0.1%	10.4%	4.9%	4.7%
EPS - excl. FAS 123 (new)	($0.20)	($0.00)	$0.30	$0.55	$0.78
% change yoy	27.7%	(102.6%)	30.8%	85.3%	41.4%
EPS - excl. FAS 123 (old)	($0.22)	($0.00)	$0.28	$0.53	$0.77
% change yoy	20.4%	(101.0%)	22.7%	89.8%	44.9%
EPS - incl. FAS 123 (new)	($0.22)	($0.03)	$0.19	$0.49	$0.72
% change yoy	100.2%	(185.2%)	414.8%	159.2%	47.1%
EPS - incl. FAS 123 (old)	($0.24)	($0.03)	$0.17	$0.47	$0.71
% change yoy	28.7%	(181.4%)	364.4%	174.6%	51.3%

Source: Company data, Goldman Sachs Research estimates.

The following trends have driven our increased view of expected June quarter and fiscal 2006 growth estimates:

- **WMG increased US album share yoy in 3QFY06** – According to SoundScan data, Warner Music Group increased its June quarter album share in the US by just over 300 basis points yoy to 19.25% from 16.1% a year ago. Album unit sales for the industry was down 5.3% yoy in the June quarter, implying that album unit sales (including only physical and digital albums, not digital tracks) for Warner Music were up approximately 13% yoy in the US. We note that WMG is typically stronger in the US than internationally (WMG generates approximately 50% of revenue internationally). Our conservative yoy physical revenue growth estimate of 6.5% for the quarter

(as opposed to the 13% yoy growth implied by the SoundScan data) incorporates potential downside from international unit sales. Additionally, the 13% album unit sales increase stated above does not include our $82 mn digital revenue estimate (an 86% yoy increase).

- SoundScan data for the industry is marginally up YTD – YTD through the week of 7/2/06, album sales plus digital (includes physical and digital albums and also digital/physical track equivalents) are up 0.1% yoy. However, Warner Music Group has shown significant increases in market share over the past two quarters, which in conjunction with flat industry sales has led to overall revenue growth at Warner Music Group that has outpaced the market.

Recommendation: Our thesis remains unchanged in that we see WMG as an investment in existing content that can be further monetized through new formats and new distribution channels. We see digital growth offsetting physical declines, driving mid-single digit EBITDA growth in 2008-09. Each incremental dollar of revenue in these new formats will likely be more profitable given digital music's better margin contribution. Thematically, within the broader media landscape, we continue to favor content-centric companies given the secular advertising issues that are negatively impacting growth for ad-centric companies, combined with our view that the value of content will continue to increase as competition among distributors increases and new distribution platforms emerge. Additionally, we believe that music content specifically is advantaged because it has already suffered through the worst of Internet piracy, while other types of content have yet to be challenged by Internet piracy. We believe that digital momentum, fed by announcements such as the potential introduction of Apple's iPod phone later this year/early next year, Amazon's and/or Google's possible digital music distribution business, new wireless carrier deals, rapid adoption of 3G phones, and the expiration of the satellite radio agreement, will continue to drive incremental revenue streams for the music labels.

3QFY06 Expectations: We estimate total company 3QFY06 revenue, EBITDA, and EPS of $815 mn, $86m, ($0.22), respectively, reflecting yoy revenue and EBITDA growth of 11.1% and 22.2%, respectively (EBITDA/EPS estimates excluding FAS 123 are $90 mn/($0.19)). Additionally, we forecast $82m of digital revenue in the quarter, accounting for 10.1% of total revenue, which compares with $90m in 2QFY06, representing 11.3% of total revenue.

- Recorded Music: We expect WMG to report revenue and EBITDA for Recorded Music of $673 mn and $82 mn, respectively, reflecting yoy increases of 14% and 23%. We believe that 3QFY06 revenue was driven mainly by releases by Red Hot Chili Peppers (5/9/06), T.I. (3/28/06) and Daniel Powter (4/11/06) as well as continued sales from earlier releases by Madonna and Big & Rich (11/15/05), and Enya (11/22/05). We expect margins to improve 80 basis points yoy to 12.2% from 11.4%, reflecting the improving margin mix between digital and physical music.

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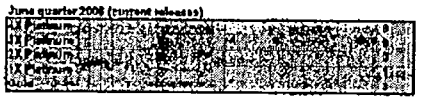
Exhibit 2: June quarter year-over-year release schedule

ALBUM

Release Date	Artist / Album Title	Gold	Platinum
6/15/2004	Green Day - American Idiot		4X
1/4/2005	James Blunt - Back to Bedlam		2X
2/8/2005	Michael Buble - Its Time		1X
3/29/2005	Larry The Cable Guy - The Right To Bare Arms	X	
6/18/2005	Rob Thomas - ...Something To Be		1X
6/7/2005	Avenged Sevenfold - City Of Evil	X	
8/2/2005	Faith Hill - Fire Bee		2X
8/30/2005	Death Cab For Cutie - Plans	X	
9/9/2005	Staind - Chapter V	X	
9/20/2005	Disturbed - Ten Thousand Fists		1X
9/27/2005	Neil Young - Prairie Wind	X	
9/27/2005	HUM - Dark Light		
9/27/2005	Paul Wall - The Peoples Champ		1X
9/27/2005	Sean Paul - The Trinity		1X
10/4/2005	Shinedown - Us And Them		
11/8/2005	D4L - Down For Life		
11/1/2005	Jersey Boys - Original Broadway Cast Recording		
11/15/2005	Big & Rich - Comin' to Your City		1X
11/15/2005	Madonna - Confessions on a Dance Floor		1X
11/22/2005	Enya - Amarantine		1X
11/22/2005	Fort Minor - The Rising Tide		
2/7/2006	Various Artists: Totally Country Five [1]		
2/28/2006	Kid Rock - Live Trucker		
3/7/2006	Juvenile - Reality Check	X	
3/14/2006	Queensryche - Operation: Mindcrime II		
3/21/2006	MyChemical Romance - Life on the Murder Scene		
3/28/2006	T.I. - King		1X
4/4/2006	The Flaming Lips - At War With The Mystics		
4/8/2006	Chris Isaak - Best of Chris Isaak		
4/8/2006	Neil Young - Living With War	X	
6/11/2006	Buckcherry - 15		
6/11/2006	Cam'ron - Dipset: The Movement Goes On		
6/11/2006	Daniel Powter - Back to Bedlam	X	
6/11/2006	Dulk to Spill - You In Reverse		
6/14/2006	E-40 - My Ghetto Report Card		
6/14/2006	Black Sabbath - Greatest Hits 1970-1978		
6/23/2006	The Wreckers - Stand Still, Look Pretty		
6/25/2006	The Streets - The Hardest Way To Make An Easy Living		
6/25/2006	Goo Goo Dolls - Let Love In		
6/25/2006	Taking Back Sunday - Louder Now	X	
6/25/2006	Mark Knopfler and Emmylou Harris - All The Roadrunning		
5/2/2005	Jewel - Goodbye Alice In Wonderland		
5/9/2006	Red Hot Chili Peppers - Stadium Arcadium		1X
5/9/2006	Paul Simon - Surprise		
5/9/2006	Gnarls Barkley - St. Elsewhere		
6/6/2006	Head Automatica - Popegenic		
6/6/2006	Zero 7 - The Garden		
6/6/2006	Various Artists - Blue Collar Comedy Tour: One For The Road		
6/13/2006	Regina Spektor - Begin To Hope		

Release Date	Artist / Album Title	Gold	Platinum
6/10/2003	Damien Rice - O		
10/7/2003	Jet - Get Born		1X
10/21/2003	Eagles - The Very Best Of		3X
11/11/2003	Josh Groban - Closer		4X
2/24/2004	Lil Scrappy/Trillville - The King of Crunk	X	
5/4/2004	Big & Rich - Home of a Different Color		2X
6/8/2004	My Chemical Romance - Three Cheers for Sweet Revenge	X	
6/15/2004	Shinedown - Leave A Whisper	X	
7/27/2004	Dwight Yoakam - The Very Best of Dwight Yoakam		
8/17/2004	Ryan Cabrera - Take It All Away	X	
9/24/2004	Green Day - American Idiot		4X
9/28/2004	The Used - In Love And Death		
10/19/2004	Ray Charles - Ray (Soundtrack)		1X
10/26/2004	Simple Plan - Still Not Getting Any...		1X
10/26/2004	Trick Daddy - Thug Matrimony: Married to the Streets	X	
10/26/2004	Blake Shelton - Blake Shelton's Barn & Grill	X	
11/30/2004	T.I. - Urban Legend		1X
11/30/2004	Jay Z / Linkin Park - Collision Course [2]		
2/8/2005	Various Artists: Totally Country Four [1]		
2/8/2005	Michael Buble - Its Time	X	
3/15/2005	Crosby, Stills & Nash - Greatest Hits		
3/29/2005	Larry the Cable Guy - The Right to Bare Arms	X	
4/5/2005	Various Artists - The OC: Music From Mix 4		
4/5/2005	Hot Hot Heat - Elevator		
4/5/2005	Brandy - The Best Of Brandy		
4/12/2005	American Hi-Fi - Hearts On Parade		
4/19/2005	Mike Jones - Who Is Mike Jones?		1X
4/19/2005	Rob Thomas - ...Something To Be		1X
4/22/2005	Tweet - It's Me Again		
4/22/2005	Blue Fancy - Silent Alarm		
4/26/2005	New Order - Waiting For The Sirens' Call		
5/10/2005	Baby Einstein: Music Box Orchestra		
5/17/2005	Cowboy Troy - Loco Motive		
5/17/2005	Pretty Ricky - Bluestars		
5/24/2005	The Light In The Piazza - Original Broadway Cast Recording		
6/7/2005	Avenged Sevenfold - City Of Evil	X	
6/7/2005	Dream Theater - Octavarium		

June quarter 2006 (current releases)



June quarter 2006 (current releases)

Gold = 500,000 units; Platinum = 1 mn units

[1] Released with Sony BMG Music and Sony Music

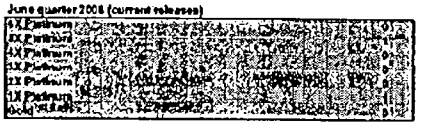
[2] Released with Machine Shop, Roc-A-Fella and Def Jam

DIGITAL DOWNLOADS

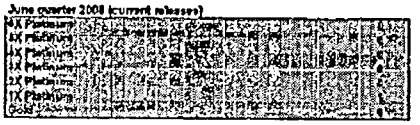
Release Date	Artist / Song Title	Gold	Platinum
8/31/1999	Vitamin C - Graduation (Friends Forever)		
1/4/2005	James Blunt - You're Beautiful	6X	
4/18/2005	Rob Thomas - Ever The Same		
6/2/2005	Jewel - Again and Again		
8/27/2005	Sean Paul - Temperature	3X	
9/27/2005	Sean Paul - We Be Dumin'		
11/22/2005	Fort Minor - Where'd You Go		
3/28/2006	T.I. - What You Know		
3/28/2006	T.I. - Why You Wanna		
4/11/2006	Daniel Powter - Bad Day	6X	
4/18/2006	Buckcherry - Crazy Bitch		
4/23/2006	The Wreckers - Leave The Pieces		
4/25/2006	Taking Back Sunday - Makedamaure		
4/25/2006	Goo Goo Dolls - Better Days	1X	
4/25/2006	Goo Goo Dolls - Stay With You		
5/9/2006	Red Hot Chili Peppers - Dani California		

Release Date	Artist / Song Title	Gold	Platinum
10/14/1997	Green Day - Time Of Your Life		1X
8/31/1999	Vitamin C - Graduation (Friends Forever)		
10/7/2003	Jet - Look What You've Done	X	
2/24/2004	Lil Scrappy/Trillville - Some Girl		
5/4/2004	Big & Rich - Save A Horse (Ride A Cowboy)		1X
6/8/2004	My Chemical Romance - Helena		
8/24/2004	Green Day - Holiday		
9/24/2004	Green Day - American Idiot		1X
9/24/2004	Green Day - Boulevard Of Broken Dreams		1X
9/28/2004	The Used - Under Pressure		
10/26/2004	Simple Plan - Untitled (How Can This Happen To Me?)		
10/26/2004	Simple Plan - Shut Up		
10/26/2004	Trick Daddy - Sugar (Gimme Some)		
11/30/2004	Jay Z / Linkin Park - Numb / Encore [2]		1X
11/30/2004	T.I. - Bring Em Out		
11/30/2004	T.I. - U Don't Know Me		
4/18/2005	Rob Thomas - Lonely No More		1X
4/19/2005	Mike Jones - Still Tippin'		
5/17/2005	Pretty Ricky - Grind With Me		
8/14/2005	Fat Joe (Feat. Nelly) - Get Ill Poppin'		

June quarter 2006 (current releases)



June quarter 2006 (current releases)



Gold = 500,000 downloads; Platinum = 1 mn downloads

Source: Billboard, Nielsen SoundScan.

- Music Publishing: We forecast 3QFY06 Music Publishing revenue and EBITDA of $149 mn (-2.5% yoy) and $28 mn (-3.3% y/y), respectively. We forecast margins down 20 basis points yoy to 18.8% from 19% in the year ago quarter, reflecting increased investment in the Publishing business which is currently in the process of being restructured, consistent with management's goal to restore growth to the Publishing business over the next 12-24 months.

FY2006 Outlook: We now forecast total revenue and EBITDA for fiscal year 2006 of $3.53 bn and $512 mn ($528 mn excluding FAS 123), respectively, implying 1.8% yoy revenue growth and an EBITDA increase of 11% yoy (+9% yoy excluding FAS 123), respectively. We forecast EBITDA margins to improve 125 basis points during the year as we forecast 9.5% of fiscal 2006 revenue will be generated by higher margin digital music revenue versus 4.5% in fiscal year 2005. If margins were constant between fiscal 2005 and 2006, $468 mn in EBITDA would be generated rather than our estimate of $512 mn, implying a difference of $44 mn. We estimate that WMG will generate approximately $180 mn in incremental digital music revenue in fiscal 2006 versus 2005, resulting in $44 mn more profit than if this $180 mn in revenue was physical given the 10-15% margin advantage that digital music has over physical. We look to new releases by Tom Petty (07/25/06), Barenaked Ladies (9/12/06), and P-Diddy (9/19/06), along with continued momentum from late 2005/early 2006 releases - Madonna, Enya, Big & Rich, Sean Paul, Paul Wall, T.I., Red Hot Chili Peppers - to drive revenue growth in FY2006.

As we head into fiscal 2007, we see the potential for the following new incremental revenue streams to help maintain WMG's revenue growth momentum: 1) additional revenue from a re-negotiated satellite radio license agreement, which is set to expire at the end of calendar 2006; 2) potential introduction of Apple's iPod phone later this year/early next year; 3) the potential launch of Amazon's and/or Google's digital music distribution business; 4) new wireless carrier deals; and 5) portable music device licensing fees from the satellite operators.

Exhibit 3: 3QFY06 Actual versus Estimates

$ millions, except per-share data

	GS	Y/Y Comparison			Q/Q Comparison		
	Jun-06 Estimate	Jun-05 [1] Actual	Change Absolute	Change Percent	Mar-06 [1] Actual	Change Absolute	Change Percent
Revenue							
Recorded Music	$873	$588	$85	14%	$876	($3)	0%
Music Publishing	149	153	(4)	-3%	129	20	16%
Intersegment eliminations	(7)	(7)	0	NA	(9)	2	NA
Total Revenues	$815	$734	$81	11%	$796	$19	2%
Operating Expenses							
Recorded Music	$591	$521	$70	13%	$587	$4	1%
Music Publishing	121	124	(3)	-2%	82	39	48%
Intersegment eliminations	14	19	(5)	-26%	13	1	6%
Stock based compensation (FAS 123)	4	9	(5)	-56%	2	2	100%
Total Operating Expenses (Excl. FAS 123)	$726	$664	$62	9%	$682	$44	6%
% of Revenue	89.0%	90.5%	-1.4%	—	85.7%	3.3%	—
Total Operating Expenses (Incl. FAS 123)	$730	$673	$57	8%	$684	($684)	-100.0%
% of Revenue	89.5%	91.7%	-2.2%	—	85.9%	-85.9%	—
EBITDA							
Recorded Music	$82	$67	$15	23%	$89	($7)	-8%
Music Publishing [2]	28	29	(1)	-3%	47	(19)	-40%
Corporate expense/other	(25)	(26)	1	NA	(24)	(1)	NA
Total EBITDA (Excl. FAS 123)	$90	$79	$11	13%	$114	($24)	-21%
EBITDA margin	11.0%	10.8%	0.2%	—	14.3%	-3.3%	—
Total EBITDA (Incl. FAS 123)	$86	$70	$16	22%	$112	($112)	-100%
EBITDA margin	10.5%	9.5%	1.0%	—	14.1%	-14.1%	—
Depreciation and amortization							
Depreciation	8	12	(4)	-29%	11	(3)	-23%
Amortization of Intangible Assets	47	47	0	1%	48	(1)	-1%
Total Depreciation and amortization	$56	$59	($3)	-5%	$59	($3)	-5%
Operating Income (Excl. FAS 123 and non-recurring items)	$34	$20	$14	68%	$55	($21)	-39%
Operating margin	4.1%	2.7%	1.4%	—	6.9%	-2.8%	—
Operating Income (Incl. FAS 123)	$30	$11	$19	169%	$53	($23)	-44%
Operating margin	3.6%	1.5%	2.1%	—	6.7%	-3.0%	—
Net Interest Income (Expense)	(43)	(50)	7	NA	(45)	2	NA
Other Income (Expenses)	4	2	2	100%	3	1	33%
Income (Loss) before taxes (Excl. Non-recurring items)	($6)	($28)	$22	NA	$13	($19)	-144%
Pretax Margin	(0.7%)	(3.8%)	3.1%	—	1.6%	-2.3%	—
Income (Loss) before taxes incl FAS 123 (Excl. Non-recurring items)	($10)	($37)	$27	NA	$11	($21)	-189%
Pretax Margin	(1.2%)	(5.0%)	3.8%	—	1.4%	-2.6%	—
Provision for income taxes (Excl. Non-recurring items) [3]	(22)	(7)	(16)	NA	($13)	(9)	NA
% tax rate	385.6%	23.2%	362.4%	—	(101.5%)	487.1%	—
Provision for income taxes (Excl. Non-recurring items) [3]	($22)	($7)	($16)	NA	($13)	($9)	NA
% tax rate	385.6%	23.2%	362.4%	—	(101.5%)	487.1%	—
Net Income (loss) (Excl. FAS 123 and Non-recurring items)	($28)	($35)	$5	NA	($0)	($28)	NA
Net Income (loss) (Incl. FAS 123 and Non-recurring items)	($32)	($44)	$11	NA	($2)	($30)	NA
Non-recurring items [3]	-	-	-	NA	(5)	5	NA
Net Income (Loss) After Dividends (Excl. FAS 123)	($28)	($35)	$5	NA	($5)	($23)	NA
Net Income (Loss) After Dividends (Incl. FAS 123)	($32)	($44)	$11	NA	($7)	($25)	NA
EPS Before Extraordinary Item (Diluted) Excl. FAS 123	($0.20)	($0.27)	$0.06	NA	($0.00)	($0.20)	NA
EPS Before Extraordinary Item (Diluted) Incl. FAS 123	($0.22)	($0.34)	$0.12	NA	($0.02)	($0.21)	NA
EPS Reported (Diluted) Incl. FAS 123	($0.22)	($0.34)	$0.12	NA	($0.05)	($0.18)	NA
Weighted Average common shares (basic)	142.6	127.0	15.7	12%	141.9	0.7	0%
Weighted Average common shares (diluted)	142.7	127.0	15.7	12%	141.9	0.8	1%

Key Metrics

	GS	Y/Y Comparison			Q/Q Comparison		
	Jun-06 Estimate	Jun-05 [1] Actual	Change Absolute	Change Percent	Mar-06 [1] Actual	Change Absolute	Change Percent
Digital Revenue	$82	$44	$38	86.4%	$90	($8)	-9%
as a % of total revenue	10.1%	6.0%	4.1%	—	11.3%	-1.2%	—

(1) Pro forma for sale of the sheet music business to Alfred Publishing Co., Inc. which was completed on June 1, 2005 and contributed $11 mn in revenue and $1 mn in EBITDA in MQ05 and $8 mn in revenue and a $1 mn loss in EBITDA in JQ05.
(2) MQ06 EBITDA excludes an $8 mn severance charge related to the departure of an executive.
(3) MQ06 reflects an after-tax adjustment for the $8 mn severance charge.

Source: Company data, Goldman Sachs Research estimates.

RegAC

I, Anthony Noto, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

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Growth is a composite of next year's estimate over current year's estimate, e.g. EPS, EBITDA, Revenue. Return is a year one prospective aggregate of various return on capital measures, e.g. CROCI, ROACE, and ROE. Multiple is a composite of one-year forward valuation ratios, e.g. P/E, dividend yield, EV/FCF, EV/EBITDA, EV/DACF, Price/Book. Volatility is measured as 30-day historical volatility, annualized and adjusted for dividends.

Quantum

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Goldman Sachs expects to receive or intends to seek compensation for investment banking services in the next 3 months: Warner Music Group Corp. ($26.92)

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Goldman Sachs Investment Research global coverage universe

	Rating Distribution			Investment Banking Relationships		
	Buy	Hold	Sell	Buy	Hold	Sell
Global	27%	59%	14%	57%	49%	45%

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Price target and rating history chart(s)

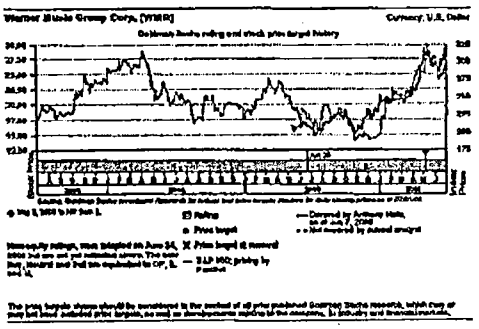

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EXHIBIT CO 0960

Goldman Sachs

Warner Music Group Corp. (WMG)

DQ05 First Take - Thesis in-tact as digital is replacing physical and mix is increasing margins

The Goldman Sachs Group, Inc.
February 14, 2006

In-Line/Neutral
United States
Consumer Cyclicals
Music

Stock data

Price	$20.80
52-week range	$21.43 - 14.75
Dividend yield	2.5%

Capitalization

Market cap	$3,130 mn
Enterprise value	$4,937 mn
Net debt/equity	2,822.8%
Shares outstanding	150.5 mn

Price performance (%)

	1M	3M	12M
Absolute	(0.3)	30.7	--
Rel to S&P 500	1.6	28.4	--

Warner Music Group reported flat y/y rev (ex FX) & 210bps of EBITDA margin exp, which reinforces our thesis that digital music rev growth can replace physical music declines (even despite the tough DQ comp) & that this mix shift drives margin gains, resulting in low-to mid-single digit EBITDA growth. Items of note: 1) excl FX & sale of print business, rev declined 0.2%, which is nominal & does not chg our view on WMG's ability to sustain growth or profitability; 2) margin expansion of 210 bps reinforces our view that the increased mix of digital drives margin expansion leading to EBITDA growth w/flat rev; & 3) on an LTM basis, revs were up 3% y/y vs an est'd decline for the industry. We believe WMG can successfully sell its valuable music content in new formats, new distribution channels and on new platforms to achieve sustainable FCF growth. Our rating remains IL/N w/ a revised implied value of $24.

Forecasts and valuation

Fiscal year ended	EPS $	P/E X	Revenue $ mn	EBITDA $ mn	EV/EBITDA X
09/04A	--	--	3,388	390.8	12.6
09/05A	0.03	NM	3,468	484.0	10.2
09/06E	0.16	134.0	3,436	513.5	9.6
09/07E	0.45	46.3	3,513	540.1	9.1

EPS	Fiscal year ended 09/05A	Fiscal year ended 09/06E		Fiscal year ended 09/07E	
		New	Old	New	Old
1Q	$0.29	$0.49	unch	--	--
2Q	$0.04	($0.11)	unch	--	--
3Q	($0.34)	($0.17)	unch	--	--
4Q	$0.04	($0.05)	unch	--	--
Full year	$0.03	$0.16	unch	$0.45	unch

Source: Company data, Goldman Sachs Research estimates

- **Results:** WMG reported DQ05 rev/EBITDA/EPS of $1.04b (-3% y/y)/$208m (+9%)/$0.50 vs. GS ests $1.08b/$200m/$0.52 (all excl FAS 123). On a relative basis, WMG missed our revenue estimate by 4% but exceeded EBITDA by 4%. The bigger takeaway is what this result implies for our thesis. Digital revenue was $69m, representing 6.6% of total revenue up from 5.9% in the prior quarter, in-line with our est of $70m. Recorded Music revenue declined 2% y/y to $920m, while EBITDA for Recorded Music increased 6% to $208m. Recorded Music revenue growth was driven by releases from Madonna, Enya, Green Day, Notorious BIG and James Blunt. While domestic Recorded Music revenue declined 1.5% y/y, international Recorded Music revenue actually grew by 1.8%, excluding $23m negative impact of exchange rates. Music Publishing revenue decreased 6% y/y (excluding

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print business in the year ago quarter) to $131m, while Music Publishing EBITDA decreased 9% y/y to $21m. The decline was due mainly to weaker mechanical and performance revenue, resulting from less radio airplay and declines in prior period record sales. While total company EBITDA beat our estimate by $8m (4%), EPS was $0.02 below our estimate (excluding FAS 123) due to higher net interest expense and higher income taxes than expected (see exhibit 1 Actuals vs Estimates).

Recommendation: We see ~15% appreciation in the shares of Warner Music Group and our thesis remains unchanged in that we see WMG as an investment in existing content that can be further monetized through new formats and new distribution channels. Additionally, each incremental dollar of revenue in these new formats will likely be more profitable given digital music's better margin contribution. Thematically, within the broader media landscape, we continue to favor content-centric companies given the secular advertising issues that are negatively impacting growth for ad-centric companies, combined with our view that the value of content will continue to increase as competition among distributors increases and new distribution platforms emerge. Additionally, we believe that music content specifically is advantaged because it has already suffered through the worst of Internet piracy, while other types of content have not yet. We believe that digital momentum, fed by announcements such as the potential introduction of Apple's iPod phone this year, AMZN's possible digital music distribution business, new wireless carrier deals, rapid adoption of 3G phones, negotiations with Apple for variable pricing, and the expiration of the satellite radio agreement, will continue to drive incremental revenue streams for the music labels. We see ~15%+ upside in WMG to our revised implied value of $24 after rolling forward our valuation to the end of 2006. Furthermore, we believe WMG's risk/reward compared to EMI (not covered) is favorable as WMG currently trades at a ~5% discount to EMI's 2006E EV/EBITDA multiple.

I, Anthony Noto, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

Exhibit 1: F1Q06 Actual vs. Estimates

millions, except per-share data

Income Statement

(millions of dollars, except per share items and key metrics; FYE September)

	Actual vs. Estimate Comparison				Y/Y Comparison			Q/Q Comparison		
	Dec-05		Change		Dec-04[1]	Change		Sep-05[1]	Change	
	Actual	Estimate	Variance	Percent	Actual	Absolute	Percent	Actual	Absolute	Percent
Revenue										
Recorded Music	$920	$950	($30)	-3%	$940	($20)	-2%	$775	$145	19%
Music Publishing	131	140	(9)	-6%	140	(9)	-6%	137	(6)	-4%
Intersegment eliminations	(7)	(7)	0	-6%	(7)	0	NA	(7)	0	NA
Total Revenue	$1,044	$1,082	($38)	-4%	$1,073	($29)	-3%	$905	$139	15%
Operating Expenses										
Recorded Music	$714	$743	($29)	-4%	$746	($32)	-4%	$672	$42	6%
Music Publishing	110	118	(8)	-7%	117	(7)	-6%	94	16	17%
Intersegment eliminations	12	21	(9)	-42%	21	(9)	-43%	20	(8)	-40%
Stock based compensation (FAS 123)	6	4	2	50%	2	4	200%	7	(1)	-14%
Total Operating Expenses (Excl. FAS 123)	$836	$882	($46)	-5%	$884	($48)	-5%	$788	$50	6%
% of Revenue	80.1%	81.5%	-1.5%	—	82.4%	-2.3%	—	86.9%	-6.6%	—
EBITDA										
Recorded Music	$206	$207	($1)	0%	$194	$12	6%	$103	$103	100%
Music Publishing	21	22	(1)	-3%	23	(2)	-9%	43	(22)	-51%
Corporate expense/other	(25)	(32)	7	-23%	(28)	3	NA	(34)	9	NA
Total EBITDA (Excl. FAS 123)	$208	$200	$8	4%	$191	$17	9%	$119	$89	75%
EBITDA margin	19.9%	18.5%	1.5%	—	17.8%	2.1%	—	13.1%	6.8%	—
Total EBITDA (Incl. FAS 123)	$202	$196	$6	3%	$189	$13	7%	$112	($112)	-100%
EBITDA margin	19.3%	18.1%	1.3%	—	17.6%	1.7%	—	12.4%	-12.4%	—
Depreciation and amortization										
Depreciation	11	10	1	10%	14	(3)	-21%	11	0	0%
Amortization of Intangible Assets	47	47	1	1%	46	1	2%	47	0	0%
Total Depreciation and amortization	$58	$57	$2	3%	$60	($2)	-3%	$58	$0	0%
Operating Income (Excl. FAS 123 and non-recurring items)	$150	$143	$7	5%	$131	$19	15%	$61	$89	146%
Operating margin	14.4%	13.2%	1.1%	—	12.2%	2.2%	—	6.7%	7.6%	—
Operating Income (Incl. FAS 123)	$144	$139	$5	3%	$129	$16	12%	$54	$90	167%
Operating margin	13.8%	12.9%	0.9%	—	12.0%	1.8%	—	6.0%	7.8%	—
Net Interest Income (Expense)	(45)	(38)	(9)	NA	(38)	(7)	NA	(42)	(3)	NA
Other Income (Expenses)	-	(8)	8	NA	(24)	24	NA	2	(2)	-100%
Income (Loss) before taxes (Excl. Non-recurring items)	$105	$100	$5	5%	$69	$36	52%	$21	$84	400%
Pretax Margin	10.1%	9.2%	0.8%	—	6.4%	3.6%	—	2.3%	7.7%	—
Provision for income taxes (Excl. Non-recurring items)	(30)	(22)	(8)	NA	(32)	2	NA	(9)	(21)	NA
% tax rate	(28.6%)	-21.5%	-7.0%	—	(49.4%)	17.8%	—	(41.4%)	12.9%	—
Net Income (loss) (Excl. Non-recurring items)	$75	$78	($3)	($0)	$37	$38	$1	$12	$63	510%
Net Income (loss) (Incl. Non-recurring items)	$69	$74	($5)	-7%	$35	$34	97%	$5	64	$12
Dividends to Investors	(18)	(20)	2	NA	(764)	746	NA	-	(18)	NA
Net Income (Loss) After Dividends (Excl. FAS 123)	$57	$58	($1)	($0)	($727)	$784	NA	$12	$45	$4
EPS Before Extraordinary Item (Diluted) Excl. FAS 123	$0.50	$0.52	($0.02)	-4%	$0.32	$0.18	55%	$0.08	$0.42	510%
EPS Before Extraordinary Item (Diluted) Incl. FAS 123	$0.46	$0.49	($0.03)	-7%	$0.30	$0.16	51%	$0.04	$0.42	1202%
Weighted Average common shares (basic)	127.0	127.0	0	0%	-	127.0	NA	107.7	19	18%
Weighted Average common shares (diluted)	150.6	151.2	(1)	0%	115.3	35.2	31%	150.6	0	0%

Key Metrics

	Actual vs. Estimate Comparison				Y/Y Comparison			Q/Q Comparison		
	Dec-05	Dec-05	Change		Dec-04[1]	Change		Sep-05	Change	
	Actual	Estimate	Variance	Percent	Actual	Absolute	Percent	Actual	Absolute	Percent
Digital Revenue	$69	$70	(1)	-1.8%	$25	$44	176.0%	$53	$16	30%
as a % of total revenue	6.6%	6.5%	0.1%	—	2.3%	4.3%	—	5.9%	0.6%	—

Note: Pro forma for sale of the sheet music business to Alfred Publishing Co., Inc. which was completed on June 1, 2005 and contributed $15m in revenue and $1m in EBITDA in 3Q04.

Source: Company data, Goldman Sachs Research estimates.

APPENDIX 1: DISCLOSURES

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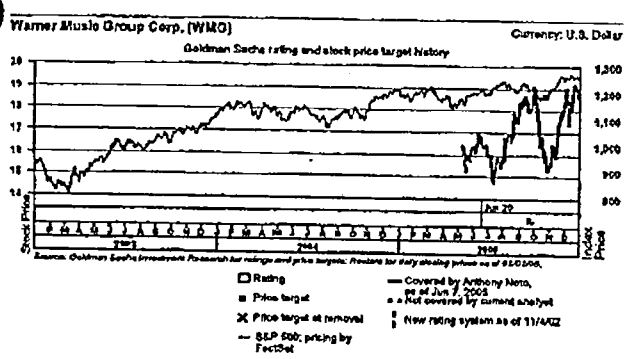

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EXHIBIT CO 0961

October 18, 2006

United States of America
Internet & Media
Small-Cap Entertainment

Warner Music Group (WMG - US$ 25.45) 2-Equal weight

Change of Earnings Forecast

F4Q06 Outlook

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Investment Conclusion

- Despite softening sales trends we continue to believe WMG's shares will trade at a premium to its fundamental fair value given investor expectations of an eventual M&A transaction with EMI.

Summary

- We are lowering F4Q06 estimates given softening sales trends. We project rev, EBITDA and EPS, respectively, of $860M (-5%), $100M (-10%) and -$0.02 (vs $0.04 last year), down from our prior outlook of $895M, $114M and $0.04.
- New release comps are unlikely to improve heading into the early part of F2007. Notable December quarter releases include Diddy, My Chemical Romance and Josh Groban. We are reducing F2007 EPS to $0.42 from our prior $0.45 estimate.
- The Sony BMG reapproval process is progressing, but could take at least six months before any decision is rendered by the EC.
- WMG trades at EV/EBITDA and FCF valuations, respectively, of 12.2x and 17.1x based on C2006E and 11.5x and 13.4x based on C2007E.

EPS (US$) (FY Sep)

	2005	2006				2007			% Change	
	Actual	Old	New	St. Est.	Old	New	St. Est.		2006	2007
1Q	0.35A	0.46A	0.46A	0.46A	N/A	N/A	0.52E		31%	N/A
2Q	0.05A	-0.05A	-0.05A	-0.05A	N/A	N/A	0.02E		-200%	N/A
3Q	-0.34A	-0.10A	-0.10A	-0.10A	N/A	N/A	-0.06E		71%	N/A
4Q	0.04A	0.04E	-0.02E	0.00E	N/A	N/A	0.06E		-150%	N/A
Year	0.05A	0.35E	-0.30E	0.33E	0.45E	0.42E	0.47E		500%	40%
P/E			84.8			60.6				

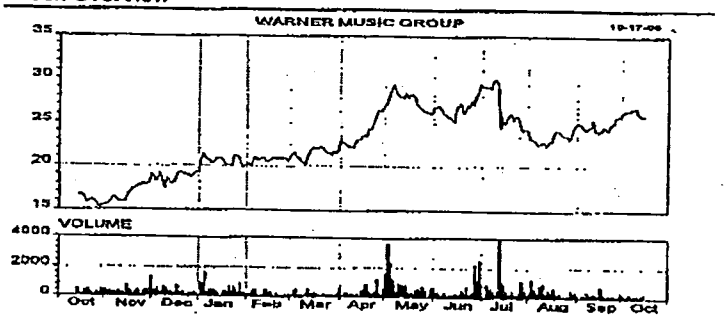
Market Data

Market Cap (Mil.)	3830
Shares Outstanding (Mil.)	150.50
Float (%)	21
Dividend Yield	2.04
Convertible	Yes
52 Week Range	31.00 - 15.03

Financial Summary

Revenue FY06 (Mil.)	3522.0
Five-Year EPS CAGR	N/A
Return on Equity	N/A
Current BVPS	0.46
Debt To Capital (%)	97.00

Stock Overview



Stock Rating

New:	2-Equal weight
Old:	2-Equal weight

Target Price

New:	US$ 23.00
Old:	US$ 23.00

Sector View: 2-Neutral

Summary

We are reducing our F4Q06 estimates for Warner Music as a result of a soft new release slate in the quarter combined with a sharp drop in the company's Top 50 album sales, a weak overall U.S. market and lower margin expectations for Publishing. In addition, against the backdrop of relatively tough comparisons over the next couple of quarters we are becoming increasingly cautious regarding fundamentals. As such, we are also reducing F2007 EPS to $0.42 from our prior $0.45 estimate. That said, we see little negative impact on Warner Music's shares as investors appear much more focused on the likelihood of an M&A transaction with EMI rather than fundamentals. We continue to believe a combination of Warner Music and EMI makes considerable strategic sense (we estimate cost savings alone could run in excess of $200 million) and renewed discussions between the two companies could push Warner Music shares back above the $30 level. As a result, we expect Warner Music will continue trading at a premium to our $23 fundamental price target. However, management teams

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PLEASE SEE ANALYST(S) CERTIFICATION(S) ON PAGE 9 AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 10

at Warner Music and EMI have stated that any discussion between the two companies has been tabled during the ongoing Sony BMG EC reapproval process, which we believe could last at least another six months.

Although we have a positive view towards Warner Music's management and their accomplishments in righting the business since purchasing the company from Time Warner, in order for us to become incrementally more positive on the shares we would desire either: 1) clearer evidence that Warner Music can sustain its (minimally) positive revenue growth trend over an extended time frame; or 2) a positive ruling from the EC reapproving the Sony BMG merger, thereby setting the stage for a potential Warner Music and EMI combination. Conversely, a negative ruling from the EC that would force the unwinding of Sony BMG combined with still declining industry fundamentals would make us much more cautious on the shares.

F4Q06 RESULTS SHOULD REFLECT A SOFT RELEASE SLATE AND MARKET SHARE DECLINES

For F4Q06 (Sept) we project Warner Music will generate revenue and EBITDA, before 1x items, or $860 million (-4.9%) and $100 million (-10.4%), respectively, which is below our prior expectations of $895 million and $114 million. In addition, our EPS estimate of ($0.02) has been reduced from our prior $0.04 projection. Our lower projections reflect softness in the company's new release slate relative to last year and a declining market share for US Top 50 album sales. Further compounding problems was a weak overall U.S. market that was down roughly 4% in the quarter. As such, we look for a decline of 4.6% in Recorded Music sales, which is a function of a 12% decline in physical sales, partially offset by a 97% increase in digital sales. For the Publishing segment we forecast a 7.5% decline in revenue as the business continues its turnaround efforts. While Warner Music continues to cut costs where possible and benefit from the digital music transition from physical sales, we believe EBITDA margins in F4Q06 will decline 70 basis points to 11.7% from 12.4% last year.

Figure 1: Warner Music Group: F4Q06 Growth Outlook ($ millions, except per share data)

	Quarterly Data			Annual Data		
	9/05A	9/06E	% Growth	F2005A	F2006E	Y-Y Growth
Revenues						
Recorded	$775.0	$739.5	(4.6%)	$2,924.0	$3,013.4	3.1%
Publishing	137.0	126.8	(7.5%)	607.0	536.7	(11.6%)
Total Segment Revenue	$912.0	$866.3	(5.0%)	$3,531.0	$3,550.1	0.5%
Other Revenue/Eliminations	(7.0)	(6.0)	(14.3%)	(29.0)	(27.9)	(3.9%)
Total Revenues	$905.0	$860.3	(4.9%)	$3,502.0	$3,522.2	0.6%
EBITDA						
Recorded	$103.0	$93.3	(9.5%)	$442.0	$473.9	7.2%
Publishing	$43.0	$44.1	2.6%	143.0	135.1	(5.6%)
Total Segment EBITDA	$146.0	$137.4	(5.9%)	$585.0	$609.0	4.1%
Corporate Overhead/Eliminations	(27.0)	(32.0)	18.5%	(94.0)	(114.9)	22.3%
FAS 123 Expense	(7.0)	(5.0)	(28.6%)	(25.0)	(17.0)	(32.0%)
EBITDA Before 1x Items	$112.0	$100.4	(10.4%)	$466.0	$477.0	2.4%
EPS (excl 1x Items)	$0.04	($0.02)	(155.3%)	$0.05	$0.30	451.6%
Digital Revenue Breakdown						
Recorded	$47.0	$92.7	97.2%	$140.2	$330.6	135.8%
Publishing	6.0	7.0	16.7%	20.0	21.0	5.0%
Digital Revenue	$53.0	$99.7	88.1%	$160.2	$351.6	119.5%
Digital Revenue as a % of Total Revenue	*5.9%*	*11.6%*		*4.6%*	*10.0%*	
% Margin						
Recorded	13.3%	12.6%	(0.7%)	15.1%	15.7%	0.6%
Publishing	31.4%	34.8%	3.4%	23.6%	25.2%	1.6%
Total Segment EBITDA	16.0%	15.9%	(0.2%)	16.6%	17.2%	0.6%
EBITDA Before 1x Items	12.4%	11.7%	(0.7%)	13.3%	13.5%	0.2%

Source: Company reports, Lehman Brothers

We believe one of the key variables negatively impacting Warner Music's F4Q06 results was its decline in US Top 50 album sales, which fell approximately 22% in the quarter compared to an 11% decline for the industry (we note Top 50 album sales account for roughly 20%-25% of total domestic album sales). Warner Music's overall market share of the Top 50 albums in the quarter was 16.2%, down from 18.4% last year.

Figure 2: Warner Music F4Q06 Top 50 Album Sales and Market Share

	Warner Music Top 50 Weekly Album Sales				US Top 50 Weekly Album Sales					
Week Ending	Sales	Y/Y % Change	QTD Sales	QTD % Change	Sales	Y/Y % Change	QTD Sales	QTD % Change	WMG Weekly Mkt Share	WMG Quarterly Mkt Share
7/9/2006	270,211	-42.2%	270,211	-42.2%	1,660,032	-36.7%	1,660,032	-36.7%	16.3%	16.3%
7/16/2006	476,489	66.5%	746,700	-3.3%	2,004,967	-7.6%	3,664,999	-23.6%	23.8%	20.4%
7/23/2006	323,176	10.3%	1,069,876	0.4%	1,653,767	-27.1%	5,318,766	-24.7%	19.5%	20.1%
7/30/2006	384,005	20.2%	1,453,881	5.0%	1,800,903	-21.6%	7,119,669	-23.9%	21.3%	20.4%
8/6/2006	283,690	-48.7%	1,737,571	-10.4%	1,738,981	-24.2%	8,858,650	-24.0%	16.3%	19.6%
8/13/2006	386,416	-27.1%	2,123,987	-14.0%	1,901,043	-10.7%	10,759,693	-21.9%	20.3%	19.7%
8/20/2006	290,806	-36.8%	2,414,793	-17.5%	2,221,884	-19.9%	12,981,577	-21.6%	13.1%	18.6%
8/27/2006	562,612	62.7%	2,977,405	-9.1%	2,154,597	16.1%	15,136,174	-17.8%	26.1%	19.7%
9/3/2005	475,608	9.5%	3,453,013	-8.9%	2,122,495	-30.0%	17,258,669	-19.5%	22.4%	20.0%
9/10/2006	341,675	-4.5%	3,794,688	-6.7%	2,342,703	8.4%	19,601,372	-17.0%	14.6%	19.4%
9/17/2006	292,293	-38.9%	4,086,981	-10.1%	2,815,912	13.6%	22,417,284	-14.1%	10.4%	18.2%
9/24/2006	227,689	-64.4%	4,314,670	-16.8%	2,529,848	0.4%	24,947,132	-12.8%	9.0%	17.3%
10/1/2006	172,078	-68.3%	4,486,748	-21.7%	2,758,793	7.0%	27,705,925	-11.2%	6.2%	16.2%

Source: hitsdailydouble.com

While Warner Music saw continued strength in the Top 50 category from carryover releases such as the Red Hot Chili Peppers, Gnarls Barkley, Panic! at the Disco and Young Joc, its new release slate in F4Q06 could not match up with last year's comparable quarter. Warner Music saw just three of its new releases in the quarter attain first week sales in excess of 100k units (Cassie, Danity Kane and Young Dro). In comparison, Warner Music saw seven of its new releases in F4Q05 sell more than 100k units in their debut week (Missy Elliot, Faith Hill, Staind, Paul Wall, Disturbed, Lil' Kim and Sean Paul). Furthermore, just one of the company's new releases in F4Q06 debuted to first week sales in excess of 200k units (Danity Kane - 215k) versus two new release albums in F4Q05 (Faith Hill - 311k, Disturbed – 232k)

Figure 3: Warner Music Group New Album Releases of Note F4Q06 Vs. F4Q05

Artist	F4Q06 (Sept) Release Date For Week Ended	Initial Week Sales	Artist	F4Q05 (Sept) Release Date For Week Ended	Initial Week Sales
Muse	7/11/2006	48,612	Missy Elliot	7/5/2005	174,000
Pimp C	7/11/2006	90,058	B5	7/19/2005	45,538
Thom Yorke	7/11/2006	84,764	Jason Mraz	7/26/2005	66,688
Tom Petty	7/25/2006	96,832	Trey Songz	7/26/2005	43,872
Cassie	8/8/2006	100,318	Faith Hill	8/2/2005	311,675
Slayer	8/8/2006	52,427	Staind	8/8/2005	188,101
Danity Kane	8/22/2006	215,733	The Click Five	8/16/2005	52,093
Paris Hilton	8/22/2006	76,091	Taproot	8/16/2005	29,746
Mana	8/22/2006	78,186	Yolanda Adams	8/30/2005	29,316
Tego Calderon	8/29/2006	22,390	Cold	8/30/2005	28,249
Young Dro	8/29/2006	103,909	Eric Clapton	8/30/2005	44,723
Barenaked Ladies	9/12/2006	30,984	Death Cab for Cutie	8/30/2005	70,801
Mastadon	9/12/2006	26,222	Trapt	9/13/2005	60,208
Lupe Fiasco	9/19/2006	65,959	Paul Wall	9/13/2005	176,800
			Ryan Cabrera	9/20/2005	41,910
			Disturbed	9/20/2005	232,699
			Lil' Kim	9/27/2005	108,939
			Sean Paul	9/27/2005	101,941
			Neil Young	9/27/2005	60,516

Source: hitsdailydouble.com

ALBUM SALES COMPARISONS ARE NOT GETTING ANY EASIER

We look for the softness seen in Warner Music's F4Q06 release slate to carry over into F1Q07. Notable albums in the quarter include releases from rockers Jet (Oct 3) and My Chemical Romance (Oct 24) along with rapper Diddy (Oct 17) and pop and classical singer Josh Groban (Nov 7). Comparisons should prove difficult against last year's quarter comparable releases which included albums from Madonna, Enya, Big & Rich, Twista and Notorious BIG. Among the most anticipated albums for F2007 will be the release of Linkin Park's third studio album, which could be out in the early part of C2007. New studio albums are also expected from rappers Paul Wall and Pretty Ricky in F2007.

Figure 4: Warner Music Group Notable Upcoming Releases

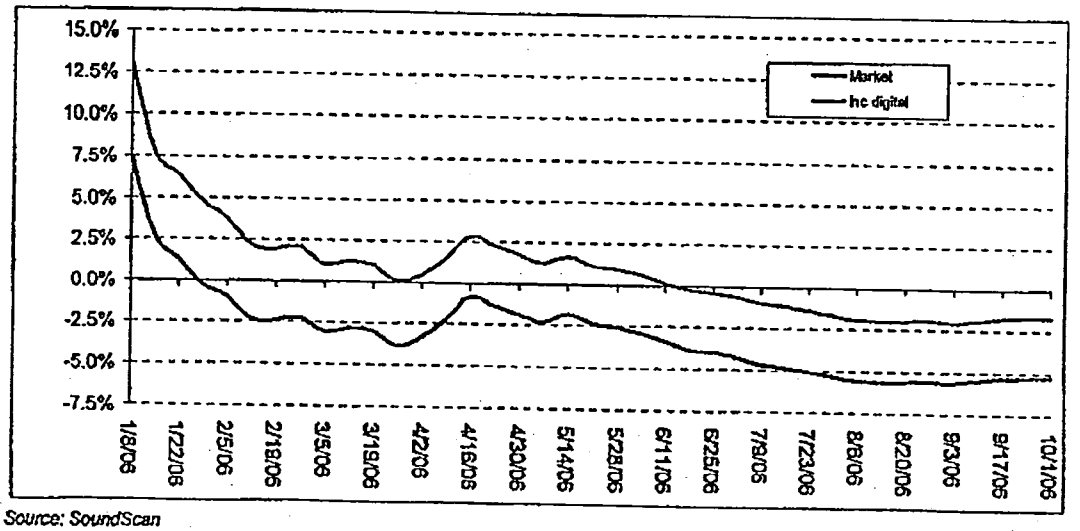
			Last Major Release			1st Week
Date	Artist	Label	Release Date	1st Week Sales	Total Sales	Sales New Album
10/3/06	Lindsey Buckingham	Warner Bros.	Debut	–	–	NA
10/3/06	Jet	Atlantic	10/7/03	16,000	1,585,000	51,326
10/3/06	Pepper	EastWest	Debut	–	–	NA
10/3/06	Skillet	Atlantic	7/19/05	9,500	92,000	NA
10/10/06	MTV My Block: Chicago	Asylum/Atlantic	Debut	–	–	
10/10/06	Robert Rudolph & The Family	Warner Bros.	8/5/03	7,800	255,000	
10/17/06	Diddy	Bad Boy/Atlantic	8/24/99	205,000	1,408,000	
10/24/06	Lil' Boosie	Asylum Atlantic	N/A	1,300	102,000	
10/24/06	My Chemical Romance	Reprise	6/8/04	11,500	1,435,000	
10/31/06	Deftones	Maverick	5/23/03	167,000	470,000	
11/7/06	JJ Cale / Eric Clapton	Reprise	N/A	–	–	
11/7/06	Josh Groban	Warner Bros.	11/11/03	375,000	5,000,000	
11/7/06	Talib Kweli	Warner Bros.	9/28/04	63,000	297,000	
11/7/06	Mozella	Maverick	Debut	–	–	
11/7/06	Z-Ro	Rap-A-Lot	Debut	–	–	

Source: hitsdailydouble.com

INDUSTRY UPDATE

US album sales year-to-date, including digital sales are down 1.8% through October 8. Digital sales have accounted for roughly 350 basis points of growth. The overall results are driven by a 5.2% decline in album sales and a 70.4% increase in digital single sales. Weekly digital single sales throughout the year have remained relatively steady between 10-11 million units per week. However, the rate of growth in digital singles has been slowing considerably.

Figure 5: US Year-to-Date Album Sales



Source: SoundScan

SONY BMG UPDATE

Sony BMG is beginning to take steps to reapply for a merger review with the EC following last July's ruling from Europe's Court of First Instance, which annulled the venture on the basis that the EC approval two years prior was based on erroneous data. In its ruling the Court of First Instance stated that the data presented to the EC neither proved nor disproved collective dominance as a result of a Sony BMG combination. Sony and BMG recently appealed this decision to the Court of Justice (the highest court in Europe), although only points of law may be argued in this appeal, which could make a reversal a difficult task to accomplish. The appeal process could take more than 12-months before a decision is rendered. As such, Sony BMG will need to simultaneously begin an EC review process in order to restart its merger campaign. A filing with the EC is expected at some point this fall. A review by the EC could take six months or potentially more, depending on how many times the regulatory body stops the clock.

VALUATION

Our DCF model implies a $23 price target for WMG by the end of 2006. We us a 10.2% weighted average cost of capital (WACC) and an unlevered free cash flow terminal multiple of 11.7x to value Warner Music's assets. Our DCF assumptions are based on a 5% equity risk premium, a 4.8% risk free rate, a beta of 1.5, a target debt-to-capital of 30% and perpetual growth of unlevered free cash flow of 1.5%. Our terminal multiple of 11.7x FCF implies a 9.2x terminal EBITDA multiple. Included in the DCF is roughly $355 million for the present value of deferred tax benefits. This value is derived from the company's NOL balance and the 338(h)(10) tax benefit arising from the asset revaluation at the time Warner Music was acquired by its current management group.

Figure 6: Warner Music Group DCF Valuation ($ millions, except per share data)

	C2005A	C2006E	C2007E	C2008E	C2009E	'05-'09 CAGR
Operating Income (EBIT)	$123.6	$248.0	$273.6	$312.8	$381.2	30.8%
Less: Cash Tax Expense	(51.6)	(71.3)	(71.1)	(75.2)	(85.6)	
Net Operating Profit Less Adjusted Taxes	$71.9	$176.8	$202.5	$237.6	$275.6	39.9%
Depreciation & Amortization	237.9	238.4	246.7	235.5	223.7	
Change in Working Capital	(7.3)	(56.8)	(11.3)	(16.9)	(11.4)	
Capital Expenditure	(30.5)	(33.6)	(40.3)	(47.8)	(55.0)	
Non-Cash Interest Expense	61.9	36.4	15.5	16.8	18.1	
Net Investment Related Losses	(1.0)	(0.6)	—	—	—	
Non-Cash, Stock-based Compensation Expense	23.0	16.8	15.3	12.3	9.8	
Other	3.3	15.2	3.0	3.0	5.1	
Unlevered Free Cash Flow	$359.3	$352.2	$431.6	$440.5	$466.0	6.7%
Less: Net Interest Expense	(181.6)	(177.7)	(169.7)	(170.1)	(170.5)	
Levered Free Cash Flow	$177.7	$204.4	$261.8	$270.4	$295.5	13.6%
Levered Free Cash Flow Shortcut:						
Cash Flow from Operations	$208.2	$238.1	$302.1	$318.2	$350.4	
less: Capital Expenditure	(30.5)	(33.6)	(40.3)	(47.8)	(55.0)	
Levered Free Cash Flow	$177.7	$204.4	$261.8	$270.4	$295.5	
2006E PV of Unlevered FCF		—	$391.7	$383.0	$348.6	
2007E PV of Unlevered FCF		—	—	399.9	364.2	
2008E PV of Unlevered FCF		—	—	—	364.2	
PV of Terminal Value		4,062.4	4,475.0	4,929.5	5,430.1	
Sum of the PV of Interim Unlevered FCF		$1,103.4	$784.1	$384.2		
PV of Terminal Value		4,062.4	4,475.0	4,929.5		
Gross Asset Value		$5,165.7	$5,259.1	$5,313.6		
Add: Cash & Equivalents		179.7	173.8	165.5		
Add: PV of Deferred Tax Benefits (Years 2010 - 2019)		357.6	393.9	433.9		
Less: Debt		(2,242.7)	(2,245.8)	(2,250.5)		
Net Asset Value (NAV)		$3,460.8	$3,581.1	$3,662.5		
Diluted Shares		151.4	153.5	155.1		
Fair Value per Share		$22.85	$23.33	$23.62		

Cost of Equity:	12.5%
Tax-Adjusted Cost of Debt:	4.8%
Debt/Total Capitalization:	30.0%
Weighted Average Cost of Capital:	10.2%
G (Perpetual Growth Rate):	1.5%
Terminal Multiple = (1+G)/(WACC-G):	11.7x
Implied Terminal Yr. Multiple on EBITDA:	9.1x

Source: Company reports, Lehman Brothers

Figure 7: Warner Music Quarterly Income Statement ($ millions, except per share data)

	12/04A	3/05A	6/05A	9/05A	2005A	12/05A	3/06A	6/06A	9/06E	2006E
Revenue										
Recorded										
Publishing	$940.0	$421.0	$588.0	$775.0	$2,924.0	$920.0	$678.0	$674.0	$738.0	$3,010.0
Other Revenue/Eliminations	$95.0	154.0	161.0	137.0	607.0	131.0	129.0	150.0	126.0	536.7
Total Revenues	(7.0)	(8.0)	(7.0)	(7.0)	(29.0)	(7.0)	(8.0)	(8.0)	(8.0)	(27.0)
% Growth	$1,028.0	$567.0	$742.0	$905.0	$3,502.0	$1,044.0	$799.0	$822.0	$856.3	$3,522.3
	(7.0)%	-4.4%	2.2%	13.4%	1.9%	(4.0)%	3.8%	10.9%	(5.6)%	0.6%
Total COGS	$541.0	$400.0	$398.0	$473.0	$1,850.0	$530.0	$409.0	$445.0	$450.2	$1,834.2
Gross Profit										
Recorded										
Publishing	$468.0	$294.0	$287.0	$371.0	$1,421.0	$472.4	$328.6	$324.4	$353.8	$1,478.8
Other/Eliminations	38.4	58.4	45.7	54.0	195.4	30.4	56.0	42.6	56.0	185.3
Total Gross Profits	37	15.0	12.4	6.5	52.0	11.2	3.0	10.0	—	22.8
% Growth	$507.0	$367.0	$346.0	$432.0	$1,652.0	$514.0	$387.0	$377.0	$410.3	$1,686.9
% Margin	(4.3)%	3.8%	3.9%	14.0%	4.1%	1.4%	8.4%	8.0%	(5.1)%	2.2%
	48.8%	47.8%	46.6%	47.7%	47.2%	48.2%	48.8%	45.9%	47.7%	47.8%
Total Operating Expenses	$300.0	$272.0	$267.0	$314.4	$1,152.4	$306.0	$283.0	$301.0	$304.8	$1,194.8
Adjusted EBITDA Before FAS 123 Expense										
Recorded										
Publishing	$200.0	$72.0	$87.0	$103.0	$442.0	$200.0	$81.0	$92.0	$92.3	$473.3
Other/Eliminations	24.0	47.0	29.0	43.0	143.0	22.0	47.0	23.0	44.1	135.1
Total Adjusted EBITDA Before FAS 123 Expense	(22.0)	(24.0)	(17.0)	(27.0)	(94.0)	(23.0)	(22.0)	(37.0)	(32.0)	(114.0)
% Growth	$199.0	$95.0	$79.0	$119.0	$491.0	$208.0	$106.0	$80.0	$105.4	$499.0
% Margin	24.5%	67.0%	6.3%	29.3%	31.3%	5.1%	11.8%	13.8%	(11.4)%	0.6%
	16.2%	12.4%	10.8%	13.1%	14.0%	19.9%	13.3%	10.9%	12.2%	14.0%
FAS 123 Expense	$(20)	$(7.0)	$(9.0)	$(7.0)	$(75.0)	$(6.0)	$(7.0)	$(4.0)	$(5.0)	$(17.0)
EBITDA Before One-Time Items	$199.0	$88.0	$70.0	$112.0	$466.0	$202.0	$104.0	$80.0	$100.4	$482.0
% Growth	24.3%	63.3%	(8.7)%	23.1%	24.0%	2.1%	18.2%	22.0%	(10.4)%	3.7%
% Margin	18.0%	11.5%	9.4%	12.4%	13.3%	18.3%	13.1%	10.5%	11.7%	14.0%
One-Time SG&A Expense Items	(5.0)	—	(102.0)	(25.0)	(114.0)	—	—	—	—	—
Net EBITDA	$190.0	$88.0	$(33.0)	$77.0	$322.0	$202.0	$104.0	$80.0	$100.4	$477.0
Depreciation	$(14.0)	$(14.0)	$(12.0)	$(11.0)	$(51.0)	$(11.0)	$(11.0)	$(10.0)	$(11.5)	$(43.5)
Amortization	(49.0)	(47.0)	(47.0)	(47.0)	(187.0)	(47.0)	(49.0)	(48.0)	(49.2)	(193.2)
Operating Income	$128.0	$27.0	$(92.0)	$19.0	$84.0	$144.0	$45.0	$28.0	$40.6	$242.3
% Growth	113.7%	220.0%	858.7%	533.3%	108.6%	10.8%	66.7%	(138.4)%	113.9%	188.6%
% Margin	11.9%	3.5%	(12.4)%	2.1%	2.4%	13.8%	5.7%	3.4%	4.7%	6.9%
Interest Expense, Net	$(38.0)	$(52.0)	$(50.0)	$(42.0)	$(182.0)	$(45.0)	$(45.0)	$(45.0)	$(45.4)	$(180.4)
Net Investment-related losses	—	—	1.0	—	1.0	—	$1.0	—	—	1.0
Loss on Repayment of Debt	—	—	(35.0)	—	(35.0)	—	—	—	—	—
Equity Method Income	(1.0)	—	—	—	(1.0)	—	—	—	—	—
Deferred financing and other costs	—	—	—	—	—	—	—	—	—	—
Unrealized gains on warrants	(22.0)	39.0	—	—	17.0	—	—	—	—	—
Minority interest	(5.0)	—	—	—	(5.0)	—	—	—	—	—
Other	4.0	—	1.0	2.0	7.0	—	2.0	1.0	—	3.0
Pre-Tax Income	$66.0	$14.0	$(175.0)	$(21.0)	$(116.0)	$98.0	$3.0	$(16.0)	$(4.8)	$63.0
Income Tax Expense	(22.0)	(10.0)	(4.0)	(8.0)	(32.0)	(30.0)	(10.0)	2.0	2.0	(36.2)
GAAP Net Income	$36.0	$4.0	$(179.0)	$(29.0)	$(169.0)	$68.0	$(7.0)	$(14.0)	$(3.0)	$45.0
Derivation of Diluted Earnings Per Share										
GAAP Net Income	$36.0	$4.0	$(179.0)	$(29.0)	$(169.0)	$68.0	$(7.0)	$(14.0)	$(3.0)	$45.0
add: Impairment of Goodwill & Intangible Assets	—	—	—	—	—	—	—	—	—	—
add: Restructuring Costs	—	—	—	7.0	7.0	—	—	—	—	—
add: Loss on Termination of Mgmt Fee	—	—	73.0	—	73.0	—	—	—	—	—
add: Loss on Repayment of Debt	—	—	35.0	—	35.0	—	—	—	—	—
add: SP-related cash bonus	—	—	10.0	—	10.0	—	—	—	—	—
add: Bonus related to stock awards	—	—	10.0	—	10.0	—	—	—	—	—
add: Mgmt Fees	3.0	2.0	1.0	—	6.0	—	—	—	—	—
less: Tax effect on non-recurring items	—	—	(3.0)	—	(3.0)	—	—	—	—	—
less: Other	1.0	—	—	22.0	23.0	—	—	—	—	—
Net Income for Diluted Calculation	$40.0	$6.0	$(44.0)	$3.0	$7.0	$68.0	$(7.0)	$(14.0)	$(3.0)	$45.0
Diluted Shares	112.3	110.0	127.4	141.2	129.4	150.2	141.0	143.7	151.3	146.0
Reported GAAP Earnings Per Share	$0.31	$0.03	$(1.41)	$(0.21)	$(1.31)	$0.48	$(0.05)	$(0.10)	$(0.02)	$0.30
less: One-Time Adjustments	0.03	0.02	1.06	0.23	1.34	—	—	—	—	—
Earnings Per Share, Excluding Items	$0.35	$0.05	$(0.34)	$0.02	$0.03	$0.48	$(0.05)	$(0.10)	$(0.02)	$0.30

Source: Company reports, Lehman Brothers

Figure 8: Warner Music Annual Income Statement ($ millions, except per share data)

	2004A	2005A	2006E	2007E	2008E	2009E	2010E
Revenues							
Recorded							
Publishing	$2,859.0	$2,924.0	$3,013.4	$3,090.3	$3,150.3	$3,236.9	$3,303.0
Other Revenue/Eliminations	601.0	607.0	536.7	546.9	561.7	579.4	603.8
Total Revenues	(23.0)	(29.0)	(27.9)	(28.5)	(29.3)	(30.0)	(30.8)
% Growth	$3,437.0	$3,502.0	$3,522.2	$3,608.7	$3,682.8	$3,785.8	$3,874.0
Total COGS	—	1.9%	0.6%	2.5%	2.1%	2.8%	2.4%
Gross Profits	$1,850.0	$1,850.0	$1,834.2	$1,850.3	$1,867.4	$1,889.2	$1,929.1
Recorded							
Publishing	$1,387.2	$1,421.0	$1,476.9	$1,544.3	$1,595.7	$1,650.3	$1,712.0
Other/Eliminations	209.2	195.4	188.3	190.7	195.8	201.6	209.5
Total Gross Profits	(9.4)	35.6	22.8	23.4	24.0	24.6	25.4
% Growth	$1,587.0	$1,652.0	$1,688.1	$1,759.4	$1,815.4	$1,886.7	$1,946.9
% Margin	—	4.1%	2.2%	4.2%	3.2%	3.9%	3.2%
Total Operating Expenses	46.2%	47.2%	47.9%	48.7%	49.3%	49.8%	50.2%
Adjusted EBITDA Before FAS 123 Expense	$1,213.0	$1,152.4	$1,194.8	$1,228.0	$1,264.0	$1,298.6	$1,332.0
Recorded							
Publishing	$291.0	$442.0	$473.9	$510.3	$530.1	$564.6	$587.8
Other/Eliminations	146.0	143.0	135.1	135.9	139.3	142.7	149.8
Total Adjusted EBITDA Before FAS 123 Expense	(62.0)	(24.0)	(114.9)	(115.5)	(118.0)	(120.2)	(122.3)
% Growth	$374.8	$491.0	$494.0	$530.4	$551.4	$588.0	$615.0
% Margin	—	31.3%	0.6%	7.4%	4.0%	6.8%	4.6%
FAS 123 Expense	10.9%	14.0%	14.0%	14.7%	15.0%	15.5%	15.9%
EBITDA Before One-Time Items	$(1.0)	$(25.0)	$(17.0)	$(16.7)	$(12.0)	$(10.3)	$(8.3)
% Growth	$373.0	$466.0	$492.4	$514.2	$539.5	$577.7	$606.7
% Margin	—	24.9%	5.7%	4.4%	4.7%	7.3%	5.0%
One-Time SG&A Expense Items	10.9%	13.3%	14.0%	14.2%	14.6%	15.3%	15.7%
Net EBITDA	(1,059.0)	(144.0)	—	—	—	—	—
	$(686.0)	$322.0	$477.0	$514.2	$539.5	$577.7	$606.7
Depreciation	$(57.0)	$(51.0)	$(43.5)	$(58.0)	$(51.0)	$(51.0)	$(53.5)
Amortization	(291.0)	(187.0)	(191.2)	(191.2)	(187.5)	(173.4)	(160.2)
Operating Income	$(954.0)	384.0	$242.3	$265.0	$299.3	$333.3	$393.3
% Growth	—	108.8%	108.4%	8.4%	12.9%	18.1%	11.3%
% Margin	(27.5)%	2.4%	6.9%	7.3%	8.1%	8.3%	10.1%
Interest Expense, Net	$(92.0)	$(182.0)	$(180.4)	$(169.7)	$(170.0)	$(170.4)	$(170.9)
Net investment-related losses	(9.0)	1.0	1.0	—	—	—	—
Loss on Repayment of Debt	(6.0)	(35.0)	—	—	—	—	
Equity Method Income	(13.0)	(1.0)	—	—	—	—	
Deal-related transaction and other costs	(63.0)	—	—	—	—	—	—
Unrealized gains on warrants	(120.0)	17.0	—	—	—	—	—
Minority Interest	(14.0)	(5.0)	—	—	—	—	—
Other	(11.0)	7.0	3.0	3.0	3.0	3.0	3.0
Pre-Tax Income	$(1,272.0)	$(114.0)	$65.9	$98.4	$132.3	$165.9	$225.3
Income Tax Expense	(150.0)	(55.0)	(38.2)	(34.4)	(46.3)	(65.1)	(84.5)
GAAP Net Income	$(1,422.0)	$(169.0)	$45.0	$63.9	$86.0	$120.8	$140.8
Derivation of Diluted Earnings Per Share							
GAAP Net Income	$(1,422.0)	$(169.0)	$45.0	$63.9	$86.0	$120.8	$140.8
add: Impairment of Goodwill & Intangible Assets	—	—	—	—	—	—	—
add: Restructuring Costs	—	7.0	—	—	—	—	—
add: Loss on Termination of Mgmt Fee	—	73.0	—	—	—	—	—
add: Loss on Repayment of Debt	—	35.0	—	—	—	—	—
add: IPO-related cash bonus	—	10.0	—	—	—	—	—
add: Bonus related to stock awards	—	19.0	—	—	—	—	—
add: Mgmt Fees	—	6.0	—	—	—	—	—
less: Tax effect on non-recurring items	—	(3.0)	—	—	—	—	—
less: Other	—	29.0	—	—	—	—	—
Net Income for Diluted Calculation	$(1,422.0)	$7.0	$45.0	$63.9	$86.0	$120.8	$140.8
Diluted Shares		128.4	150.9	151.9	154.7	156.2	157.0
Reported GAAP Earnings Per Share		$(1.31)	$0.30	$0.42	$0.56	$0.77	$0.89
less: One-Time Adjustments		1.36	—	—	—	—	—
Earnings Per Share, Excluding 1x Items		$0.05	$0.30	$0.42	$0.56	$0.77	$0.89

Source: Company reports, Lehman Brothers

Figure 9: Warner Music Annual Cash Flow Statement ($ millions, except per share data)

	2004A	2005A	2006E	2007E	2008E	2009E	2010E
Operating Activities							
Net Income	—	$(169.0)	$45.0	$63.8	$86.0	$120.8	$140.8
Depreciation & Amortization	—	239.0	234.7	249.2	239.2	224.4	221.7
Deferred Taxes	—	10.0	(35.4)	(36.1)	(26.2)	(18.1)	(8.4)
Non-Cash Interest Expense	—	58.0	43.4	15.2	16.5	17.8	19.2
Net Investment Related Losses	—	(1.0)	(1.0)	—	—	—	—
Equity Method Income	—	1.0	—	—	—	—	—
Non-Cash, Stock-based Compensation Expense	—	25.0	17.0	16.2	12.9	10.3	8.3
Unrealized gains on warrants	—	(17.0)	—	—	—	—	—
Minority Interest	—	5.0	—	—	—	—	—
Other	—	25.0	—	—	—	—	—
Changes in Operating Assets & Liabilities							
Accounts Receivable	—	$(58.0)	$115.0	$(16.6)	$(14.9)	$(19.5)	$(17.7)
Inventories	—	(3.0)	2.6	(9.4)	(0.5)	(2.6)	(2.8)
Royalty Advances	—	—	(49.8)	(10.2)	(8.7)	(12.1)	(10.6)
Accounts Payable and accrued liabilities	—	10.0	(69.0)	24.8	17.5	30.4	35.8
Other balance sheet changes	—	70.0	(64.8)	(9.8)	(10.8)	(11.4)	(4.7)
Total Working Capital		$19.0	$(66.0)	$(9.2)	$(17.4)	$(13.4)	$0.7
Cash Flow from Operations	—	$205.0	$217.8	$299.2	$310.9	$339.8	$382.3
Investing Activities							
Capital Expenditures	—	$(30.0)	$(32.0)	$(38.4)	$(46.1)	$(53.0)	$(60.9)
Investments in Acquired Businesses	—	(78.0)	(172.0)	(172.0)	(182.3)	(193.3)	(204.9)
Investments in Short Term Investments	—	—	(29.0)	—	—	—	—
Acquisitions of Publishing Copyrights	—	—	(8.0)	(8.0)	(8.5)	(9.0)	(9.5)
Other	—	94.0	—	—	—	—	—
Net Cash Used in Investing	—	$(34.0)	$(241.0)	$(218.4)	$(238.9)	$(255.2)	$(275.3)
Financing Activities							
Borrowings	—	$946.0	—	—	—	—	—
Financing Costs of Borrowings	—	(20.0)	—	—	—	—	—
Debt Repayments	—	(588.0)	(16.0)	(12.0)	(12.0)	(12.0)	(12.0)
Capital Contributions	—	—	—	—	—	—	—
(Decrease) Increase in amounts due to parent companies	—	—	—	—	—	—	—
Decrease in amounts due from TW	—	—	—	—	—	—	—
Dividends Paid	—	(917.0)	(73.0)	(73.0)	(73.0)	(73.0)	(73.0)
Share & Warrant Repurchase	—	(336.0)	—	—	—	—	—
Loans to Third Parties	—	(10.0)	—	—	—	—	—
Other	—	(43.0)	—	—	—	—	—
Proceeds from Equity Issuances	—	554.0	—	—	—	—	—
Net Cash Used in Financing	—	$(416.0)	$(89.0)	$(85.0)	$(85.0)	$(85.0)	$(85.0)
Effects of Foreign Currency	—	$(2.0)	$5.0	—	—	—	—
Net Increase in Cash	—	(267.0)	(107.2)	(4.2)	(10.9)	(0.4)	22.0
Cash Balance BOP	—	555.0	288.0	180.8	176.6	165.6	165.2
Cash Balance EOP	—	288.0	180.8	176.6	165.6	165.2	187.2
Fiscal Levered Free Cash Flow							
Cash Flow from Operations		$205.0	$217.8	$299.2	$310.9	$339.8	$382.3
Less: Capital Expenditure		(30.0)	(32.0)	(38.4)	(46.1)	(53.0)	(60.9)
Levered Free Cash Flow		$175.0	$185.8	$260.8	$264.9	$286.8	$321.3
Fiscal Levered Free Cash Flow per Share		$1.35	$1.23	$1.78	$1.71	$1.84	$2.04

Source: Company reports, Lehman Brothers

Figure 10: Warner Music Annual Balance Sheet ($ millions)

	2004A	2005A	2006E	2007E	2008E	2009E	2010E
Assets							
Current Assets							
Cash	$555.0	$288.0	$180.8	$178.6	$165.6	$165.2	$187.2
Short Term Investments	—	—	$29.0	$29.0	$29.0	$29.0	$29.0
Accounts Receivable	571.0	637.0	530.0	546.6	561.5	581.0	598.7
Inventory	65.9	52.0	50.4	50.9	51.3	54.1	56.9
Advances - Short Term	223.0	190.0	206.9	212.0	216.3	222.4	227.7
Deferred Tax Assets	38.0	35.0	40.0	40.0	40.0	40.0	40.0
Other Current Assets	58.0	39.0	96.0	86.1	93.6	100.0	106.3
Total Current Assets	$1,638.0	$1,242.0	$1,123.1	$1,143.1	$1,157.4	$1,191.7	$1,245.7
Non-Current Assets							
Royalty Advances Expected to be Recouped After One Year	$223.0	$190.0	$206.9	$212.0	$216.3	$222.4	$227.7
Investments	6.0	21.0	109.0	269.0	479.8	682.0	890.4
PP&E (Net)	169.0	157.0	146.5	126.9	121.2	123.1	130.5
Goodwill	978.0	969.0	946.0	946.0	946.0	946.0	946.0
Other Intangibles	2,037.0	1,915.0	1,797.6	1,608.6	1,419.1	1,245.7	1,077.5
Other Non-Current Assets	117.0	104.0	206.5	215.2	223.3	233.3	238.8
Total Non-Current Assets	$3,552.0	$3,256.0	$3,412.6	$3,395.8	$3,405.7	$3,452.6	$3,517.0
Total Assets	$5,090.0	$4,498.0	$4,535.8	$4,538.7	$4,563.1	$4,644.3	$4,762.8
Liabilities & Stockholders' Equity							
Current Liabilities							
Accounts Payable	$228.0	$247.0	$234.1	$234.3	$232.7	$232.9	$232.7
Royalties Payable	1,003.0	1,057.0	1,068.6	1,085.8	1,100.7	1,123.9	1,150.7
Taxes and other Withholdings	10.0	23.0	34.0	34.0	34.0	34.0	34.0
Current Portion of Long Term Debt	12.0	17.0	17.0	17.0	17.0	17.0	17.0
Note Payable to Shareholders	342.0	—	—	—	—	—	—
Dividends Payable	—	—	22.0	22.0	22.0	22.0	22.0
Other Current Liabilities	587.0	404.0	315.1	300.7	384.8	391.8	401.2
Total Current Liabilities	$2,180.0	$1,748.0	$1,749.0	$1,773.7	$1,791.2	$1,821.6	$1,857.6
Long Term Debt	$1,828.0	$2,229.0	$2,224.4	$2,227.7	$2,232.1	$2,237.9	$2,245.1
Dividends Payable	—	5.0	3.0	3.0	3.0	3.0	3.0
Deferred Tax Liabilities, net	265.0	201.0	174.6	138.5	112.2	94.1	85.7
Other non-current Liabilities	333.0	228.0	309.7	313.7	318.6	321.5	329.2
Minority Interest	204.0	—	—	—	—	—	—
Total Liabilities	$4,810.0	$4,409.0	$4,460.7	$4,456.6	$4,455.6	$4,478.2	$4,520.6
Additional PIC	—	—	—	—	—	—	—
Retained Earnings	$512.0	$548.0	$560.0	$560.0	$560.0	$560.0	$560.0
Accumulated Other Comprehensive Income, Net	(238.0)	(480.0)	(525.0)	(506.9)	(481.0)	(422.5)	(348.7)
Total Stockholders' Equity	6.0	21.0	29.0	29.0	29.0	29.0	29.0
Total Liabilities & Shareholders' Equity	$280.0	$89.0	$64.0	$82.1	$108.0	$166.2	$242.3
	$5,090.0	$4,498.0	$4,535.8	$4,538.7	$4,563.1	$4,644.3	$4,762.8

Source: Company reports, Lehman Brothers

Analyst Certification:

We, Eric O. Handler and Vijay Jayant, hereby certify (1) that the views expressed in this research Company Note accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Company Note and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Company Note.

Other Team Members:

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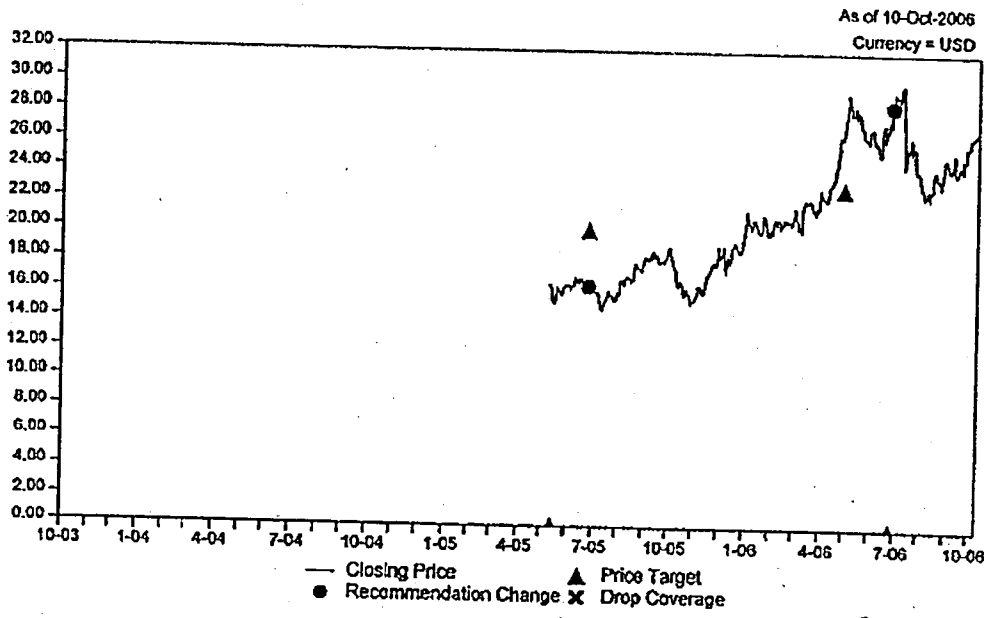
Company Description:

Important Disclosures:

Warner Music Group (WMG) **US$ 25.45 (17-Oct-2006)** **2-Equal weight / 2-Neutral**

Rating and Price Target Chart:

WARNER MUSIC GROUP



Source: FactSet

Currency=US$

Date	Closing Price	Rating	Price Target
29-Jun-06	28.55		0.00
29-Jun-06	28.55	RS-Rating Suspended	
01-May-06	27.00		23.00

Date	Closing Price	Rating	Price Target
27-Jun-05	16.35		20.00
27-Jun-05	16.35	2-Equal weight	
16-May-05	15.23		0.00

FOR EXPLANATIONS OF RATINGS REFER TO THE STOCK RATING KEYS LOCATED ON THE PAGE FOLLOWING THE LAST PRICE CHART.

Lehman Brothers Inc. and/or an affiliate has managed or co-managed within the past 12 months a 144A and/or public offering of securities for Warner Music Group.
Lehman Brothers Inc. and/or an affiliate has received compensation for investment banking services from Warner Music Group in the past 12 months.
Lehman Brothers Inc and/or an affiliate trade regularly in the shares of Warner Music Group.
Lehman Brothers Inc. has received non-investment banking related compensation from Warner Music Group within the last 12 months.
Warner Music Group is or during the past 12 months has been an investment banking client of Lehman Brothers Inc. and/or an affiliate.
Warner Music Group is or during the last 12 months has been a non-investment banking client (securities related services) of Lehman Brothers Inc.

Valuation Methodology: OOur DCF model implies a $23 price target for WMG by the end of 2006. We us a 10.2% weighted average cost of capital (WACC) and an unlevered free cash flow terminal multiple of 11.7x to value Warner Music's assets. Our DCF assumptions are based on a 5% equity risk premium, a 4.8% risk free rate, a beta of 1.5, a target debt-to-capital of 30% and perpetual growth of unlevered free cash flow of 1.5%. Our terminal multiple of 11.7x FCF implies a 9.2x terminal EBITDA multiple. Included in the DCF is roughly $355 million for the present value of deferred tax benefits. This value is derived from the company's NOL balance and the 338(h)(10) tax benefit arising from the asset revaluation at the time Warner Music was acquired by its current management group.

Risks Which May Impede the Achievement of the Price Target: Warner Music Group risks include continued declines in the global music industry, pricing pressure from larger players creating further margin disparity and potential vulnerability, increased levels of piracy, and a strengthening US dollar.

Important Disclosures Continued:
The analysts responsible for preparing this report have received compensation based upon various factors including the firm's total revenues, a portion of which is generated by investment banking activities

Company Name	Ticker	Price (17-Oct-2006)	Stock / Sector Rating
Warner Music Group	WMG	US$ 25.45	2-Equal weight / 2-Neutral

Sector Coverage Universe
Below is the list of companies that constitute the sector coverage universe against which the primary stock, Warner Music Group, is rated:
DreamWorks Animation SKG (DWA)
Marvel Entertainment (MVL)
Warner Music Group (WMG)
Lionsgate Entertainment (LGF)
Regal Entertainment Group (RGC)

Guide to Lehman Brothers Equity Research Rating System:
Our coverage analysts use a relative rating system in which they rate stocks as 1-Overweight, 2-Equal weight or 3-Underweight (see definitions below) relative to other companies covered by the analyst or a team of analysts that are deemed to be in the same industry sector (the "sector coverage universe"). To see a list of the companies that comprise a particular sector coverage universe, please go to www.lehman.com/disclosures

In addition to the stock rating, we provide sector views which rate the outlook for the sector coverage universe as 1-Positive, 2-Neutral or 3-Negative (see definitions below). A rating system using terms such as buy, hold and sell is not the equivalent of our rating system. Investors should carefully read the entire research report including the definitions of all ratings and not infer its contents from ratings alone.

Stock Rating
1-Overweight - The stock is expected to outperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.
2-Equal weight - The stock is expected to perform in line with the unweighted expected total return of the sector coverage universe over a 12- month investment horizon.
3-Underweight - The stock is expected to underperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.
RS-Rating Suspended - The rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Lehman Brothers is acting in an advisory capacity in a merger or strategic transaction involving the company.

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1-Positive - sector coverage universe fundamentals/valuations are improving.
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EXHIBIT CO 0962

May 24, 2006

United Kingdom
European Media

EMI Group (EMI.L - 260.3p) 2-Equal weight

Operating Results

Encouraging schedule, though deal key

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Investment Conclusion

- At 14x Dec 07E P/E, the stock is broadly in line with the sector. Should the market return to long-term growth, the stock would still be decent value on a stand-alone basis, in our view, although we do not expect any major further evidence of this over the next few months. At the same time we also believe any potential deal with Warner could also still be positive, as it could leave the stock on only 9.5x Mar 09E P/E, although there are still some hurdles to be cleared before this can be agreed. As such we remain Equalweight for the time being.

FY Mar	2005A	2006E		2007E		2008E	
Currency STG	Actual	Old	New	Old	New	Old	New
Revenue (m)	2001.2	2077.5	2080.0	2085.6	2085.0	2142.2	2141.0
PTP (m)	141.1	157.9	159.0	176.8	178.0	218.8	221.0
EPS (p)	13.06	14.60	15.70	15.70	16.40	18.60	19.40
Consensus (p)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EV/Revenues	N/A	N/A	1.49	N/A	1.46	N/A	1.38
EV/EBITDA	N/A	N/A	11.50	N/A	10.70	N/A	10
P/E	N/A	-	16.6	-	15.9	-	14.4

Summary

- Results in line after trading update, though EPS 7% ahead due to lower tax.
- Release schedule looks strong and should help EMI maintain share, with the recent market improvement and EMI's positive outlook supporting increase to our Mar 07E recorded organic growth to 1.5% from 0%. This is partly offset by FX, though lower tax guidance means a 4% upgrade.
- Long-term guidance of 15% group margins are below our previous interpretation, though we hadn't assumed 15% recorded margins anyway.

Market Data

Market Cap (m)	2121
Shares Outstanding (m)	792.8
Float (%)	100
Net Div Yield (%)	2.99
Convertible	Yes
Shares per ADR	N/A

Financial Summary

Five Yr. EPS CAGR (%)	N/A
Return on Equity FY05 (%)	N/A
Current BVPS (p)	0.0
Net Debt (m current)	-857.50

Stock Rating

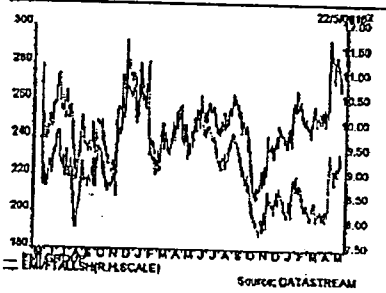
New:	2-Equal weight
Old:	2-Equal weight

Target Price

New:	320p
Old:	320p

Sector View: 1-Positive

Stock Overview



Reuters	EMI.L
Bloomberg	EMI LN
ADR	

Performance	1M	3M	12M
Absolute %	4	7	10
Rel. Market %	12	11	-6
Rel. Sector %	8	9	2

52 Week Range 294.00 - 207.00

Encouraging schedule, though deal key and implied reduction to long-term margin indications

Results were in line after trading update, though EPS 7% was ahead due to lower tax. The release schedule looks strong and should help EMI maintain share, with the recent market improvement and EMI's positive outlook supporting increase to our Mar 07E recorded organic growth to 1.5% from 0%. This is partly offset by FX, though lower tax guidance means a 4% upgrade. Long-term guidance of 15% group margin is below our previous interpretation, though we hadn't assumed 15% recorded margins anyway. At 14x Dec 07E P/E, the stock is broadly in line with the sector. Should the market return to long-term growth, the stock would still be decent value on a stand-alone basis, in our view, although we do not expect any major further evidence of this over the next few months. At the same time we also believe any deal with Warner could also still be positive, as it could leave the stock on only 9.5x Mar 09E P/E, although there are still some hurdles to be cleared before this can be agreed. As such we remain Equalweight for the time being.

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Overall results + forecasts

Results were broadly in line following a detailed trading update last month though EPS was 7% ahead at 15.7p from a low tax rate of only 18%. Sales came in marginally ahead at £2080m vs. our forecast of £2078m and consensus £2070m, with underlying revenue growth of 2.1%, helped by 150% growth in digital to 5.4% of sales. EBITA of £250m was £1m ahead of our forecasts with an improvement in group operating margin from 11.2% to 12% thanks to cost savings and higher digital margins. With interest in line, PBT was £159m vs. our £158m. The only other new number was net debt, which was broadly in line with our forecasts at £880m, though this is a slight increase from £858m at the end of last year. This is due partly to a negative working capital impact, although this should be mainly a seasonal effect.

Figure 1: FY results v Lehman forecasts

£m Yr end Mar	2005	2006	% change	% growth constant FX LB estimate		% variance
Recorded Music sales	1601	1660	3.7%	1.9%	1660	0.0%
Recorded Music EBITA	126	145	15.6%		144	0.6%
% margin	7.8%	8.7%				
Publishing sales	401	420	4.7%	2.6%	418	0.4%
Publishing EBITA	100	105	5.8%		105	0.7%
% margin	24.9%	25.1%				
Total sales	2001	2080	3.9%	2.1%	2078	0.1%
Total EBITA	225	251	11.3%		249	0.6%
% margin	11.2%	12.0%				
PX PBT	142	159	12.3%		158	0.9%
Tax rate	-31.5	-28.1			-35.1	
Tax rate	21.9%	17.6%			22.2%	
PX FD EPS	13.1	15.7	19.6%		14.6	7.5%
Year end net debt	-858	-881			-877	

Source: EMI, Lehman Brothers Research

Going forward, the positive music market so far this calendar year, coupled with the decent release schedule and the company's confidence it should see recorded growth this year mean we increase our organic recorded forecast to 1.5%, from flat, although we have also incorporated the recent negative FX moves, which offset this increase. As such we have only a slight increase in our revenue forecast, though the underlying improvement has a slight positive impact on the margin, meaning we increase our EBITA and PBT forecast by around 1%. The company's guidance for tax rate of 22% was then materially below our previous 24.5% forecast, so overall this results in a 4% increase to our 06 forecasts overall.

Figure 2: Previous forecasts v Revised forecasts for Mar 07

£m Yr end Mar 07	Previous	Revised	% change
Recorded Music sales	1660	1660	0.0%
Recorded Music EBITA	155	158	2.2%
% margin	9.3%	9.5%	
Publishing sales	427	425	-0.6%
Publishing EBITA	108	107	-0.8%
% margin	25.3%	25.2%	
Total sales	2087	2085	-0.1%
Total EBITA	263	266	1.0%
% margin	12.6%	12.7%	
PX PBT	177	179	0.7%
Tax rate	24.5%	22%	
PX FD EPS	16.7	16.4	4.5%
Year end net debt	-829	-821	1.0%

Source: Lehman Brothers Research

Beyond this, we have also increased our Mar 08E forecasts slightly as the company stated it expects the whole £30m from its recent cost cutting plan to impact by then, when we had expected this to take slightly longer. However, the company also stated it still expects long-term margins to reach 15%. While this is not specifically a reduction to long-term guidance, we had previously interpreted long-term margin expectations in the mid-teens as applying primarily to recorded music. On the other hand, this has been impacted by IFRS, and our own recorded music margin forecasts only reached 12% anyway.

Recorded Music

Music has seen organic growth of 1.9% for the year, implying around 0.2% in H2, with share improvement from 12.9% to 13.1% helped by major releases including Robbie Williams, Coldplay, Gorillaz, KT Tunstall and Keith Urban. This compares to a global market which was down around 0.9% for its fiscal year, with a similar decline in H2 as it H1, although with market data pointing to over 3% decline in calendar Q4, this would imply over 1% global growth in calendar Q1.

Within the slight global decline for the year, market performance remained extremely mixed. North America declined 1.5%, though the digital sales tripled over the year and mobile revenues increased 9x. In the UK physical sales declined 4.9%, with digital sales increasing by 170% to give a total industry decline of 3%, due to weak compilation sales especially over the Christmas period. Continental Europe industry sales declined by 3.7% with France, Spain and Italy improving while Germany is still challenging and digital sales increasing 245% over the year. Japan industry sales grew 6% including digital though EMI lost market share leading to a restructuring of the business in the region. The South East Asian market declined 3.7% partially due to the impact of piracy, Australia declined 6% though EMI gained market share and LatAm rose 6.1%.

Meanwhile digital revenues increased 160% for the year, taking than to 5.6% of the total, implying 6% in H2. This is well below the 10% of UMG and Warner in Q1, though we agree with the company that this can be mostly explained by seasonality and geography, while the company repeated its view that digital will be 25% of total sales by 2010. Higher digital margins, as well as impact of further cost cutting then resulted in 16% EBITA growth, with margin improvement from 7.8% to 8.7%.

Going forward, the newly announced schedule for this year also looks better than we might have expected, including Robbie Williams, Norah Jones, Joss Stone, and Hikaru Utada, none of which we were particularly expecting. While there may still be an H1 issue, with several releases not due until September, this should support a view that EMI's share can be close to flat this year, with sales of the Top 20 being a major determinant of share for the year (and generally accounting for 20% of sales).

Figure 3: EMI's Top20 sellers last year v EMI's release schedule this year with estimated sales of last major album

FY 06	Sales
Coldplay	9.9
Gorillaz	5.9
Robbie Williams	6.2
KT Tunstall	2.6
Keith Urban	2.5
Rolling Stones	2.4
Korn	1.8
Depeche Mode	1.6
Trace Adkins	1.5
RBD	1.5
	35.9
Paul McCartney	1.3
Dierks Bentley	1.3
Radja	1.2
Coldplay	1.2
Robbie Williams	1.1
Raphael	1.1
RBD	1.1
Kate Bush	1.1
Corinne Bailey Rae	1.0
Dem Franchiz Boys	1.0
	11.4
	47.3

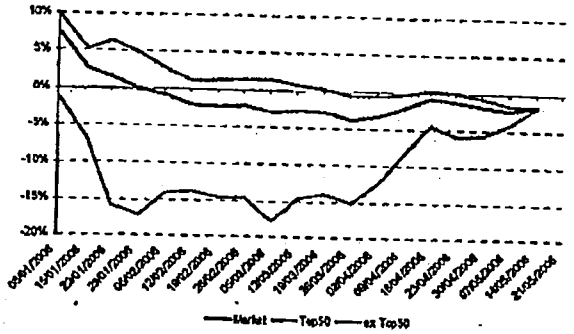
FY 07E	Estimated last sales	Previous release
Norah Jones	11.0	2004
Robbie Williams	6.2	2005
Joss Stone	3.0	2004
Janet Jackson	3.0	2004
Keith Urban	3.0	2005
KT Tunstall	3.0	2005
The Beatles	3.0	2003
Lenny Kravitz	1.3	2004
Chingy	3.5	2003
Stacie Orrico	2.0	2003
Hikaru Utada	3.0	2003
Renaud	2.0	2002
RBD	1.5	2005
Reflant K	?	?
Tiziano Ferro	?	?
Total	45.5	

Source: Lehman Brothers Research from EMI reports

While the company made limited comment on current trading, stating only that it is OK, we calculate that the global music market is up around 1% so far this calendar year, compared to the 0.9% fall in EMI's last fiscal year, with 2% increase in the US, 3% in the UK, and decent growth in Japan. Coupled with the decent release schedule this enabled the company to state it expects positive growth in recorded music this year, and we have increased our forecast from 0% to 1.5% (although this is offset by the recent FX movements). With some slight positive impact on margins this means we have increased our Recorded EBIT forecast by 2%.

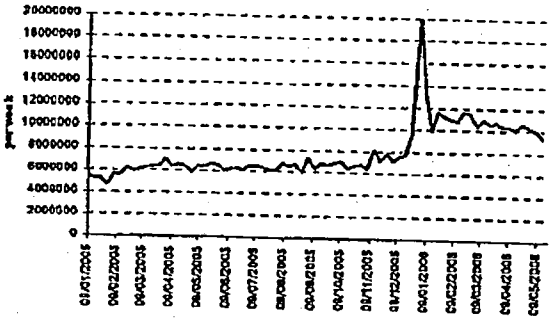
The ongoing improvements in the global market, driven by digital growth, are also encouraging for the long-term return to growth of the industry, which ourselves and EMI, which repeated its expectation that digital will account for 25% of sales by 2010, continue to expect. However, in the nearer term, we do have some concerns over changing seasonality boosting the first half in the light of recent declines in both catalogue and digital sales (see our note of May 19). The company also repeated that it is already seeing some positive impact from higher digital margins, and that it still believes there is significant scope for further improvement in the future. However, the company also stated it expects its group margin to reach 15%, rather than its recorded music margin as had been previously interpreted, although our own recorded music margin forecasts peaked at 12% anyway.

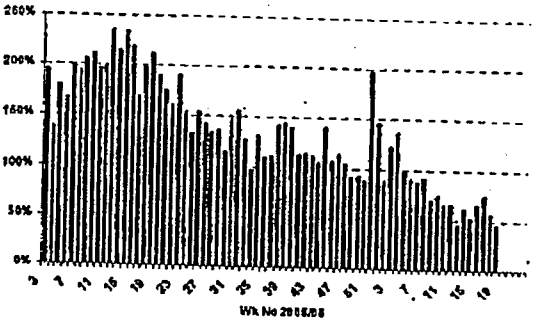
Figure 4: YTD US album volumes – Top50 v ex Top50 v mkt



Source: Lehman Brothers Research from Billboard, Hitsdailydouble

Figure 5: US digital single sales growth yoy





Source: Billboard

EMI Music Publishing

Music Publishing revenues were up 2.6% on a constant currency basis with an encouraging turn around from mechanical revenues to 3.2% growth, having been negative for the past four years, and now representing 45% of total divisional sales. Performance revenues increased 3.4% at constant currency, synchronisation increased by 5.4% at constant currency against a tough comp last year, while other revenues saw a slight decline, though excluding a drop in enforcement revenues, which are always volatile, other revenues increased 20%.

Within Publishing digital increased 46% on a constant currency bass to £20m, around 4.7% of publishing, and 5.1% in the second half. This is now lower than in recorded music, with far slower growth which reflects the fact that over 50% of publishing revenues come from B2B areas without a specific digital v physical distribution, while publishing has also been seeing material revenues from mobile areas such as ringtones for some time. These have no impact on recorded music sales, but have a material impact as they shift to ringtunes and full-track downloads.

In terms of margin, Publishing saw its first margin improvement in 8 years, from 24.9% to 25.1%, helped by the revenue growth, as well as the previous investment in improving its systems to cope with the changing world. Going forward we expect around 3% organic revenue growth in publishing this year, with a small amount of further margin improvement.

Warner Music

EMI reiterated its view that an acquisition of Warner Music would be attractive to both sets of shareholders and that it will only pursue a transaction that delivers enhanced value and earnings accretion to shareholders. It also stated it would not make any proposal unless it thought it would get regulatory approval, and given it has already made an approach it seems fair to assume EMI believes it would be able to gain regulatory approval. We expect this should be true, although would still expect it to go to Phase 2 inquiry in Europe, while any deal could require sale of material music publishing assets, which could have a 35% global share combined.

Overall we believe a potential deal would still be positive, and that a price over $30 could be justified assuming synergies close to £200m can be agreed. With a decent sale of publishing, this would leave EMI on 9.5x Mar. 2009E P/E (see our note *Deal Scenario Analysis*, 3 May), which could still look attractive, although given the hurdles which still exist, there must be some risk of the deal taking longer and being more problematic than is assumed.

Valuation

At 14x Dec 07E P/E, the stock is broadly in line with the sector, although a premium to the market. Should the market return to long-term growth, and this drive significant margin improvement, as we believe could be possible, the stock would still be decent value on a stand-alone basis, in our view, although we do not expect any major further evidence of this over the next few months. Rather slowing catalogue and digital sales could raise some questions around this. At the same time we also believe any potential deal with Warner could also still be positive, as it could leave the stock on only 9.5x Mar 09E P/E, although there are still some hurdles to be cleared before this can be agreed. As such we remain Equalweight for the time being.

Our 320p price target is based on a stand-alone DCF with 5% medium-term recorded revenue growth and 12% long-term recorded margins (9.5% discount rate and 4% terminal growth).

Figure 8: EMI stand-alone multiples

Year Ends 31 March (£ Million)	2005	2006	2007	2008	2009	2010	2011
EV/Sales	1.49	1.44	1.41	1.34	1.23	1.13	1.12
EV/EBITDA	12.0	10.9	10.1	8.8	7.7	7.0	7.0
FD EV/EBITDA	12.4	11.2	10.4	9.1	8.0	7.2	6.6
EV/EBIT	13.2	12.0	11.1	9.6	8.4	7.6	7.5
EV/NOPLAT	17.0	14.5	14.2	12.6	11.3	10.5	10.8
Price/cash flow	38.1	37.7	33.4	13.9	11.8	10.8	10.8
FD PX PE	20.0	16.7	15.9	13.5	11.8	10.8	9.8
PE Warner best case			29.9	14.3	11.3		
Dividend yield	3.1%	3.1%	3.3%	3.4%	3.8%	0.0%	0.0%
Calender year	2004	2005	2006	2007	2008	2009	2010
EV/Sales	1.43	1.45	1.43	1.37	1.28	1.17	1.10
EV/EBITDA	11.2	11.1	10.4	9.2	8.1	7.3	6.8
FD EV/EBITDA		11.4	10.6	9.5	8.3	7.5	6.9
EV/EBIT	12.5	12.2	11.4	10.1	8.8	7.9	7.4
Recorded EV/EBIT	11.2	9.2	7.9	6.0	4.5	3.4	2.5
EV/NOPLAT	16.0	15.0	14.4	13.2	11.8	10.9	10.5
Price/cash flow	30.5	37.6	34.4	16.3	12.3	11.0	10.2
FD PX PE	19.1	17.4	16.1	14.0	12.1	11.0	10.0
Dividend yield	3.1%	3.1%	3.2%	3.4%	3.7%	4.1%	4.5%

Source: Lehman Brothers Research

Figure 7: Revised P&L

Year Ends 31 March (£ Millions)	2006A	2007A	2008E	2009E	2010E
Total Revenues	2,001	2,080	2,085	2,144	2,249
% Growth	-5.6%	3.9%	0.2%	2.8%	4.9%
Operating Costs	(1,752)	(1,804)	(1,793)	(1,819)	(1,891)
% growth	-4.6%	3.0%	-0.6%	1.4%	4.0%
EBITDA	249	276	292	325	358
% Growth	-12.4%	10.8%	5.7%	11.4%	10.2%
% Margin	12.4%	13.3%	14.0%	15.2%	15.9%
Depreciation	(24)	(25)	(26)	(27)	(28)
Headline EBITA	225	251	265	298	330
% Growth	-9.7%	11.3%	6.0%	12.3%	10.8%
% Margin	11.2%	12.0%	12.7%	13.9%	14.7%
Operating Exceptionals	(18)	4	(60)	0	0
Non-Operating Exceptionals	0	0	45	0	0
Total Exceptionals	(18)	4	(15)	0	0
Goodwill Amortisation	0	0	0	0	0
Copyright Amortisation	(48)	(50)	(49)	(48)	(47)
Total Amortisation	(48)	(50)	(49)	(48)	(47)
Operating profit	160	205	202	250	283
% growth	266.1%	28.2%	-1.5%	24.1%	13.3%
% margin	8.0%	9.8%	9.7%	11.7%	12.6%
Net Associates	1	1	1	1	1
EBIT	161	206	203	251	284
% Growth	3	0	(0)	0	0
HMV Pre Tax Profit	0	0	0	0	0
Core net interest	(85)	(92)	(88)	(77)	(68)
Exceptional financial charge	23	5	0	0	0
Group Net Interest	(62)	(88)	(88)	(77)	(68)
Headline Pre Tax Profit	141	159	178	222	263
% Growth	-13.6%	12.9%	12.0%	24.2%	18.7%
Reported Pre Tax Profit	99	118	115	174	216
% Growth	NM	19.3%	-3.0%	51.6%	24.5%
Income Taxes Pre Exceptionals	(32)	(28)	(39)	(53)	(68)
% Tax Rate	22.3%	17.6%	22.0%	24.0%	26.0%
Income Taxes on Exceptionals	8	0	0	0	0
Income Taxes Post Exceptionals	(24)	(28)	(39)	(53)	(68)
Minorities Pre Exceptionals	(5)	(4)	(6)	(8)	(10)
Minorities On Exceptionals	5	(0)	0	0	0
Minorities Post Exceptionals	1	(4)	(6)	(8)	(10)
Reported Net Income	76	86	70	112	138
% Growth	NM	13.9%	-18.9%	60.9%	22.9%
% Margin	3.8%	4.1%	3.3%	5.2%	6.1%
Dividends	(63)	(63)	(67)	(71)	(79)
Retained earnings	13	23	3	41	59
Headline Net Income	105	127	134	160	185
% Growth	-15.5%	21.3%	6.0%	19.8%	15.5%
% Margin	5.2%	6.1%	6.4%	7.5%	8.2%
Average Number of Shares	786	786	787	788	789
Dilution	87	88	88	88	88
Fully Diluted Shares	873	874	875	876	877
Headline EPS	13.4	16.2	17.0	20.3	23.5
Basic EPS	9.6	10.9	8.9	14.3	17.5
Headline EPS Fully Diluted	13.1	15.7	16.4	19.4	22.2
Reported EPS Fully Diluted	9.7	10.9	9.1	13.9	16.8
DPS	8.0	8.0	8.5	9.0	10.0

Source: EMI, Lehman Brothers Research

Figure 8: Revised P&L

Year End 30 March (£ Million)	2005A	2006A	2007E	2008E	2009E
EBITA	225	251	265	298	330
Cash exceptionals	3	(2)	(57)	4	5
Goodwill	0	0	0	0	0
Depreciation	24	25	26	27	28
Provisions Created	15	18	0	0	0
Provisions utilised	(76)	(36)	0	0	0
Associate dividends	0	1	1	1	1
Cash In	191	257	236	330	364
Decrease in stock	0	0	0	0	0
Decrease in debtors	0	0	0	0	0
Increase in creditors	0	0	0	0	0
Change in Net Working Capital	25	(28)	0	0	0
Dividends paid to minorities	(1)	(3)	(6)	(8)	(10)
Net interest	(92)	(102)	(88)	(77)	(68)
Tax paid	(33)	(40)	(39)	(53)	(68)
Cash out	(101)	(172)	(133)	(139)	(146)
Gross trading cash flow	90	85	103	191	218
Net purchase of music copyrights	(6)	3	(6)	(7)	(7)
Physical capex	(30)	(30)	(31)	(32)	(34)
Sale of tangible fixed assets	3	16	65	0	0
Net purchase of investments	(3)	0	0	0	0
Buy-backs for share awards	(0)	(1)	(1)	(1)	(1)
Earn-outs paid	0	(2)	(2)	(2)	0
Dividends paid	(63)	(61)	(67)	(71)	(79)
Net trading cash flow	(9)	10	60	78	97
Acquisitions/disposals	(73)	(2)	0	0	0
Share issues	2	1	0	0	0
Other/currency	(27)	(32)	0	0	0
Change in net cash	(107)	(24)	60	78	97
Free Cash Flow	54	55	62	149	176
Net debt	(858)	(881)	(821)	(742)	(645)

Source: EMI, Lehman Brothers Research

Figure 9: Revised P&L

Year End 30 March (£ Million)	2005A	2006A	2007E	2008E	2009E
Net Tangible Fixed Assets	200	197	202	207	213
Music Copyrights	405				
Goodwill	35				
Net Intangible Fixed Assets	440	432	390	348	309
Investments/Other Assets	102	92	92	92	92
Total fixed assets	741	721	684	648	614
Stocks	28				
Current debtors	770				
Current creditors	(279)				
Net working capital	519	547	547	547	547
Cash	241				
Short-term debt	(31)				
Long term debt	(1,067)				
Net Cash (Debt)	(858)	(881)	(821)	(742)	(645)
Provisions + deferred tax	(52)	(39)	(39)	(39)	(39)
Earnouts	0	0	0	0	0
Other Liabilities	(1,147)	(1,075)	(1,094)	(1,095)	(1,099)
Total Equity	(796)	(727)	(722)	(681)	(622)
Minority Interests	(49)	(49)	(50)	(50)	(50)
Shareholders Funds	(846)	(775)	(772)	(731)	(672)

Source: EMI, Lehman Brothers Research

Figure 10: Revised P&L

Year Ends 31 March £ Million	2006A	2007A	2008A	2007E	2008E	2009E
N America	425	485	471	483	507	
% Growth	-18.7%	14.2%	-2.9%	2.5%	5.0%	
% of Total	26.6%	29.2%	28.4%	28.4%	28.4%	
UK	267	277	285	292	307	
% Growth	6.7%	3.4%	3.0%	2.5%	5.0%	
% of Total	16.7%	16.7%	17.2%	17.2%	17.2%	
Con EU	514	509	509	521	547	
% Growth	-3.7%	-1.0%	0.0%	2.5%	5.0%	
% of Total	32.1%	30.6%	30.6%	30.6%	30.6%	
Asia	326	297	297	304	319	
% Growth	-8.7%	-9.0%	0.0%	2.5%	5.0%	
% of Total	20.4%	17.9%	17.9%	17.9%	17.9%	
Other	68	93	99	101	106	
% Growth	15.1%	36.3%	6.1%	2.5%	5.0%	
% of Total	4.3%	5.6%	5.9%	5.9%	5.9%	
Total Recorded Music Revenues - £	1,601	1,660	1,660	1,702	1,787	
% Growth	-7.1%	3.7%	0.0%	2.5%	5.0%	
% growth const currency	-7.4%	1.9%	1.5%	2.5%	5.0%	
Stated market	-1.0%	-0.9%	1.5%	2.5%	5.0%	
Market share	12.9%	13.1%	13.1%	13.1%	13.1%	
Costs	(1,475)	(1,515)	(1,502)	(1,516)	(1,574)	
% growth	-6.4%	2.7%	-0.9%	0.9%	3.8%	
Costs ex additional cost savings	(1,510)	(1,530)	(1,511)	(1,535)	(1,574)	
% growth	-4.2%	3.7%	-0.3%	2.2%	3.8%	
% growth ex currency	-4.5%	1.9%	1.2%	2.2%	3.8%	
Increase in cost savings	35	15	9	19	0	
Operating Profit	126	145	158	186	213	
% Growth	-14.9%	15.6%	9.2%	17.5%	14.6%	
% Margin	7.8%	8.7%	9.5%	10.9%	11.9%	

Source: EMI, Lehman Brothers Research

Figure 11: Revised P&L

Year Ends 31 March £ Million	2006A	2007A	2008E	2007E	2008E	2009E
North America	156	164	166	172	180	
% Growth	4.8%	4.7%	1.2%	4.0%	4.5%	
United Kingdom	72	71	72	75	78	
% Growth	24.3%	4.7%	1.2%	4.0%	4.5%	
Continental Europe	120	122	123	128	134	
% Growth	1.9%	4.7%	1.2%	4.0%	4.5%	
Asia Pacific	40	42	42	44	46	
% Growth	0.7%	4.7%	1.2%	4.0%	4.5%	
Other (Including Latin America)	12	21	21	22	23	
Total Music Publishing	401	420	425	442	462	
% Growth	0.7%	4.7%	1.2%	4.0%	4.5%	
Mechanical	180	185	188	187	192	
% growth const currency	-9.8%	3.2%	-0.9%	1.5%	2.5%	
% of Total	44.8%	45.1%	43.6%	42.4%	41.6%	
Performance	108	112	120	126	133	
% growth const currency	4%	3%	5%	6%	6%	
% of Total	27.0%	27.2%	27.8%	28.4%	28.8%	
Synchronisation	67	71	77	80	85	
% Growth	6.8%	5.4%	6.0%	6.0%	6.0%	
% growth const currency	16.8%	17.2%	17.9%	18.2%	18.4%	
Other	46	43	46	49	51	
% growth const currency	43.1%	-5.7%	6.0%	6.0%	6.0%	
% of Total	11.4%	10.5%	10.6%	11.0%	11.1%	
Total	401	411	431	442	462	
% growth const currency	0.7%	2.6%	2.6%	4.0%	4.5%	
Currency	0	9	(6)	0	0	
Total Music Publising Revenues - £	401	420	425	442	462	
% Growth	0.7%	4.7%	1.2%	4.0%	4.5%	
Operating profit	100	105	107	112	117	
% Growth	-2.3%	6.8%	1.6%	4.5%	4.5%	
% Margin	24.9%	25.1%	25.2%	25.3%	25.3%	

Source: EMI, Lehman Brothers Research

Figure 12: Revised P&L

Year Ends 31 December (Million)	2006A	2007A	2008E	2009E	2010E
North America	581	649	637	656	687
United Kingdom	340	348	357	367	385
Continental Europe	634	630	632	649	681
Asia Pacific	366	339	339	348	365
Other (Including Latin America)	80	114	120	123	129
Total Revenues	2,001	2,080	2,085	2,144	2,249
% growth					
North America	-13.5%	11.7%	-1.9%	2.9%	4.9%
United Kingdom	10.0%	2.5%	2.6%	2.8%	4.9%
Continental Europe	-2.6%	-0.6%	0.2%	2.8%	4.9%
Asia Pacific	-13.6%	-7.5%	0.1%	2.7%	4.9%
Other (Including Latin America)	22.3%	42.1%	5.2%	2.8%	4.9%
Total	-5.6%	3.9%	0.2%	2.8%	4.9%
Share of total					
North America	29.0%	31%	31%	31%	31%
United Kingdom	17.0%	17%	17%	17%	17%
Continental Europe	31.7%	30%	30%	30%	30%
Asia Pacific	18.3%	16%	16%	16%	16%
Other (Including Latin America)	4.0%	5%	6%	6%	6%
Operating profit					
N America	69				
UK	46				
EU	84				
Asia	18				
ROW	8				
Total	225	251	265	298	330
% margin					
N America	11.9%				
UK	13.6%				
EU	13.3%				
Asia	4.9%				
ROW	9.6%				
Total	11.2%	12.0%	12.7%	13.9%	14.7%
% growth					
N America	-31%				
UK	-14%				
EU	36%				
Asia	-45%				
ROW	265%				
% growth	-9.7%	11.3%	6.0%	12.3%	10.8%
% of total					
N America	30.6%				
UK	20.6%				
EU	37.5%				
Asia	7.9%				
ROW	3.4%				

Source: EMI, Lehman Brothers Research

Analyst Certification:

I, Richard Jones, hereby certify (1) that the views expressed in this research Company Note accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Company Note and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Company Note.

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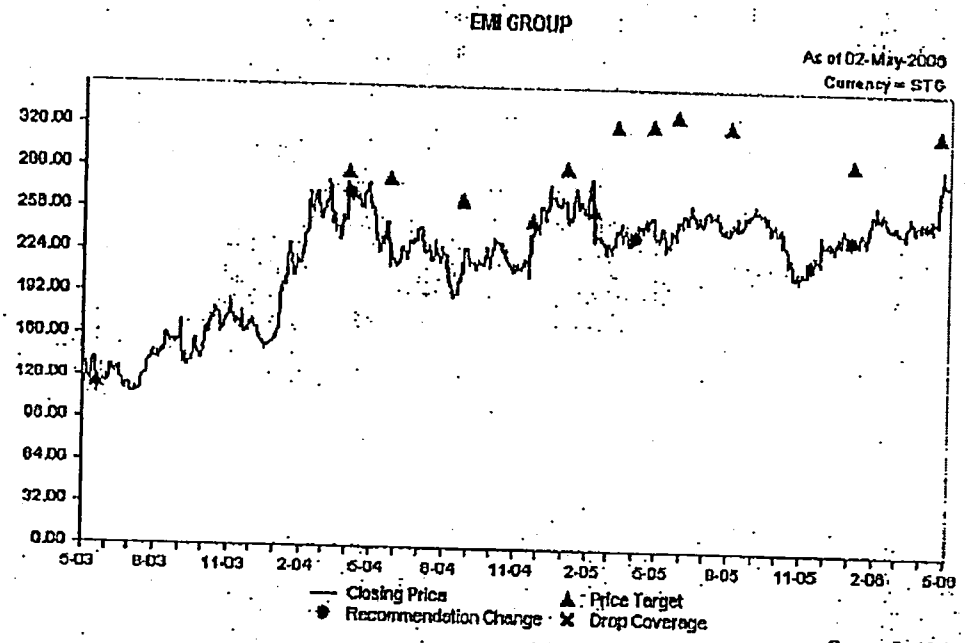
Company Description:

EMI is the world's third largest music company. The company comprises of two divisions, Recorded Music and Music Publishing. Labels include EMI, Virgin and Capitol with artists such as Robbie Williams, Janet Jackson and Garth Books. EMI is the world market leader in music publishing.

Important Disclosures:

EMI Group (EMI.L) 260.3p (22-May-2006) 2-Equal weight / 1-Positive

Rating and Price Target Chart:



Currency=STG

Date	Closing Price	Rating	Price Target
20-Apr-06	277.25		320.00
03-Jan-06	238.00		297.00
03-Jan-06	238.00	3 -Underweight	
01-Aug-05	247.25		324.00
25-May-05	244.50		331.00
25-Apr-05	252.75		324.00
04-Apr-05	237.50	1 -Overweight	
08-Mar-05	242.00		322.00

Date	Closing Price	Rating	Price Target
08-Feb-05	236.75		259.00
04-Jan-05	257.00		290.00
22-Nov-04	237.00		250.00
24-Aug-04	213.00		265.00
25-May-04	214.50		280.00
05-Apr-04	268.00	2 -Equal weight	
02-Apr-04	274.25		285.00
21-May-03	116.00		125.00

FOR EXPLANATIONS OF RATINGS REFER TO THE STOCK RATING KEYS LOCATED ON THE PAGE FOLLOWING THE LAST PRICE CHART.

Lehman Brothers Inc. and/or its affiliate beneficially owns 1% or more of any class of common equity securities of the subject company as of the end of the last month.

Lehman Brothers Inc. and/or an affiliate holds a short position of at least 1% of the subject company's capital.

Lehman Brothers Inc. and/or an affiliate trades regularly in the subject company's shares.

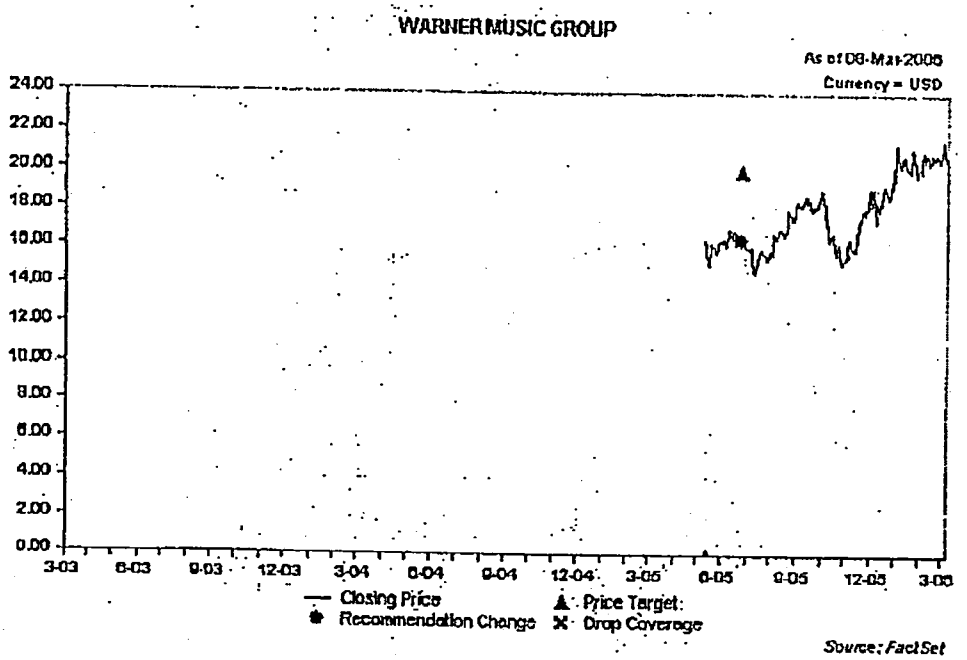
Valuation Methodology: Our price target is based on a stand-alone DCF with 5% medium-term recorded revenue growth and 12% long-term recorded margins (9.5% discount rate and 4% terminal growth).

Risks Which May Impede the Achievement of the Price Target: EMI Group obtains the majority of its revenue from the sale of recorded music. Long-range forecasts are therefore dependent on developments in anti-piracy technology and the extent to which illegal free downloads of music continues. EMI also has significant exposure to Continental Europe, the US and Asia, so sterling results may differ from same-currency results.

Important Disclosures Continued:

Warner Music Group (WMG) **$ 27.15 (22-May-2006)** **2-Equal weight / 2-Neutral**

Rating and Price Target Chart:



Currency=$

Date	Closing Price	Rating	Price Target
27-Jun-05	16.35		20.00
27-Jun-05	16.35	2-Equal weight	

Date	Closing Price	Rating	Price Target
16-May-05	15.23		0.00

FOR EXPLANATIONS OF RATINGS REFER TO THE STOCK RATING KEYS LOCATED ON THE PAGE FOLLOWING THE LAST PRICE CHART.

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Lehman Brothers Inc. and/or an affiliate trades regularly in the subject company's shares.
Lehman Brothers Inc. has received non-investment banking related compensation from the subject company within the last 12 months.
The subject company is or during the past 12 months has been an investment banking client of Lehman Brothers Inc. and/or an affiliate.
The subject company is or during the last 12 months has been a non-investment banking client (securities related services) of Lehman Brothers Inc.

Risks Which May Impede the Achievement of the Price Target: Warner Music Group risks include continued declines in the global music industry, pricing pressure from larger players creating further margin disparity and potential vulnerability, increased levels of piracy, and a strengthening US dollar.

Important Disclosures Continued:
The analysts responsible for preparing this report have received compensation based upon various factors including the firm's total revenues, a portion of which is generated by investment banking activities

Company Name	Ticker	Price (22-May-2006)	Stock / Sector Rating
EMI Group	EMI.L	260.3p	2-Equal weight / 1-Positive

Related Stocks	Ticker	Price (22-May-2006)	Stock / Sector Rating
Warner Music Group	WMG	$ 27.15	2-Equal weight / 2-Neutral

Sector Coverage Universe
Below is the list of companies that constitute the sector coverage universe against which the primary stock, EMI Group, is rated:

Aegis (AGS.L)
BSkyB (BSY.L)
Daily Mail & General Trust (DMGOa.L)
EMI Group (EMI.L)
Gcap Media (GCAP.L)
Havas (EURC.PA)
Lagardere (LAGA.PA)
Mediaset (MS.MI)
Pearson (PSON.L)
Publicis (PUBP.PA)
Reed Elsevier plc (REL.L)
RTL (AUDKLBR)
Sogecable (SGC.MC)
Telecinco (TL5.MC)
TPI - Telefónica Publicidad e Información (TPI.MC)
Vivendi Universal (EAUG.PA)
Wolters Kluwer (WLSNc.AS)
Antena3 (A3TV.MC)
Central European Media Enterprises Ltd (CETV.OQ)
Emap (EMA.L)
ENIRO (ENRO.ST)
Groupe Metropole Television (MMTP.PA)
ITV (ITV.L)
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Reuters (RTR.L)
Seat Pagine Gialle (PG.MI)
Taylor Nelson Sofres (TNN.L)
TF1 (TFFP.PA)
Trinity Mirror (TNI.L)
VNU (VNUN.AS)
WPP (WPP.L)

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Our coverage analysts use a relative rating system in which they rate stocks as 1-Overweight, 2-Equal weight or 3-Underweight (see definitions below) relative to other companies covered by the analyst or a team of analysts that are deemed to be in the same industry sector (the "sector coverage universe"). To see a list of the companies that comprise a particular sector coverage universe, please go to www.lehman.com/disclosures

In addition to the stock rating, we provide sector views which rate the outlook for the sector coverage universe as 1-Positive, 2-Neutral or 3-Negative (see definitions below). A rating system using terms such as buy, hold and sell is not the equivalent of our rating system. Investors should carefully read the entire research report including the definitions of all ratings and not infer its contents from ratings alone.

Stock Rating
1-Overweight - The stock is expected to outperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.
2-Equal weight - The stock is expected to perform in line with the unweighted expected total return of the sector coverage universe over a 12- month investment horizon.
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3-Negative - sector coverage universe fundamentals/valuations are deteriorating.

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EXHIBIT CO 0963

Warner Music Group

Merger Acquisition
Divestiture

NO RATING

EMI | United States | Music
14 July 2006

Merrill Lynch

Back to fundamentals

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EMI and WMG pull bids

EMI announced it is withdrawing its bid of $31 for WMG. Subsequently, WMG withdrew its bid for EMI, citing regulatory concerns following the recent Court decision to annul the EC's authorization of the Sony BMG joint venture. Notably, EMI stated that it "continues to believe, that there are good arguments for regulatory approval of a combination." This suggests even substantial cost savings did not justify a higher bid. However, we suspect the Court's decision and the possibility of a long period of uncertainty were key drivers in its decision as well. As this announcement settles into the market, we will reevaluate our No Opinion rating.

Merger froth to subside; fundamentals to come into focus

For now, this announcement is likely to take the merger froth off of WMG and return the market's focus to the underlying fundamentals of the business. WMG is likely to report a strong 3Q (see below) and the company has made substantial inroads in market share and digital distribution. However, WMG is currently trading at 11.5x CY06E EBITDA, a significant premium to its peer group.

Expect strong 3Q results

Warner Music will announce F3Q results on August 3 and we anticipate continued strength in results given market share data and trends over the last several quarters. We project total revenue growth of 1% and EBITDA growth of 14%, due largely to significant expense control. Our F3Q06 adjusted EPS estimate of a ($0.20) loss would be a significant improvement over a loss of ($0.34) a year ago and compares to consensus of ($0.17).

Estimates (Sep)

(US$)	2004A	2005A	2006E	2007E	2008E
EPS	(2.62)	0.06	0.13	0.20	0.26
GAAP EPS	(12.58)	(1.39)	0.13	0.20	0.26
EPS Change (YoY)	NA	NM	116.7%	53.8%	30.0%
Consensus EPS (First Call: 17-Jul-2006)			0.24	0.42	0.54
Dividend Rate	0	0.53	0.53	0.54	0.55

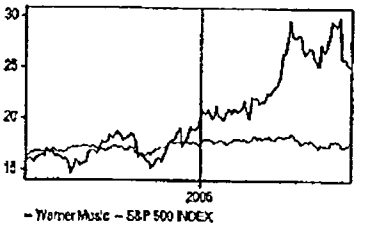
Valuation (Sep)

	2004A	2005A	2006E	2007E	2008E
P/E	NM	420.2x	193.9x	126.1x	97.0x
GAAP P/E	NM	NM	193.9x	126.1x	97.0x
Dividend Yield	0%	2.1%	2.1%	2.1%	2.2%
EV / EBITDA*	NM	19.0x	12.7x	12.3x	12.0x
Free Cash Flow Yield*	11.5%	6.8%	4.5%	5.6%	6.0%

* For full definitions of *iQmethod*™ measures, see page 3.

Stock Data

Price	US$25.21
Investment Opinion	-6-
Volatility Risk	NA
52-Week Range	US$15.03-31.00
Mkt Val / Shares Out (mn)	US$3,794 / 150.5
ML Symbol / Exchange	WMG / NYS
Bloomberg / Reuters	WMG US / WMG.N
ROE (2006E)	47.4%
Total Dbt to Cap (Mar-2006A)	95.4%
Est. 5-Yr EPS / DPS Growth	NA / 1.5%



Quarterly Earnings Estimates

	2005	2006
Q1	0.34A	0.46A
Q2	-0.26A	-0.05A
Q3	-0.34A	-0.20E
Q4	0.04A	-0.09E

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Refer to important disclosures on page 4 to 5. Analyst Certification on page 3.

iQprofile℠ Warner Music Group

Key Income Statement Data (Sep)	2004A	2005A	2006E	2007E	2008E
(US$ Millions)					
Sales	3,437	3,502	3,441	3,508	3,611
Gross Profit	1,587	1,652	1,686	1,742	1,809
Sell General & Admin Expenses	(1,220)	(1,250)	(1,203)	(1,244)	(1,299)
EBITDA	(686)	322	482	498	510
Depreciation & Amortization	(268)	(238)	(235)	(237)	(239)
Net Interest & Other Income	(318)	(198)	(177)	(175)	(170)
Tax Expense / Benefit (Reported)	(150)	(55)	(50)	(55)	(60)
Net Income (Adjusted)	(296)	7	20	31	41
Average Fully Diluted Shares Outstanding	113	129	151	153	156
Key Cash Flow Statement Data					
Net Income from Cont Operations (GAAP)	(1,422)	(169)	20	31	41
Depreciation & Amortization	268	238	235	237	239
Change in Working Capital	295	19	(72)	(57)	(51)
Deferred Taxation Charge	4	0	0	0	0
Other Adjustments, Net	1,330	201	106	72	72
Cash Flow from Cont. Operations	475	289	288	283	301
Capital Expenditure	(39)	(30)	(118)	(69)	(73)
(Acquisition) / Disposal of Investments	NA	NA	NA	NA	NA
Other Cash Inflow / (Outflow)	(2,607)	(24)	0	0	0
Cash Flow from Investing	(2,646)	(54)	(118)	(69)	(73)
Share Issue / (Repurchase)	1,313	323	1	1	1
Cost of Dividends Paid	(350)	(1,074)	(80)	(82)	(85)
Cash Flow from Financing	2,679	(416)	(95)	(81)	(84)
Net Debt	1,285	1,958	1,888	1,755	1,611
Change in Net Debt	1,011	518	(92)	(133)	(144)
Key Balance Sheet Data					
Cash & Equivalents	555	288	342	475	519
Trade Receivables	571	637	585	624	672
Other Current Assets	412	317	437	442	453
Property, Plant & Equipment	189	157	148	139	134
Other Non-Current Assets	3,363	3,099	2,908	2,717	2,528
Total Assets	5,090	4,498	4,417	4,398	4,413
Short-Term Debt	12	17	17	17	17
Other Current Liabilities	2,168	1,731	1,756	1,745	1,761
Long-Term Debt	1,828	2,229	2,213	2,213	2,213
Other Non-Current Liabilities	802	432	437	448	448
Total Liabilities	4,810	4,409	4,423	4,423	4,439
Total Equity	280	89	(6)	(25)	(26)
Total Equity & Liabilities	5,090	4,498	4,417	4,398	4,413
Key Metrics					
iQmethod℠* - Bus Performance					
Return on Capital Employed	-22.5%	9.5%	11.8%	12.1%	12.3%
Return on Equity	-31.7%	4.0%	47.4%	NM	NM
Operating Margin	-27.8%	2.4%	7.2%	7.4%	7.5%
Free Cash Flow	436	259	171	214	228
iQmethod℠* - Quality of Earnings					
Cash Realization Ratio	NM	39.1x	14.6x	9.1x	7.3x
Asset Replacement Ratio	0.6x	0.6x	2.7x	1.5x	1.5x
Tax Rate	NM	NM	71.7%	63.9%	59.2%
Net Debt-to-Equity Ratio	458.9%	2,200.0%	NM	NM	NM
Interest Cover	-10.5x	0.4x	1.3x	1.5x	1.6x

* For full definitions of *iQmethod℠* measures, see page 3.

Company Description

Warner Music Group (WMG), the fourth-largest music company in the world, operates two distinct businesses: Recorded Music and Music Publishing. Its two major domestic labels are Warner Bros Records and The Atlantic Records Group. WMG was acquired from Time Warner in February 2004 by a group of private investors led by Edgar Bronfman, Jr. (now chairman and CEO), and financial sponsors Thomas H. Lee Partners, Bain Capital, and Providence Equity.

Stock Data

Average Daily Volume	686,773
Brokers Covered (FirstCall)	9

Analyst Certification

I, Jessica Reif Cohen, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

iQmethod℠ Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap, = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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Investment Rating Distribution: Media & Entertainment Group (as of 30 Jun 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	53	37.06%	Buy	15	28.30%
Neutral	80	55.94%	Neutral	19	23.75%
Sell	10	6.99%	Sell	3	30.00%

Investment Rating Distribution: Global Group (as of 30 Jun 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1264	44.12%	Buy	430	34.02%
Neutral	1398	48.80%	Neutral	404	28.90%
Sell	203	7.09%	Sell	45	22.17%

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EXHIBIT CO 0964

EMI Group

Company Update **NEUTRAL**

Equity | United Kingdom | Entertainment
20 April 2006 (Corrected)

Merrill Lynch

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EMI-Warner: Take Five

According to the Sunday Times, EMI and Warner might proceed with their oft-attempted but never consummated merger. This note goes through the various scenarios and value ascribed to it.

We believe there is a 70% chance of the merger happening in 2006, with a 70% chance of regulatory approval and 80% chance of the structure being a nil-premium merger (the two other possibilities being one company buying the other at a premium and assuming control). The weighted-average value of all these scenarios comes to 301p, a 2% premium to current share price. In other words, to buy EMI now you have to be convinced that a merger will indeed happen (321p value).

Market recovery taking place as expected

This note also details the latest trends in the most important music markets. 2006 is off to a good start with the US (3.5% volume), UK (4.5% volume) and Japan (9.4% shipment revenues) in positive territory.

Re-iterate Neutral

While we recognise that the music market is recovering (as we had forecast) and that there is an option value to the potential deal with Warner, there are still uncertainties regarding the company's business model (especially sustainable growth rate). As a consequence, we believe investors should not pay a premium for the stock. EMI currently trades on 16.5x 2007E P/E in line with the media sector and at a 30% premium to the UK market. We remain Neutral.

Estimates (Mar)

(£)	2004A Other GAAP	2005A IFRS	2006E IFRS	2007E IFRS	2008E IFRS
EPS (Adjusted Diluted)	15.5	13.1	14.6	16.2	18.4
EPS Change (YoY)	-0.6%	-15.7%	11.7%	11.0%	13.7%
Dividend / Share	8.00	8.00	8.00	8.50	9.00
ADR EPS (Adjusted Diluted - US$)	0.57	0.49	0.51	0.58	0.66
ADR Dividend / Share (US$)	0.29	0.30	0.28	0.30	0.32

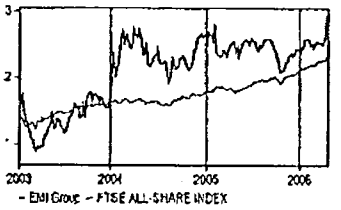
Valuation (Mar)

	2004A	2005A	2006E	2007E	2008E
P/E	19.0x	22.5x	20.2x	18.2x	16.0x
Dividend Yield	2.72%	2.72%	2.72%	2.89%	3.06%
EV / EBITDA*	11.2x	12.7x	11.4x	10.4x	9.38x
Free Cash Flow Yield*	5.36%	1.88%	2.12%	4.63%	5.66%

* For full definitions of iQmethod℠ measures, see page 18.
Per share figures are in pence except where otherwise noted.

Stock Data

Price (Common / ADR)	294.00p / US$10.65
Investment Opinion	C-2-7 / C-2-7
Volatility Risk	HIGH / HIGH
52-Week Range	205.50p-299.00p
Market Value (mn)	£2,312
Shares Outstanding (mn)	786.4 / 393.2
Average Daily Volume	13,399,785
ML Symbol / Exchange	EMIPF / LSE
ML Symbol / Exchange	EMIPY / OTU
Bloomberg / Reuters	EMI LN / EMIL.L
ROE (2006E)	NM
Net Dbt to Eqty (Mar-2005A)	NM
Est. 5-Yr EPS / DPS Growth	14.3% / - - -
Free Float	100.0%



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Refer to important disclosures on page 20 to 22. Analyst Certification on page 19.

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iQprofile℠ EMI Group

Key Income Statement Data (Mar)	2004A	2005A	2006E	2007E	2008E
(£ Millions)	Other GAAP	IFRS	IFRS	IFRS	IFRS
Sales	2,121	2,001	2,077	2,127	2,197
EBITDA Adjusted	284	250	279	305	338
Depreciation & Amortization	(86.9)	(71.9)	(78.0)	(82.0)	(86.0)
EBIT Adjusted	198	178	201	223	252
Net Interest & Other Income	(96.1)	(61.7)	(76.2)	(88.4)	(83.9)
Tax Expense / Benefit	(19.7)	(23.9)	(34.8)	(43.6)	(53.5)
Net Income (Adjusted)	124	105	118	133	152
Average Fully Diluted Shares Outstanding	827	873	874	874	875
Key Cash Flow Statement Data					
Net Income (Reported)	(71.6)	75.0	84.8	85.6	108
Depreciation & Amortization	85.9	71.9	78.0	82.0	86.0
Change in Working Capital	60.4	27.5	(35.9)	(11.3)	(11.6)
Deferred Taxation Charge	0	0	0	0	0
Other Adjustments, Net	105	(95.6)	(36.6)	(2.59)	(0.70)
Cash Flow from Operations	180	79.3	90.3	154	180
Capital Expenditure	(56.4)	(35.9)	(41.3)	(46.5)	(48.8)
(Acquisition) / Disposal of Investments	(89.4)	(70.9)	(5.50)	0	0
Other Cash Inflow / (Outflow)	79.5	(1.70)	0	0	0
Cash Flow from Investing	(66.3)	(109)	(46.8)	(46.5)	(48.8)
Share Issue / (Repurchase)	0	1.70	0	0	0
Cost of Dividends Paid	(62.7)	(62.9)	(62.8)	(62.9)	(66.9)
Cash Flow from Financing	124	(59.5)	(62.8)	(62.9)	(66.9)
Non Cash Changes to Debt	---	---	---	---	---
Change in Net Debt	(50.9)	90.4	19.3	(44.3)	(64.2)
Net Debt	791	858	877	833	768
Key Balance Sheet Data					
Property, Plant & Equipment	221	200	205	210	212
Goodwill	31.1	35.1	40.6	40.6	40.6
Other Intangibles	451	405	363	322	283
Other Non-Current Assets	38.2	23.4	23.4	23.4	23.4
Trade Receivables	345	300	294	289	283
Cash & Equivalents	345	243	223	267	332
Other Current Assets	492	551	572	576	581
Total Assets	1,923	1,757	1,722	1,729	1,754
Long-Term Debt	1,137	1,100	1,100	1,100	1,100
Other Non-Current Liabilities	338	245	225	225	225
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	1,300	1,246	1,226	1,213	1,200
Total Liabilities	2,774	2,591	2,550	2,537	2,524
Total Equity	(852)	(834)	(829)	(809)	(770)
Total Equity & Liabilities	1,923	1,757	1,722	1,729	1,754
Key Metrics					
iQmethod*℠ - Bus Performance					
Return On Capital Employed	31.0%	22.9%	27.5%	28.5%	30.7%
Return On Equity	NM	NM	NM	NM	NM
Operating Margin	2.06%	7.98%	9.66%	10.5%	11.5%
Free Cash Flow (MM)	124	43.4	49.0	107	131
iQmethod*℠ - Quality of Earnings					
Cash Realization Ratio	1.45x	0.76x	0.76x	1.16x	1.18x
Asset Replacement Ratio	1.61x	1.50x	1.38x	1.33x	1.22x
Tax Rate	NM	24.1%	27.9%	32.4%	31.8%
Net Debt/Equity	NM	NM	NM	NM	NM
Interest Cover	2.06x	2.09x	2.21x	2.52x	3.00x

* For full definitions of *iQmethod*℠ measures, see page 18.

Company Description

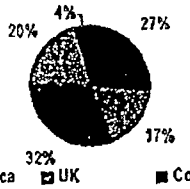
Music: EMI Music is the third largest music company in the world the other majors being Universal, Warner, Sony & BMG. Its main labels are Virgin and Capitol. Its music publishing arm is the largest in the world.

Chart 1: Revenue Breakdown, 2005A

Recorded Music Music Publishing

Source: Company data

Chart 2: Recorded Musci by Region, 2005A



N.America UK Cont. Europe
Asia Pac Other

Source: Company data

EMI-Warner merger

Overview

According to the Sunday Times (April 23), *senior executives at EMI and Warner Music Group are preparing for preliminary talks that could eventually lead to the creation of the world's third largest-music company. Sources close to both groups said the firms' on-off discussions would resume in earnest within months, with advisers on both sides being briefed to prepare for merger talks. EMI is understood to have lined up Citigroup and UBS to assist it, while Goldman Sachs and Lehman Brothers are in the frame to advise Warner. Although no approach has yet been made by either company or its advisers, sources close to both said this weekend they were separately working through the potential structure of any transaction. "This deal's going to happen. The only question is timing," said one adviser this weekend.*

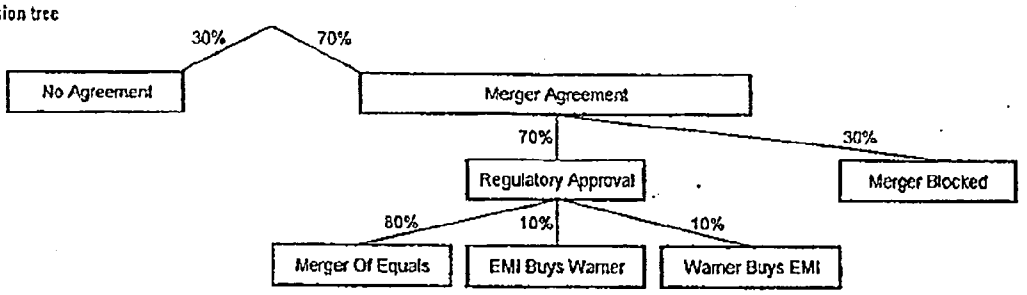
We would remind investors that the two companies tried to merge twice officially (rejected by regulators once and Warner sold to venture capitalists the second time) and probably more unofficially. Indeed, the "news" that EMI and Warner Music will be discussing a merger seems to reappear every couple of months. This is not to say that a merger is not likely to occur, but it does point to a high degree of uncertainty with regard to timing (a potentially important point from a valuation perspective). The article is also suitably vague (discussion would resume within months; no approach has been made by either companies).

A merger between the two companies is a compelling opportunity to create value, in our opinion, and could generate synergies that we value at £1.31bn (US$2.35bn) (31% of the companies' combined market capitalisation). We derive that number by capitalising our estimated £140m (US$250m) cost savings at 10x and subtracting our estimated merger one-off costs of £225m (US$400m).

In addition to our synergy estimates, the most important questions are how the two companies will split the value created by these potential synergies (likely the main determinant of any potential acquisition premium), the structure (i.e., would it be a merger of equals or will one company purchase the other) and if it is a merger of equals what multiple the new company would trade at.

Chart 3 shows the probabilities we attach to each scenarios. We believe there is a 70% chance of the merger happening in 2006, with a 70% chance of regulatory approval and 80% chance of the structure being a nil-premium merger (the two other possibilities being one company buying the other at a premium and assuming control). The weighted-average value of all these scenarios come at 301p, a 2% premium to current share price (split 51% deal does not happen whereby EMI reverts to fair value, see Table 14, page 16 and 49% deal happens). In other words, to buy EMI now you have to be convinced that a merger will indeed happen (321p value).

Chart 3: Decision tree



Value	285p	321p	298p	320p	285p
Probability	30.0%	39.2%	4.9%	4.9%	21.0%
Weighted Average					301p

Source: Merrill Lynch estimates

Regulatory approval

There are two schools of thought when it come to regulatory approval:

- In delivering its verdict on Sony-BMG, the Commission said it was unable to find evidence that the reduction to four majors from five would strengthen the collectively held dominant position or lead to tacit collusion. Nor was it able to demonstrate that coordinated pricing behavior had existed in the past. Therefore, if the commission was not able to prove collective dominance from 5 to 4, it won't be able to prove it from 4 to 3.

- In delivering its verdict on Sony-BMG, The Commission made a point of warning against any hopes the clearance signaled a more laissez-faire attitude. It said it will "very carefully scrutinise any further major concentration in the industry." Furthermore, the US anti-trust had no opposition in previous merger but it approaches mergers in a slightly different way than the EU and might have issue with music majors going from 4 to 3 (*"as you go from five to four to three, you're going toward a very oligopolistic industry, and at some point the barriers have got to be put back"*, Michael Friedman, entertainment and intellectual property partner with law firm Jenkens & Gilchrist Parker Chapin LLP).

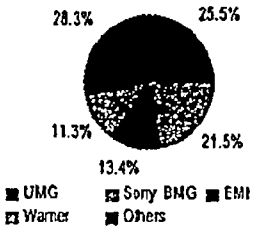
Overall, we put the probability of regulatory approval at 70%. This for two reasons:

- The regulators approved the Sony-BMG merger without conditions and the two companies had at the time similar market shares to EMI and Warner currently.

- Such a merger would create only the third player in the market as opposed to a dominant industry leader.

However, as the EU Commission said it would "carefully scrutinise any further major concentration in the industry", we believe that some conditions would be imposed on the merger. The most likely is the disposal of one of the music publishing businesses as the combined entity would have close to 40% market share (Warner Chappell is the most likely candidate being smaller). The second option is the sale of some local operations were market shares are too high (this would impact some European countries).

Chart 4: Worldwide recorded music share



Source: IFPI

Cost savings

The key rationale for an EMI-WMG combination would be the significant cost savings potential their superior scale would allow. In fact, we see little other reason for the merger, as there is likely to be little impact on revenue. This makes cost savings perhaps the most important assumption for our analysis.

Fortunately, we have several data points to help us assess the potential savings. When EMI tried to merge with Warner back in January 2000 (blocked by the regulator), the two companies announced £250m (US$450m) of cost savings at a one-off cost of £425m (US$765m). Cost savings would have been centered around manufacturing and distribution, overheads, repertoire costs, label structure, IT and shared services.

When EMI tried to merger with Warner back in November 2003 (Time Warner chose to sell the business to a private equity consortium instead), the press talked about US$300m (£170m) of cost savings (25 November 2003 - The Times, Toronto Star, Birmingham Post etc).

Since the official £250m cost saving figure was unveiled by the two companies, EMI cut costs by £200m (US$356m) split into £100m (first Alain Levy initiative coming from restructuring labels and repertoire), £50m (outsourcing manufacturing), £20m (IT services) and £30m (Japan and others as unveiled last week). Warner Music in turn cut costs by over US$250m (£140m) following its sale to private equity investors, much of it from a 30% reduction in its artist roster. Furthermore, the cost savings included publishing at the time and our main assumption calls for Warner Chappell to be sold to get regulatory approval.

While obviously a lot of the cost cutting would come from putting the two companies together, we believe that some of the cost cutting originally planned has already been implemented by the two companies separately.

We forecast US$250m (£140m) of cost savings

US$250m (£140m) in cost savings therefore seems like a more reasonable target and we have used it as our working assumption for this note. US$250mn also seems reasonable in the context of the US$300m (£170m) target given by Sony-BMG when they announced their merger.

Such cost cutting would lead to a 15.9% EBIT margin, well above Universal Music's 9.8% margin. Universal is the recorded music industry leader but has a smaller publishing arm (7% of revenues) versus 12% for EMI-Warner pro forma post Warner Chappell disposal.

Scenario analysis

We have taken our estimate of US$250m (£140m) in cost savings and used it to analyse the impact the three potential merger scenarios we laid out above would have on Warner Music. Our other primary assumption is that the combined company will trade at 10.0x 2006E EBITDA, a 15% discount to current multiples for EMI and WMG respectively (as current valuation includes an option value for the merger in our view).

Table 1 summarises our forecasts for EMI.

Table 1: EMI summary forecasts

£ Million (March Year-End)	2005A	2006E	2007E	2008E	2009E
Revenues	2,001	2,077	2,127	2,197	2,288
% Growth	–	3.8%	2.4%	3.3%	4.1%
EBITDA	249	279	305	338	361
% Growth	–	11.9%	9.4%	10.8%	6.9%
% Margin	12.4%	13.4%	14.3%	15.4%	15.8%
Depreciation and Amortisation	(24)	(30)	(35)	(40)	(41)
EBITA	225	249	270	298	320
% Growth	–	10.5%	8.6%	10.4%	7.5%
% Margin	11.2%	12.0%	12.7%	13.6%	14.0%
Associates	1	0	0	0	0
Net Interests	(85)	(91)	(88)	(84)	(73)
Headline Pre Tax Profit	141	158	182	214	247
% Growth	–	12.0%	14.9%	17.8%	15.3%
% Margin	7.1%	7.6%	8.5%	9.7%	10.8%
Taxes	(32)	(35)	(44)	(53)	(64)
% Tax Rate	22.5%	22.0%	24.0%	25.0%	26.0%
Headline Net Income	105	118	133	152	171
% Growth	–	12.8%	12.0%	14.8%	12.5%
% Margin	5.2%	5.7%	6.2%	6.9%	7.5%
Average Diluted Number of Shares	873	874	874	875	876
Convertible Interest	9	9	9	9	9
Headline EPS	13.3p	14.6p	16.2p	18.4p	20.6p
% Growth	–	9.7%	11.0%	13.7%	11.7%

Sources: Company data, Merrill Lynch.

Table 2 summarises our forecasts for Warner.

Table 2: Warner summary forecasts

US$ Million (September Year-End)	2005A	2006E	2007E	2008E	2009E
Revenues	3,502	3,355	3,437	3,542	3,640
% Growth	–	-3.9%	2.1%	3.1%	2.8%
EBITDA	466	456	464	477	487
% Growth	–	-2.1%	1.8%	2.6%	2.2%
% Margin	13.3%	13.6%	13.5%	13.5%	13.4%
Depreciation and Amortisation	(51)	(44)	(46)	(48)	(50)
EBITA	415	412	419	429	437
% Growth	–	-0.6%	1.6%	2.4%	1.8%
% Margin	11.9%	12.3%	12.2%	12.1%	12.0%
Other Income/(Expenses)	148	0	0	0	0
Net Interests	(182)	(179)	(174)	(170)	(165)
Headline Pre Tax Profit	381	234	245	259	272
% Growth	–	-38.7%	4.7%	6.0%	4.9%
% Margin	10.9%	6.9%	7.1%	7.3%	7.5%
Taxes	(55)	(47)	(53)	(57)	(61)
% Tax Rate	31.0%	31.0%	31.0%	32.0%	33.0%
Headline Net Income	326	187	192	202	210
% Growth	–	-42.8%	2.9%	5.2%	4.2%
% Margin	9.3%	5.5%	5.6%	5.7%	5.8%
Average Diluted Number of Shares	129	151	153	156	158
Headline EPS	$2.52	$1.24	$1.25	$1.30	$1.33
% Growth	–	-51.1%	1.4%	3.6%	2.7%

Sources: Company data, Merrill Lynch.

Table 3 shows the capitalisation of both companies in GBP and USD. EMI is currently worth £2.33bn (US$4.17bn) while Warner is worth £2.10bn (US$3.76bn). A merger of equals (nil premium) would see EMI shareholders get 53% of the combined entity.

Table 3: EMI and Warner capitalisation

Items	EMI (£)	EMI (US$)	Warner (£)	Warner (US$)
Share Price	294p	US$5.26	1,397p	US$25.00
Number of Shares	792.9	792.9	150.5	150.5
Market Capitalisation	2,331	4,172	2,102	3,763
Net Debt (Current) (a)	(877)	(1,569)	(1,097)	(1,963)
Enterprise Value	3,208	5,742	3,199	5,726
Exchange Rate		1.79		1.79
EMI Weight	53%		47%	

Sources: Company data, Reuters

Table 4 shows our pro forma preliminary forecasts from an EMI shareholders stand-point. We have assumed a December year-end (EMI March, Warner September) and £140m of cost savings from the first year onwards with no P&L costs associated (either merger accounting or exceptionals). Such a merger is extremely accretive for EMI shareholders (41% on 2006E calendarised).

Table 4: Merged entity summary forecasts

£ Million (December Year-End)	2005A	2006E	2007E	2008E
EMI Revenues	2,058	2,115	2,179	2,265
Warner Revenues	1,937	1,890	1,935	1,993
Total Revenues	3,995	4,005	4,114	4,258
% Growth	–	0.2%	2.7%	3.5%
EMI EBITDA	271	298	330	355
Warner EBITDA	259	256	261	268
Cost Savings	140	140	140	140
Total EBITDA	670	694	731	763
% Growth	–	3.6%	5.2%	4.4%
% Margin	16.8%	17.3%	17.8%	17.9%
Depreciation and Amortisation	(56)	(59)	(65)	(68)
EBITA	614	636	666	695
% Growth	–	3.5%	4.8%	4.4%
% Margin	15.4%	15.9%	16.2%	16.3%
Other	62	0	0	0
Net Interests	(190)	(188)	(182)	(170)
Headline Pre Tax Profit	486	447	484	525
% Growth	–	-7.9%	8.2%	8.4%
% Margin	12.2%	11.2%	11.8%	12.3%
Taxes	(129)	(117)	(132)	(147)
% Tax Rate	26.6%	26.2%	27.2%	28.1%
Headline Net Income	357	330	353	377
% Growth	–	-7.4%	6.8%	7.0%
% Margin	8.9%	8.2%	8.6%	8.9%
EMI Average Number of Shares	1,499	1,500	1,501	1,503
Convertible Interest	9	9	9	9
Headline EPS	24.4p	22.6p	24.1p	25.7p
% Growth	–	-7.3%	6.6%	6.7%

Sources: Company data, Reuters

Scenario 1: Merger of equals

The first structure we have envisaged is a simple nil premium merger whereby EMI shareholders get 53% of the merged entity and Warner's 47%. This is probably too simplistic a structure (in 2000, it was a 50-50% merger and EMI shareholders got cash to reduce their stake) but we wanted to keep things as simple as possible.

Table 5 shows the upside from a nil-premium merger to EMI shareholders. We have assumed that the ongoing business would be valued at 10.0x 2006E EV/EBITDA, a 15% discount to current multiple of 11.5x as we believe it includes some option value for the merger (see Table 6). We have assumed that Warner Chappell would be disposed at 14.0x EV/EBITDA (in line with recent catalogue deal multiples of 13-14x) with 20% capital gain taxes and that obtaining the merger savings would cost £223m (US$400m) or 1.6x the cost savings of £140m (US$250m). In 2000, the £250m of cost savings would have cost £425m (1.7x) and the most recent £30m of savings should cost £60m (2.0x). On that basis, the merged entity is worth 321p for an EMI shareholders and US$27.27 for a Warner shareholder

Table 5: Upside from nil-premium merger to EMI shareholders

Items	EMI (£)	Warner (US$)
Current Share Price	294p	US$25.00
2006E EBITDA	694	1,242
Warner Chappell EBITDA	(76)	(136)
EBITDA Post Disposal	618	1,106
Multiples	10.0x	10.0x
Enterprise Value	6,181	11,063
EMI Net Debt	(877)	(1,569)
Warner Net Debt	(1,097)	(1,963)
Merger Costs	(223)	(400)
Warner Chappell (14.0x EV/EBITDA)	851	1,524
Net Debt	(1,345)	(2,408)
Equity Value	4,835	8,655
Number of Shares	1507.8	317.4
Post Merger Share Price	321p	US$27.27
% Upside	9.1%	9.1%

Sources: Merrill Lynch estimates, Reuters.

Of the potential merger scenarios, we view this as the most likely outcome. This structure neatly sidesteps the question of how the potential cost savings of a merger should be split among the shareholders of the companies, although it does not solve the management issue (more on that later).

Table 6: Music companies' trading multiples

		EV/Sales			EV/EBITDA			P/E		
	Price	2006E	2007E	2008E	2006E	2007E	2008E	2006E	2007E	2008E
EMI	294p	1.57x	1.51x	1.44x	11.0x	10.2x	9.6x	18.5x	16.5x	14.6x
WMG	$25.00	1.73x	1.69x	1.64x	12.0x	11.8x	11.5x	n/m	n/m	n/m
Average		1.65x	1.60x	1.54x	11.5x	11.0x	10.5x	18.5x	16.5x	14.6x

Sources: Reuters, Merrill Lynch estimates.

We feel the two biggest assumptions in our calculation are the trading multiples we value the company at (is 10.0x too aggressive as both companies' share price currently include some merger speculations?) and the cost savings (is US$250m the right number when so much cost savings have already been achieved?).

Table 7 shows the sensitivity of our calculated merged entity share price to these two variables. Assuming 11.0x EV/EBITDA and US$200m of cost savings result in a 341p valuation for instance.

Table 7: Merger of equals - Sensitivity to cost savings and trading multiples

Trading Multiples \ Cost Savings	US150m £84m	US200m £112m	US250m £140m	US300m £168m	US350m £196m
9.0x	246p	263p	280p	296p	313p
9.5x	265p	283p	300p	318p	335p
10.0x	284p	302p	321p	339p	358p
10.5x	302p	322p	341p	361p	380p
11.0x	321p	341p	362p	382p	402p

Source: Merrill Lynch estimates

EMI takes Warner over

The second potential structure is EMI taking Warner over at a premium. We have assumed a 25% premium to the last 3 months average or a take-over price of US$26.84. We have then assumed that EMI gears up to 4.0x EV/EBITDA (Warner went to 5.0x went it was taken-over but EMI management are not venture capitalists in our opinion and current shareholders would find that too risky in our view). On that basis, EMI could take on £2.47bn of debt, meaning it would have to issue £1.13bn of equity (subtracting from these £2.47bn EMI and Warner debt, the one-off cost of the merger and the proceeds from Warner Chappell). We have assumed EMI would issue equity at a 15% discount, creating 452m new shares.

Table 8: Equity issuance needed to take-over Warner

Items	Warner (£)	Warner (US$)
Last 3 Month Share Price		US$21.47
Premium		25%
Take Over Price		US$26.84
Number of Shares		150.5
Equity Value	2,256	4,039
EBITDA	618	
Gearing	4.0x	
Maxium Debt Level	2,472	4,425
EMI Debt	(877)	(1,569)
Warner Debt	(1,097)	(1,963)
Merger Cost	(223)	(400)
Take Over Price	(2,256)	(4,039)
Warner Chappell (14.0x EV/EBITDA)	851	1,524
Necessary Equity Financing	(1,130)	(2,022)
Current Share Price	294p	
Discount	15%	
New Share Created	452.1	

Source: Merrill Lynch estimates

Table 9 shows the upside from a Warner take-over to EMI shareholders. We have made the same assumptions as previously (10.0x EV/EBITDA fair value, disposal of Warner Chappell at 14.0x with 20% capital gain taxes, costs of merger savings). The difference comes from the extra debt and the extra shares. On that basis, the merged entity would be worth 298p for EMI shareholders.

Table 9: Upside from Warner take-over to EMI shareholders

Items	EMI (£)
Current Share Price	294p
2006E EBITDA	694
Warner Chappell EBITDA	(76)
EBITDA Post Disposal	618
Multiples	10.0x
Enterprise Value	6,181
EMI Net Debt	(877)
Warner Net Debt	(1,097)
Merger Costs	(223)
Take Over Price	(2,256)
Equity Financing	1,130
Warner Chappell (14.0x EV/EBITDA)	851
Net Debt	(2,472)
Equity Value	3,708
Number of Shares	1244.9
Post Merger Share Price	298p
% Upside	1.3%

Source: Reuters, Merrill Lynch estimates.

Table 10 shows the sensitivity of our calculated merged entity share price to cost savings and fair value multiples. Assuming 11.0x EV/EBITDA and US$200m of cost savings result in a 323p valuation for instance.

Table 10: Warner Take-Over - Sensitivity to cost savings and trading multiples

Exit Multiples \ Cost Savings	US150m £84m	US200m £112m	US250m £140m	US300m £168m	US350m £196m
9.0x	208p	228p	248p	268p	289p
9.5x	230p	252p	273p	294p	316p
10.0x	253p	275p	298p	320p	343p
10.5x	276p	299p	323p	346p	370p
11.0x	298p	323p	348p	372p	397p

Source: Merrill Lynch estimates.

Warner takes EMI over

The last structure assumes that Warner takes over EMI at a premium. How much EMI is worth on that basis is purely based on how much premium investors think Warner will pay. We would just point out that EMI last six-month average was 242p and last three-month average was 250p. Putting on a 25% premium yields 302p and 320p respectively.

Other considerations

Management relationships could be an obstacle

It is unclear who would run a combined company and does not appear either management team is eager to exit their current role. Moreover, key members of the respective management teams are generally considered to have poor relationships, suggesting it could be difficult to bring the two sides together. This could be the most significant obstacle to a merger.

Sony BMG highlights execution risk

Notwithstanding the clear cost savings, every merger comes with significant execution risk. The uncertainty regarding the ability of the two management teams to work together could increase the risk of a poor integration in this case. The importance of solid execution and management coordination is highlighted by

the Sony-BMG debacle. The combined company has generally failed to meet expectations (losing significant market share) and its management discord has been public and messy.

Model update

Trading statement

On 20 April, EMI issued a trading statement for FY 31 March 2006 in line with our expectations but 5% above consensus then. *Overall, the Group expects to report full-year revenue growth of close to 4%* (we had 3.0%) and *adjusted PBT is expected to have increased by approximately 12%* (we had 12.2%).

EMI Music gained market share in the year and on a constant revenue basis, revenues are expected to have increased by approximately 2% (we had 1.1%). EMI Music operating margin improved *almost one percentage point* and operating profit grew *approximately 15%* (we had 1.2% and 18.2%).

EMI Music Publishing expects to report constant currency revenue growth of approximately 2.5% (we had 4.4%) and *operating margin improved significantly in the second half, resulting in a modest increase in the full year margin* (we had a 0.2 percentage point fall to 24.7%).

The company is also unveiling a new cost saving initiative, particularly centered on its Japanese subsidiary. *In conjunction with these restructurings, EMI Music plans to enter into sale and leaseback agreements for its two Japanese properties and other property in the US. EMI Group expects that in total these initiatives will deliver cost savings of at least £30m per annum. It is anticipated that not less than £10m of these savings will be delivered in fiscal 2007, with the full run rate achieved in fiscal 2008. The total cash cost of these restructuring initiatives of approximately £60m, will be more than offset by the cash proceeds from the property disposals.*

Change in forecasts

Following that statement, we have left our forecasts more or less unchanged as shown in Table 11.

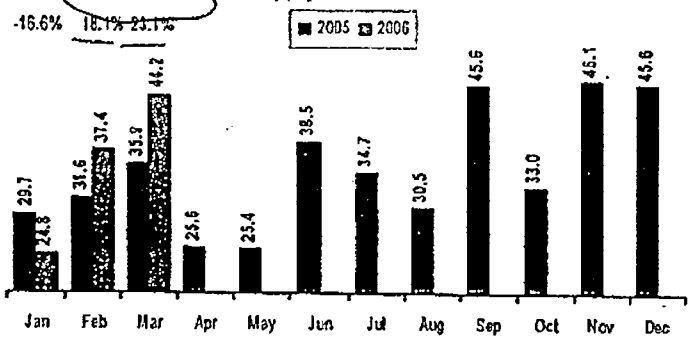
Table 11: Change in forecasts

£ Million	2006E	2007E	2008E	2009E
Revenues - Old	2,060.3	2,139.1	2,229.1	2,326.6
Revenues - New	2,077.3	2,127.4	2,198.7	2,287.8
Difference	1%	-1%	-1%	-2%
EBITA - Old	251.9	273.0	290.7	311.6
EBITA - New	248.6	269.9	297.9	320.2
Difference	-1%	-1%	2%	3%
Headline PTP - Old	158.3	185.0	211.5	244.3
Headline PTP - New	158.0	181.5	214.0	246.8
Difference	0%	-2%	1%	1%
Diluted Headline EPS - Old	14.5p	16.4p	18.3p	20.7p
Diluted Headline EPS - New	14.6p	16.2p	18.4p	20.6p
Difference	0%	-1%	0%	-1%

Source: Merrill Lynch estimates

We have made nonetheless several small changes to our model:

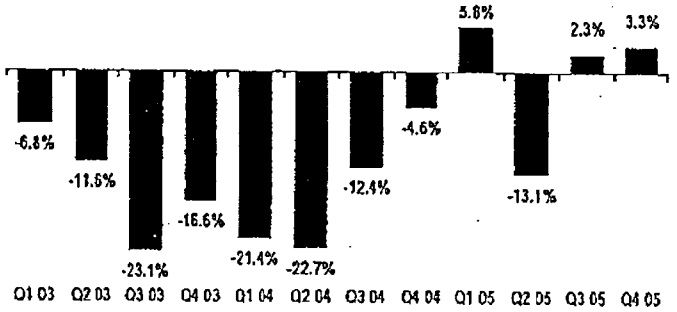
Chart 10: Japanese market – Monthly physical sales



Source: RIAJ.

According to SNEP (local music body), the French market was up 0.5% on a wholesale basis (including online) in 2005 after two terrible years (-14.6% in 2003 and -14.3% in 2004).

Chart 11: French market – Quarterly wholesale sales growth



Source: SNEP.

Market forecast

Taking these trends into account, we forecast the recorded music market to grow 2.5% on a constant currency basis in calendar 2006 and 3.0% in 2007. In terms of regional breakdown, we forecast the US to be up 3.5%, the UK to grow 2.5%, Japan to be up 5.0%, France to be up 2.5%, Germany to be up 2.5% and the rest of the world to be flat.

Table 13: Worldwide recorded music market forecasts

US$ Million (2005 US$)	2004	2005	2006	2007	05/04	06/05	07/06
US	12,153	12,269	12,698	13,270	1.0%	3.5%	4.5%
UK	3,509	3,445	3,515	3,603	-1.8%	2.0%	2.5%
Japan	5,073	5,448	5,720	5,892	7.4%	5.0%	3.0%
France	2,004	1,990	2,040	2,091	-0.7%	2.5%	2.5%
Germany	2,176	2,211	2,266	2,323	1.6%	2.5%	2.5%
Top 5 Markets	24,915	25,364	26,240	27,178	1.8%	3.5%	3.6%
Other Markets	9,369	8,092	8,052	8,132	-13.6%	-0.5%	1.0%
Total Market	34,284	33,456	34,291	35,310	-2.4%	2.5%	3.0%

Sources: IFPI, Merrill Lynch

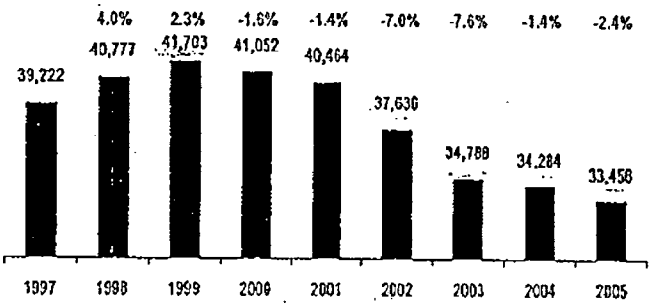
- Lowered fiscal 2007 recorded music revenue growth to 2.1% from 3.8% (based on our new market and market share forecasts).
- Decrease fiscal 2007 recorded music margin to 9.5% from 9.7% (resulting from lower revenue).
- Put in £10m and £30m of cost savings in fiscal 2007 and 2008 respectively.
- Increase fiscal 2007 publishing margin to 25.0% from 24.7% to reflect the higher 2006 base.
- Lower fiscal 2007 tax rate to 24.0% from 24.5%.
- Increase minorities by about £2m from fiscal 2008 onwards to reflect Japanese restructuring.

Industry trading

2005 IFPI data

On March 31, the IFPI, the worldwide music trade organization, released data for the music market in 2005. On a constant currency basis, the market declined 2.4% on a retail basis and 3.1% on a wholesale basis. Since its 1999 peak, the market has declined 19.8% on a constant currency and retail basis.

Chart 5: Worldwide music market (retail, constant currency)



Source: IFPI

This 3.1% wholesale constant currency decline in 2005 was the result of physical sales declining 6.7% and online sales growing 187.9%.

Table 12: 2005 wholesale music sales by medium

	2004	2005	Growth
CD	18,109	17,019	-6.0%
DVD	1,610	1,540	-4.3%
Singles	821	721	-12.2%
Other Physical (Cassettes, LPs, VHS and Other)	531	372	-29.9%
Physical Sales	21,071	19,652	-6.7%
Digital Sales	397	1,143	187.9%
Total Wholesale Sales	21,468	20,795	-3.1%

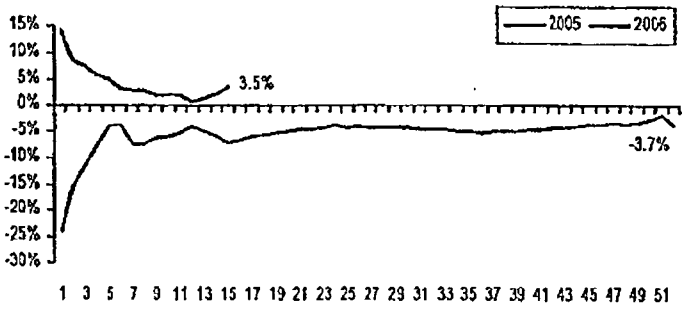
Source: IFPI

2006 recent trading

USA

In 2005, the US market declined 3.7% in terms of track equivalent album units (one physical album equates to 10 tracks, one single to one track and one online download to one track). In 2006 year-to-date (until April 16), the market is up 3.5%. This is clearly encouraging.

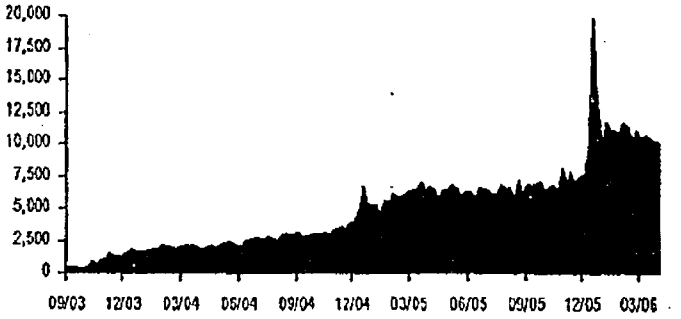
Chart 6: Year-to-date track equivalent album unit sales in the US



Source: Soundscan.

Physical albums are down 0.8% year-to-date while online downloads are up 84.3%. That said, since the Christmas spike download have started to trend down slightly. Last year, they were flat for most of the year post Christmas spike.

Chart 7: US market – Online downloads



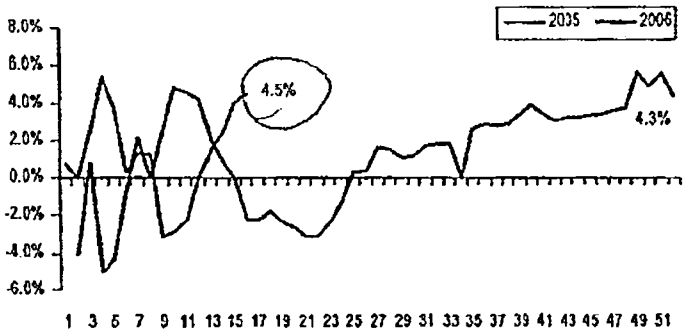
Source: Soundscan.

Other Countries

In the UK, album unit sales are up 4.5% year-to-date while singles including online downloads are up 131.5%.

UK +4.5

Chart 8: UK albums – Unit sales year-to-date

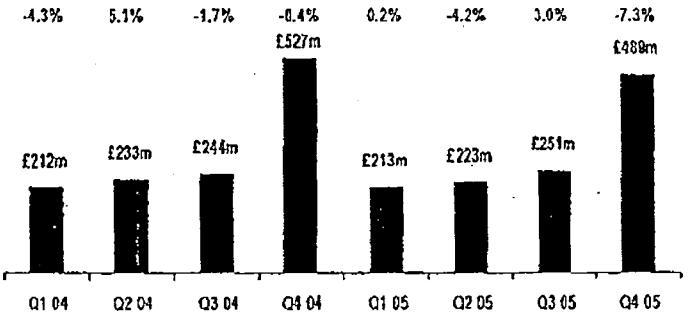


Source: Music Week.

Japan +9.4

Taking these two volume numbers into account price decline of 2% would indicate the market is currently up approximately 5%. The market has been quite volatile over the past 8 quarters but that would represent a solid performance on par with Q2 2004.

Chart 9: UK quarterly retail sales



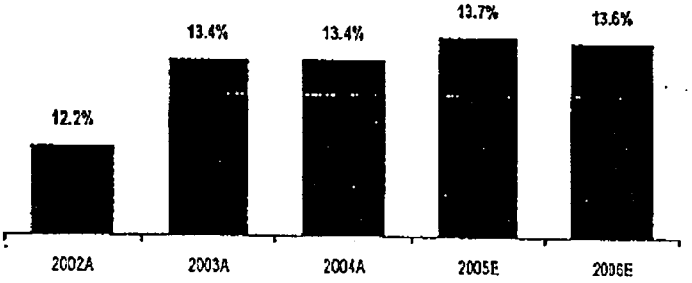
Source: BPI.

The Japanese market has been volatile this year with January down 16.6% and February and March up 18.1% and 23.1% respectively. The market is up 9.4% year-to-date (physical only). The RIAJ has not yet reported online sales for Q1 but if we assume they are up 100% then the market would be up 15.2%. It should be noted though that these data are production figures not shipment data.

Market share

Chart 12 details EMI's recorded market share. We expect EMI gained some share in 2005 (our estimate calls for 13.7%) while we believe EMI will lose some of that back in 2006E. This is why we expect EMI's recorded music to grow 2.1% while we forecast the market to grow 2.5%.

Chart 12: Emi recorded music market share



Sources: IFPI, Merrill Lynch estimates.

Fair value

We have a fair value estimate of 285p based on separate DCF valuations of the music publishing and recorded music business as shown in Table 14.

Table 14: Fair value (E)

(£ Million)	Value	Valuation Method
NPV Music Publishing	988	DCF (9.0% WACC and 3.5% In-Perpetuity)
NPV Recorded Music	2,186	DCF (9.5% WACC and 3.0% In-Perpetuity)
Minorities	-150	Comparable multiple
Firm Value	3,024	
Net (Debt)/Cash	-791	
Market Cap	2,233	
No. of Shares	784	
Equity Value per Share	285p	
% Upside (294p as of 25/04/06)	-3.1%	

Source: Merrill Lynch estimates

Financials

Table 15: EMI - Income Statement

March 31 Year-End (£ Million)	2004A	2005A	2006E	2007E	2008E	2009E
Recorded Music	1,722.8	1,600.5	1,659.3	1,693.4	1,746.0	1,820.1
Music Publishing	397.9	400.7	418.0	434.0	450.7	467.6
Total Revenues	2,120.7	2,001.2	2,077.3	2,127.4	2,196.7	2,287.8
% Growth	-2.5%	-5.6%	3.8%	2.4%	3.3%	4.1%
Operating Costs Ex D&A	(1,836.4)	(1,752.2)	(1,798.7)	(1,822.5)	(1,858.8)	(1,926.5)
EBITDA	284.3	249.0	278.6	304.9	337.9	361.2
% Growth	-4.3%	-12.4%	11.9%	9.4%	10.8%	6.9%
% Margin	13.4%	12.4%	13.4%	14.3%	15.4%	15.8%
Depreciation and Amortisation	(35.0)	(23.9)	(30.0)	(35.0)	(40.0)	(41.0)
Recorded Music	147.4	125.5	144.3	161.6	185.4	203.5
Music Publishing	101.9	99.6	104.3	108.3	112.5	116.7
Total EBITA	249.3	225.1	248.6	269.9	297.9	320.2
% Growth	-1.9%	-9.7%	10.5%	8.6%	10.4%	7.5%
% Margin	11.8%	11.2%	12.0%	12.7%	13.6%	14.0%
Operating Exceptionals	(138.3)	0.0	0.0	0.0	0.0	0.0
Non-Operating Exceptional	(16.5)	(17.5)	0.0	0.0	0.0	0.0
Goodwill Amortisation	(4.0)	0.0	0.0	0.0	0.0	0.0
Copyright Amortisation	(46.9)	(48.0)	(48.0)	(47.0)	(46.0)	(45.0)
Net Associates	(0.3)	1.1	0.0	0.0	0.0	0.0
EBIT	43.3	160.7	200.6	222.9	251.9	275.2
% Growth	-89.1%	271.1%	24.8%	11.1%	13.0%	9.3%
% Margin	2.0%	8.0%	9.7%	10.5%	11.5%	12.0%
HMV Pre Tax Profit	0.0	0.0	0.0	0.0	0.0	0.0
Net Interest (Recurring)	(85.9)	(85.1)	(90.6)	(88.4)	(83.9)	(73.5)
Net Interest (Exceptionals)	(10.2)	23.4	14.4	0.0	0.0	0.0
Headline Pre tax profit	163.3	141.1	158.0	181.6	214.0	248.8
% Growth	-7.9%	-13.6%	12.0%	14.9%	17.8%	15.3%
% Margin	7.7%	7.1%	7.6%	8.5%	9.7%	10.8%
Reported Pre-Tax Profit	(52.8)	99.0	124.4	134.6	168.0	201.8
% Growth	NM	NM	25.7%	8.2%	24.8%	20.1%
% Margin	-2.5%	4.9%	6.0%	6.3%	7.6%	8.8%
Reported Tax charge	(19.7)	(23.9)	(34.8)	(43.6)	(53.5)	(64.2)
% Tax Rate	19.9%	22.3%	22.0%	24.0%	25.0%	26.0%
Minorities Pre Exceptionals	(6.5)	(4.3)	(4.8)	(5.4)	(8.3)	(11.4)
Minorities Exceptionals	7.4	4.8	0.0	0.0	0.0	0.0
Headline Net Income	124.3	105.0	118.4	132.5	152.2	171.2
% Growth	1.7%	-15.5%	12.8%	12.0%	14.8%	12.5%
% Margin	5.9%	5.2%	5.7%	6.2%	6.9%	7.5%
Reported Net Income	(71.6)	75.6	84.8	85.6	106.2	126.2
% Growth	NM	NM	12.2%	0.9%	24.1%	18.8%
% Margin	-3.4%	3.8%	4.1%	4.0%	4.8%	5.5%
Diluted Headline EPS	15.5p	13.3p	14.6p	16.2p	18.4p	20.6p
Diluted Basic EPS	-8.2p	9.9p	10.7p	10.8p	13.2p	15.4p
DPS	8.0p	8.0p	8.0p	8.5p	9.0p	9.5p

Source: Merrill Lynch estimates

Table 16: EMI - Cashflow Statement

March 31 Year-End (£ Million)	2004A	2005A	2006E	2007E	2008E	2009E
Group Operating Profit/(Loss)	60.1	177.1	200.6	222.9	251.9	275.2
Depreciation	35.0	23.9	30.0	35.0	40.0	41.0
Amortisation	50.9	48.0	48.0	47.0	46.0	45.0
Asset Write-Downs	65.7	0.0	0.0	0.0	0.0	0.0
Net Provisions (Created Minus Used)	37.3	(62.8)	(20.0)	0.0	0.0	0.0
Change in Working Capital	60.4	27.5	(35.9)	(11.3)	(11.6)	(12.1)
Net Cash Flow from Operations	309.4	213.6	222.7	293.7	326.3	349.1
Dividends Received from Associates	0.0	0.0	0.0	0.0	0.0	0.0
Net Interest (Including Leases)	(95.4)	(100.3)	(90.6)	(88.4)	(83.9)	(73.5)
Dividends Paid To Minorities	(3.5)	(1.3)	(7.0)	(8.0)	(9.0)	(10.0)
Tax Paid	(30.6)	(32.7)	(34.8)	(43.6)	(53.5)	(64.2)
Operating Cash Flow	179.9	79.3	90.3	153.7	179.8	201.5
Capital Expenditure - Fixed Assets	(51.3)	(29.9)	(35.0)	(40.0)	(42.0)	(44.0)
Capital Expenditure - Music Copyright	(5.1)	(6.0)	(5.3)	(5.5)	(6.8)	(7.0)
Fixed Asset Disposals	78.4	3.5	0.0	0.0	0.0	0.0
Net Fixed Asset Investments	0.7	(3.2)	0.0	0.0	0.0	0.0
Net Investment in Associates	0.4	(2.0)	0.0	0.0	0.0	0.0
Acquisitions	(89.4)	(70.9)	(5.5)	0.0	0.0	0.0
Investing Cash Flow	(66.3)	(108.5)	(46.8)	(45.5)	(48.8)	(51.0)
Shares Issued	0.0	1.7	0.0	0.0	0.0	0.0
Dividends Paid	(62.7)	(62.9)	(62.8)	(62.9)	(66.9)	(70.9)
Change in Debt	187.0	1.7	0.0	0.0	0.0	0.0
Financing Cash Flow	124.3	(59.5)	(62.8)	(62.9)	(66.9)	(70.9)
Change in Cash and Liquid Funds	237.9	(88.7)	(19.3)	44.3	64.2	79.6
Management of Liquid Resources	(1.7)	(0.8)	0.0	0.0	0.0	0.0
Change in Cash	236.2	(89.5)	(19.3)	44.3	64.2	79.6

Source: Merrill Lynch estimates

Table 17: EMI - Balance Sheet

March 31 Year-End (£ Million)	2004A	2005A	2006E	2007E	2008E	2009E
Music Copyrights	450.5	404.6	362.9	322.4	283.1	245.2
Goodwill	31.1	35.1	40.6	40.6	40.6	40.6
Tangible Fixed Assets	229.6	200.0	205.0	210.9	212.0	215.0
Investments in Associates	5.5	8.5	8.5	8.5	8.5	8.5
Other Fixed Asset Investment	32.7	14.9	14.9	14.9	14.9	14.9
Stocks	28.1	28.2	49.0	53.2	57.6	62.2
Trade Debtors	345.3	300.1	294.5	288.7	282.8	276.6
Other Debtors (Including Deferred Taxation)	463.5	523.0	523.0	523.0	523.0	523.0
Cash and Liquid Funds	345.2	242.5	223.2	267.5	331.6	411.2
Total Assets	1,922.5	1,756.9	1,721.5	1,728.8	1,754.2	1,797.2
Shareholders' Fund (Incl. Minorities)	(851.9)	(834.1)	(828.7)	(888.6)	(770.1)	(713.4)
Trade Creditors	198.7	196.7	175.9	163.2	150.0	136.3
Other Creditors	1,103.0	1,049.6	1,049.6	1,049.6	1,049.6	1,049.6
Deferred Taxation and Provisions	221.8	151.9	131.9	131.9	131.9	131.9
Associate Liabilities	115.3	92.8	92.8	92.8	92.8	92.8
Financial Debt	1,136.6	1,100.0	1,100.0	1,100.0	1,100.0	1,100.0
Total Sh. Fund and Liabilities	1,922.5	1,756.9	1,721.5	1,728.8	1,754.2	1,797.2
Closing (Debt)/Cash	(791.4)	(857.5)	(876.8)	(832.5)	(768.4)	(688.8)

Source: Merrill Lynch estimates

Analyst Certification

I, Julien Roch, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

iQmethod™ Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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EXHIBIT CO 0965

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Stock Rating
Equal-weight
Industry View
Attractive

EMI

Upside Case Stretched

What's Changed

Price Target	300p to 270p
2006/7e EPS	*Reduced by 5% to 15.6p*

The three planks of the buy case: These are well known and have consistently been (i) that the growth in digital leads to a revival in the overall recorded music market (ii) that digital also ignites growth in music publishing which is simultaneously highly attractive to private equity buyers (iii) that a merger with Warner Music Group extracts significant value for the group.

Music market still sluggish, forecasts stretched: The IFPI numbers for H1 2006 show the global recorded music market declined in value by 4.4%. 2006 is likely to be the sixth successive year of recorded music decline. EMI will, meanwhile have to produce its best Recorded Music H2 performance since 2001 (when it sold 21.6 million Beatles *'One'* albums in H2) to meet our current year forecasts. EMI also reports no growth in its H1 music publishing revenues. This is a business with compound revenue growth of 1.4% pa and EBITA growth of 0.1% pa in 2001 - 2006. Read through valuations from the Vivendi-BMG Music Publishing deal are overdone in our view.

Sony-BMG, Warner-EMI - major obstacles: Our reading of the European Court of First Instance's ruling suggests that the Court believes the evidence on the Sony-BMG case points to a condition of collective dominance already existing. If so it will be very tough for Sony-BMG to overturn the annulment. It will be even tougher for a subsequent merger of EMI and Warner to take place. Without a Recorded Music buyer a private equity approach to EMI looks in turn less likely. A major prop to the EMI share price has been kicked away.

Price target reduced to 270p: It assumes existing forecasts and a rating in line with UK media (both potentially optimistic). If our reading of the European Court of First Instance decision is correct, and downgrades ensue on trading, downside could be 225p.

Key Ratios and Statistics

Reuters: EMI.L; Bloomberg: EMI LN
Media & Internet/United Kingdom

Price target	300p
Stk price close (Nov 8, 2006)	277p
Mkt cap, curr (mn)	£2,418
52-Week Range	215-273p

Fiscal Year (Mar)	2006	2007e	2008e	2009e
ModelWare EPS (p)	15.7	15.6	18.5	20.0
Prior ModelWare EPS (p)		16.4		
P/E	16.3	17.7	14.9	13.9
Consensus EPS (p)	16.2	15.7	18.2	20.4
Div yld (%)	3.1	2.9	2.9	2.9

E = Morgan Stanley Research estimates

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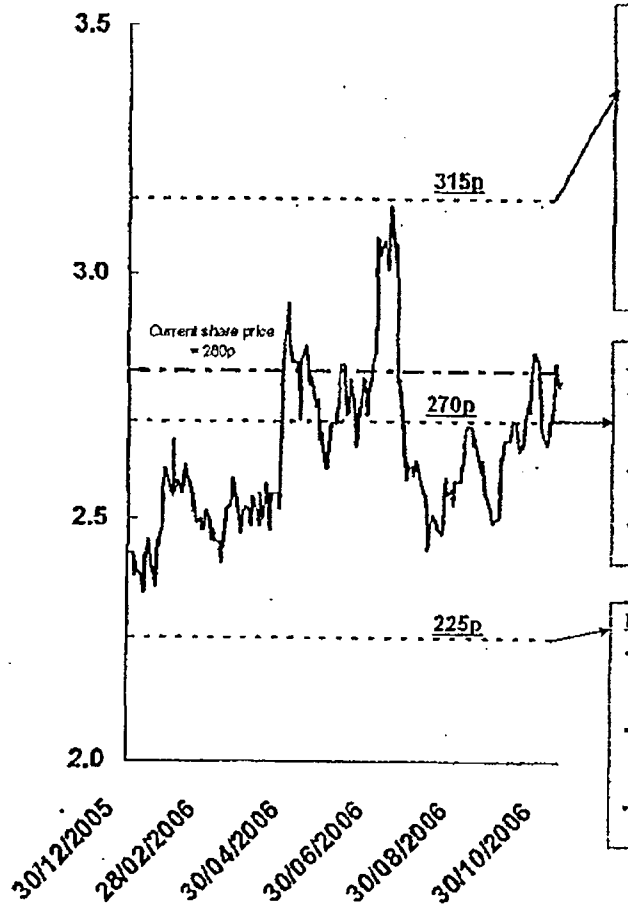
For analyst certification and other important disclosures refer to the Disclosure Section

Exhibit 1
EMI Scenario



Bull Case: 315p – Forecasts Hold, Offers renewed

- Sony-BMG deal is passed and Warner-EMI offers are resumed – WMG last offered 315p per share
- *Sum of the parts reflects upper end implied value for EMI* Music Publishing at £1929m implying 316p per share for the group
- Current forecasts remain intact, assuming 2% growth in Recorded Music market in each of the next three years
- Implies a calendarised EV/EBITA multiple of 12.9x 2006 dropping to 11.2x 2008. P/E's of 20.1x 2006 dropping to 16.1x 2008

Base Case: 270p

- Continued belief that a Warner-EMI deal at some point is possible – although our view is that this is increasingly unlikely
- Lack of outlet for Recorded Music reduces interest in read across valuations for EMI Music Publishing
- Forecasts for the group hold at current levels – though this is demanding - and the stock rates in line with UK media

Bear Case: 225p – No bid possible

- Sony-BMG merger remains blocked, potential Warner-EMI deal ruled out, likelihood of private equity interest thereby reduced
- Flat recorded music markets in each of 2006/7 to 2008/9 mean group forecasts fall by 5% in 2006/7, 8% in 2007/8 and 12% in 2008/9
- EMI is derated by circa 10% to remove the perceived upside from bid potential

Source: Company data, Morgan Stanley Research

sales grow $1.8bn pa, the market will show virtually zero growth.

EMI Recorded Music forecasts at risk

- Our forecasts for EMI assume 2% annual recorded music market growth and EMI holding share in each of the next three years. This looks optimistic in the *context of the overall music market growth.*

- More immediately our forecasts, and the market consensus, assume EMI Recorded Music will *contribute around £138m of* EBITA *in H2 06/07.* This would represent the best H2 since 2000/1 when EMI sold 21.6 million Beatles 'One' albums. Given the rather ordinary EMI H2 release schedule this *forecast looks vulnerable.*

- At the simplest level if we were to assume flat music market growth each year between 2006/7 and 2008/9 *our Recorded Music forecasts would drop* by £5m, £17m and £26m, respectively reducing our group pre-tax forecasts by 5%, 8% and 12%.

Valuation: upside looks limited, downside risks increased

We proffer four benchmarks for the EMI share price:

- WMG offered 315p per share in July 2006 before the EUCOFI decision on Sony-BMG.

- Our sum of the parts using the (potentially unrealisable) BMG Music Publishing multiple for EMI Music Publishing is 295p.

- On current forecasts EMI at 270p trades at or around the UK media sector average multiple on P/Es and EV/EBITDA (see Exhibit 2).

Exhibit 2

EMI at 270p price target

Y/e	2005	2006	2007e	2008e
EV/Sales	1.57	1.54	1.49	1.46
EV/ EBITDA	12.03	11.53	10.54	9.95
P/e	18.0	17.3	15.1	13.8
FCF Yield	2.3	3.7	5.0	6.7
Dividend Yield	2.96	2.96	2.96	2.96
UK Media averages				
EV/Sales	2.5	2.3	2.2	2.1
EV/ EBITDA	11.7	10.9	10.2	9.4
P/e	17.4	17.3	15.5	13.7
FCF Yield	6.1	5.6	6.2	7.4
Dividend Yield	2.4	2.6	2.8	3.1

e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

- If we assume that our EMI forecasts are 10% too high by 2007/8 and that the disappearance of bid speculation due to the Sony-BMG decision depresses the rating by 10%, the outturn for the share price would be 225p.

Price target reduced to 270p: downside risks remain

- We feel that the EMI-WMG deal related upside has been compromised by the EUCOFI decision.

- On current forecasts and given that view, our price target is reduced to 270p (from 300p) to represent a sustainable level for EMI on its own trading merits.

- The risk is that forecasts remain too high and that downgrades drag the stock lower.

misrepresenting sales to the tune of £12m. These sales were simply non-existent. Product related to these sales was however prepared and shipped with £9m of cost being incurred. This is the cost now being felt through the P&L.

- There appears to be no need to restate prior year earnings. This suggests that the alleged fraud is relatively recent and that the underlying profitability of the Brazilian operation should be largely unaffected. In the normal course of events we believe the Brazilian business is relatively minor with annual profitability of around £2m at the EBITA level.

- EMI is conducting a full investigation and has suspended certain of its Brazilian management team. It would appear, however, that the effect is relatively localised.

Our view: annoying but no more

- Under the new CFO Martin Stewart we believe the financial discipline of EMI has become much tighter in the last two years. We are inclined more to congratulate EMI for its internal controls in discovering the fraud rather than castigate it for allowing the fraud to occur.

- We do not subscribe to the view that the fraud was discovered as part of some due diligence process for a would-be buyer of the group as some of the optimists appear to hope.

- The effect of the fraud is a one-off to 2006/7. It should not impact the underlying earnings potential of the group.

Our revised expectations for EMI's half year, including the impact of the accounting fraud, are shown in Exhibit 3 below.

Overall at the group level, including the impact of the fraud we look for turnover to decline by 6.3% to £866m, EBITA by 27% to £63m, pre-tax by 52% to £19.6m and EPS by 48% to 2.1p.

Exhibit 3
2006/7e interim forecast

	1H04/5	1H05/6	1H06/07e	% chg
Recorded Music				
Turnover underlying	660	721	675	-6.3
Costs	-631.8	-682.4	-655	-4.0
EBITA underlying	28.2	38.3	20	-47.8
Margin %	4.3%	5.3%	3.0%	-44.2
Impact of Fraud				
Turnover	0	0	-12	
EBITA	0	0	-9	
Total Turnover	660	720.7	663	
Total EBITA	28.2	38.3	11	
Margin %	4.3%	5.3%	1.7%	
Music Publishing				
Turnover	191	204	203	-0.4
EBITA	48.4	48.4	52	7.4
Margin %	25.3%	23.7%	25.6%	7.9
Total				
Turnover	851	925	866	-6.3
EBITA	76.6	86.7	63.0	-27.3
Margin %	9.0%	9.4%	7.3%	
Associates	0.3	0.6	0.5	-16.7
Net interest	-30.3	-46.3	-44	-5.0
One off finance costs	-3.4	0	0	
Interest total	-39.7	-46.3	-44.0	-5.0
Pre tax	37.3	41.1	19.6	-52.4
Taxation	-8.7	-9.0	-4.3	-52.4
Minorities	-3.2	-1.3	-1.5	15.4
Net income	25.4	30.8	13.8	-55.2
Convert adjustment	3.45	4.6	4.75	3.3
Amortise equity portion	1	0.0	0.0	
Adjusted Net income	29.9	35.4	18.5	-47.6
Net EPS Fully Diluted	3.42	4.04	2.12	-47.6
Net Dividend				
No of shares	872.4	874.1	874.2	
Tax Rate	23.3	22.0	22	

e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

Vivendi's purchase of BMG Music Publishing: the implications for EMI

- In September Vivendi made an offer to buy BMG Music Publishing for €1.63bn. The deal is subject to regulatory approval. Bertelsmann in its statement says that it *'expects to receive the funds prior to year end 2006'* and Vivendi may have taken on a degree of regulatory risk here.

Investment Case

EMI-WMG deal: major obstacles ahead

Much of this note discusses in detail the reasons why the European Court of First Instance (EUCOFI) decided in July to annul the EU's decision to allow the Sony-BMG merger. We believe that the EUCOFI's view was, contrary to the EU's findings, that a position of collective dominance probably already existed (or could not be ruled out) prior to the Sony-BMG merger and that such a position of collective dominance might be strengthened by further consolidation through the Sony-BMG merger.

The implications of this are that the task of persuading the EU that a revised Sony-BMG deal should be accepted looks very difficult. Even if permission for Sony-BMG could be achieved (and this would be likely to come with stringent behavioural conditions) there would need to be a separate process to prove that further reducing the number of music majors through an EMI-WMG deal would not in turn create a position of collective dominance. Put plainly our view is:

- The prospect of Sony BMG being allowed is no more than 60% and then with conditions.
- The probability of a subsequent music merger (EMI-Warner) being allowed is no more than 50%.
- The overall prospect of both mergers being allowed (assuming as we do that EMI-Warner would be contingent on Sony-BMG being passed) is no more than 30%.
- Even then, given the need to build in time for investigative processes, any such deal could be at least two years away.

Our view is that the market should work on the basis that the prospect of an EMI-Warner deal is essentially ruled out. If this is the case it removes a large part of the upside case for the shares.

Music publishing excitement - overdone

- The sight of Vivendi proposing to pay 4.4x sales and 20x EBITDA for BMG Music Publishing in a deal worth €1.63bn has excited a lot of attention for EMI as analysts have looked at read-across values for EMI Music Publishing.
- This clearly is relevant to EMI but we keep our excitement in check. Vivendi's price assumes synergies are achievable of a type unlikely to be available to a buyer of EMI Music Publishing. We value EMI Music Publishing on a read across from the BMG multiples at £1.73bn (199p per share) equivalent to 3.8x 2007 sales and 14x EBITDA. We feel this is an upbeat valuation given EMI Music Publishing's record of 1.4% pa compound revenue growth and 0.1% pa compound EBITA growth in the last five years.
- The excitement over Music Publishing values assumes in turn that such value can be unlocked. There are three potential obstacles to this (i) the Vivendi-BMG MP deal is under regulatory scrutiny with the EU likely to give its initial decision on December 8th (ii) EMI is not a seller of its music publishing business unless it can merge with Warner, which we feel is unlikely (iii) private equity is not likely, in our view, to bid for EMI in order to obtain the music publishing business unless it can find a prospective home for the recorded music operation. In turn we feel this is likely, given the Sony-BMG decision, to be difficult.
- In the meantime EMI has said it will report zero revenue growth underlying in Music Publishing in the first half of 2006/7.

Music market still down - digital panacea not working

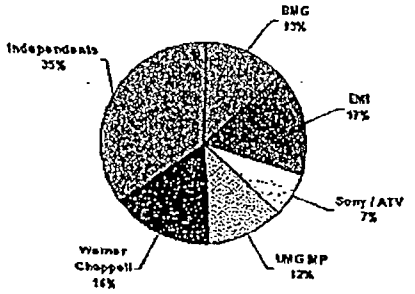
Since mid 2003, and the introduction of the Apple iTunes store, the stock market has taken the view that growth in digital music sales would ignite renewed growth in the value of the global recorded music market. EMI has been rerated accordingly since that time (in spring 2003 the EMI share price was 91p with a forward P/E for March 2003 of 5.9x and an ordinary yield of 8.6%).

In fact the value of the global recorded music market has continued to decline, registering falls in each of 2003, 2004 and 2005. In the first half of 2006 the IFPI reports the value of the global recorded music market to have accelerated its rate of decline, down 4.0% at the wholesale level despite over 100% growth in digital sales. Physical sales, which are still 90% of the total, declined 10% in H1. On our numbers if physical declines 5% pa to the end of the decade and digital

- BMG Music Publishing generated €371m of revenue and €81m of EBITDA in the year to December 2005. This implies a purchase multiple by Vivendi of 4.4x sales and 20.1x EBITDA.

- The deal should make Vivendi the largest music publishing business in the world, overtaking EMI (see Exhibit 4). UMG hitherto has had a relatively small music publishing operation. Of UMG's revenues of €4.99bn in 2005 only 8%, or €399m arose from Music Publishing. The combined business will have sales of €770m.

Exhibit 4
Global Music Publishing Shares - 2005



Source: Company data, Morgan Stanley Research

- Vivendi claims that the BMG music publishing purchase *'will increase Vivendi's profit in the first year'*. We take this to mean that the deal will be earnings enhancing in 2007. Vivendi management has referred to *'substantial synergies'* while being reluctant to be specific about the potential scale of these.

- In our view music publishing is a stable but relatively modest growth business with industry revenues growing by around 3% - 4% pa. We estimate the combined UMG-BMG music publishing EBITDA margin to be 23.5% in 2005. Assuming 50% drop through of incremental revenue to profit plus €40m of cost savings (equivalent to 5% of the combined revenues or 7% of the combined cost base) EBITDA margins for the combined entity climb rapidly to 30% in 2007 and 30.5% in 2008 (see Exhibit 5).

- On this basis the deal is indeed earnings enhancing. If we attribute all of the costs savings to BMG, the estimated BMG MP contribution to EBITA in 2007 would be €129m versus an incremental interest charge of €89.5m. The return on capital is less impressive. Assuming a 30% tax charge the return on capital is just 5.3% in 2007 rising to 6.1% in 2008.

Exhibit 5
UMG MP plus BMGMP

	2005	2006e	2007e	2008e
Revenues - BMG MP	371	384	397	411
Revenues - UMG MP	399	413	427	442
Revenue Total	770	797	825	854
EBITDA - BMG MP	81	87.5	93.9	100.2
EBITDA - UMG MP	100	107	114	120
EBITDA sub total	181	194	208	221
Cost savings	0	30	40	40
Total EBITDA	181	224	248	261
Depreciation	-10	-11	-12	-13
EBITA	171	213	236	248
Revenue growth		3.5	3.5	3.5
Total EBITDA Margin %	23.5	28.1	30.0	30.5
EBITA margin %	22.2	26.8	28.6	29.0

e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

The purchase of BMG Music Publishing by Vivendi and the apparent interest of private equity groups in the asset as well has led to considerable interest in the read-across value to EMI Music Publishing.

Using the same historical multiples for EMI Music Publishing, which is a larger business with greater market share than BMG MP, the implied valuation for EMI MP ranges between £1.62bn and £2.1bn (see Exhibit 6). We are inclined to take the lower end of this scale.

Exhibit 6
Implied EMI Music Publishing Value from Vivendi purchase of BMG MP for €1.63bn

	2005	2006	2007e
BMG			
Revenue	371	384	397
EBITDA	81	87.5	113.9
Turnover x	4.4	4.2	4.1
EBITDA x	20.1	18.6	14.3
EMI MP	2006	2007	2008
Revenue Total	419	435	455
Operating profit	105.4	108	113
EBITDA	115	118	123
Turnover x	4.4	4.2	4.1
EBITDA x	20.1	18.6	14.3
Implied value for EMI MP	1841	1846	1868
	2121	2012	1617
Average	1981	1929	1743

e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

- Vivendi has clearly paid a price that assumes that synergies can be obtained from the combined BMG MP and Vivendi MP businesses. If we attribute half of the projected cost savings to BMG MP in 2007 this should capture the effect. On this basis the equivalent valuation of EMI MP would emerge at between £1.62bn and £1.87bn using the implied 2007 purchase multiples.

- We believe that EMI Music Publishing is unlikely to end up in the hands of another industry player due to the concentration issues that this would raise. As a result any buyer would have to purchase EMI MP without the benefit of potential cost savings, effectively therefore seeking incremental value from a business already the largest in its industry and relatively well run in terms of margin performance.

- Our mid-point valuation for EMI MP is thus £1.74bn (the mid point of £1.62bn and £1.87bn). While below the peak implied valuation of the Vivendi purchase of BMG MP it still represents a healthy 3.8x 2007 sales and just over 14x EBITDA. This is for a business with a pretty lacklustre historic record - compound revenue growth averaged 1.4% pa 2000/1 to 2005/6 and compound EBITA growth was 0.1% pa with margins slithering from 26.9% to 25.2%. In the first half of 2006/7 EMI has stated that revenue growth is again zero with the margin likely to be similar to that of 2004/5 (H1 2005/6 margins were artificially depressed by the cost timing effects). Albeit that music publishing has some interesting growth areas there seems little reason for private equity or anyone else to go overboard in paying up for such prospects.

- A further consideration is that the Vivendi-BMG MP purchase has yet to be approved by the regulator. EU regulators have set a December 8th deadline for an initial ruling on the deal. Any interruption to the deal process would be negative to the market's perception of the value of EMI Music Publishing. IMPALA (the group who successfully appealed against the Sony-BMG Recorded Music merger) has also objected to the Vivendi-BMG MP deal.

Exhibit 7
EMI Music Publishing: The Historical Record

Music Publishing	2001	2002	2003	2004	2005	2006	CAGR %
Turnover	390.7	416.4	401.2	397.9	400.7	419	1.4
Costs	-215.7	-233	-221.2	-217	-215.7	-229	
Net publishing share	175	183.4	180	181	185	190	
Costs	-70	-75.6	-76.4	-79	-84.8	-84.6	
Operating profit	105	107.8	103.6	101.9	100.2	105.4	0.1
Margins	26.9	25.9	25.8	25.6	25.0	25.2	

Source: Company data, Morgan Stanley Research

- One other implication of rising valuations for Music Publishing businesses is that in the event one day of a renewed EMI bid for Warner Music Group, EMI will presumably have to pay a raised value for Warner's Music publishing operation - even if it is only then to sell it on.

If we plug our £1.74bn valuation for Music Publishing into our sum of the parts the effect is to produce a group valuation of £2572m or 295p per share.

The other key elements of our sum of the parts are:

- We value Recorded Music using a divisional DCF at £1637m or 188p per share. Our DCF assumes a 1.5% perpetuity growth rate with EBITA margins peaking at 12.4%. We use a discount rate of 8.75%. The valuation is equivalent to a 2006/7 turnover multiple of 1.0x and an implied P/E of 14.6x 2006/7 EPS. The five year record of EMI Recorded Music is shown in Exhibit 9. Compound revenue growth has been -6.1% in the last five years with a compound EBITA decline of 8.1%.

- We use the end 2005/6 net debt figure of £880m. Underlying net debt at EMI tends to creep up given the low level of underlying cash generation. We adjust out the convertible debt of £135m, subtract £75m for minorities and use the fully diluted share count.

Exhibit 8

EMI sum of the parts

Sum of the parts	Turnover 2007	Net Pub. Share	EBIT	Margin	Tax rate	PAT	Turnover	EBIT	Net Pub. Share	P/e	Value	Value
	£m	£m	£m	%	%	£m	x	x	x	x	£m	p
Recorded Music	1681		149	8.9	25	112.1	1.0	11.0	na	14.6	1637	188
Music Publishing	435	191	108	24.8	25	81.0	4.0	16.1	9.1	21.5	1740	199
Total Business	2116		257	12.2		193	1.6	13.1		17.5	3377	387
Other Holdings											15	2
Total											3392	389
Net Debt											-880	-101
Adjust for convertible											135	15
Minorities											-75	-9
Sum of Parts											2572	295
No. of shares	872.8											

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

EMI Trading Update

The EMI trading statement produced on October 16 was much in line with expectations. The key points were:

- For the first half of 2006/7 EMI looks for a decline in total revenues of 3% on a constant currency basis and 5% on a reported basis. Underlying pre-tax profit was expected to be around £27m.

- At the divisional level EMI Recorded Music is expected to see a decline in revenues of around 4% in the first six months. EMI suffers from a tough comparable in Recorded Music in H1 due to the heavy sales of the Coldplay and Gorillaz albums in the equivalent period which sold 7.5m and 3.4m units respectively with a total sales value of £55m.

  By contrast the H1 release schedule for EMI in 2006/7 has been relatively slight, relying on Utada, Chingy and crossover albums from 2005/6 from artists like Corinne Bailey Rae, The Kooks and Diam's. The major releases from EMI fall into H2 with Robbie Williams, Janet Jackson, The Beatles, Keith Urban and RBD due to release albums in Q3 and Norah Jones and Joss Stone due to release in Q4.

- The Recorded Music market has performed relatively poorly in this period. The US retail market including digital is down around 1% ytd with the wholesale number much weaker. The UK market was down 3% in calendar H1, France was down around 5% in the same period and Germany down 2% - 3%. The best performing market (up 5% - 6% including digital) is Japan. Here, however, EMI is suffering from weak market share with its business being restructured. Consensus forecasts for modest growth in the music industry in calendar 2006 already look optimistic.

- EMI states that the negative impact of lower revenues and the changed mix of releases year on year is partly offset by progress on the cost saving initiatives launched in April. EMI has approximately £10m of cost benefit from its £30m saving plan coming through in 2006/7. EMI expects its Recorded Music divisional operating margin to be around 3% for H1. This implies EBITA of around £20m, down almost 50% from the first half of 2005/6.

- In Music Publishing EMI expects to report first half revenues in line with those of 2005/6, arguably a disappointing outturn given the *'growth'* tag that tends to be applied to the Music Publishing business. The divisional operating margin is expected to expand to 25% from 23.7% in 2005/6, although 2005/6 H1 profits were depressed by the bunching of one-off costs. A 25% margin outturn would be similar to that achieved in 2004/5. We look for Music Publishing EBITA of £52m, a margin of 25.6%.

- Overall this would produce total turnover down 5% at £878m and EBITA down 17% at £72m with pre-tax falling by 31% to £28.5m, marginally above the £27m forecast by EMI.

Problems in Brazil

We must, however also factor in the subsequent news, announced on 25th October that EMI has been subject to an accounting fraud in Brazil. There are relatively few details revealed but we believe the main issues are:

- EMI has been subject to an accounting fraud in its Recorded Music business in Brazil. The fraud was uncovered as part of the regular internal control processes at EMI.

- The company believes that the fraud has led to the overstatement of EMI's Music revenues by approximately £12m and of its profits by £9m.

- The apparent high profitability of the Brazilian operation is misleading. The fraud involved

Company Description

EMI is the third largest global recorded music business and the largest global music publishing business in the world.

Industry View: Attractive

Seeing the improving advertising environment and the potentially dramatic effect of the turnaround on depressed ratings and on the possibility of corporate and private equity interest, we view the industry as Attractive.

GICS Sector: Consumer Discretionary

Strategist Recommended Weight: 10.5%
MSCI Europe Weight: 9.6%

for acquisitions before July 2007. In particular it is looking to buy a controlling stake in a Western European media company in a deal worth $4bn. Jackson commented,

"It's well positioned as a player in Europe but there is room for expansion ... it has global aspirations".

In our view EMI does not fit these criteria:

- EMI has a market capitalisation of £2.36bn, equivalent to $4.4bn. This exceeds the $4bn Istithmar has talked about, though notably the *'deal'* is said to be worth $4bn for a controlling stake, which would imply a bigger company than EMI.

- The interview suggests that Istithmar is looking to buy a *'controlling stake'*. There is, however, no controlling stake to buy in EMI. Istithmar would be obliged to bid outright for the whole company in the public market.

- Istithmar talks of its target company as having room for expansion in Europe and global aspirations. EMI is already leader in the European markets in music publishing and recorded music and is the third largest global recorded music business.

It is difficult to rule such things out definitively but we suggest that these remarks imply that Istithmar's would - be target is not EMI.

More broadly on the possibility of a private equity bid for EMI our view is:

(i) Private equity is unlikely in our view to bid for the EMI Group, particularly given the premium that shareholders of public companies tend to demand.

(ii) The major stumbling block is likely to be the need to purchase the Recorded Music business. Private equity would, in our view, struggle to find a third party to take the business off their hands.

(iii) Private equity is likely to be highly interested in buying music publishing assets. In our view, however, private equity is likely to wait on the sidelines to compete for the music publishing asset that would have to be spun out of a combined Warner Music Group - EMI.

Warner-EMI: Where are we?

In this context it is worth recapping on the state of the Warner Music / EMI relative bid proposals.

(i) On May 3rd 2006 EMI confirmed that it had offered $28.5 per share in cash and shares for WMG but that the approach had been turned down by the WMG shareholders. WMG itself said on May 5th that its shareholders *'had unanimously rejected it'*.

(ii) On June 14 EMI received an *'unsolicited alternative proposal'* for WMG to acquire EMI at 315p in cash, an offer *'unanimously rejected'* by the EMI Board.

(iii) On June 23rd EMI raised its offer for WMG to $31 per share in cash. EMI intended to fund such an offer by a mixture of debt, the sale of one of the music publishing businesses and a rights issue, although the proportions contributed by each have not been revealed.

(iv) On June 27th WMG rejected this offer and submitted a revised proposal to bid for EMI at 320p a share in cash. This offer, in turn, was *'unanimously rejected'* by the EMI board.

(v) On July 13th the European Court of First Instance declared the EU's authorisation of the Sony-BMG joint venture to be annulled. On July 27th EMI announced that *'against this background EMI has decided not to pursue a combination with Warner Music for the time being. The Board will review this position in the light of future developments'*.

On the same day WMG announced,

"The July 13 ruling of the European Court of First Instance regarding Sony BMG has created uncertainty regarding a potential combination of WMG and EMI Group plc. WMG will monitor the situation carefully, but until matters become clearer, for instance as a result of the re-review of Sony BMG by the European Commission or through an appeal to the European Court of Justice, WMG does not believe that it would be prudent to pursue combinations of WMG and EMI".

The stock market continues to believe in the merits of a WMG-EMI deal despite the regulatory obstacle that has been thrown up. Broadly the merits of such a combination are perceived to be:

'found a parallelism in the majors prices both gross and net and, second, considered that the market was sufficiently transparent to permit the development of a collective dominant position of the majors and the monitoring of collusion on prices".

The EUCOFI also points out that the commission observes that *'a large part of the majors' sales of recorded music is channelled to a limited number of customers'* and concludes that *'this situation of a limited number of players in the market is conducive to cooperative strategies on behalf of the majors and also facilitates the monitoring and information flow ... the market investigation revealed that Sony and BMG had set up a system of weekly reports which include information on competitors'.*

The EUCOFI then assesses the EU's switch in position to its final judgement that the market is opaque rather than transparent and concludes that the EU has ignored its own evidence in deciding on the opaqueness of the market.

"Numerous responses [from retailers] reveal that the discounts were transparent and that the majors were aware of them ... it follows that the commission's assessment of the retailers' responses is vitiated by a manifest error" (387).

(iii) The EUCOFI states that the EU's reasoning to argue that the music markets were not transparent in regard to pricing was contradictory and ill-founded and on that this basis alone the merger permission should be annulled.

(v) The EUCOFI discusses at some length the issue of *'campaign discounts'*. The EU used the existence of these to show diversity of prices and non-collaboration amongst the music majors. The EUCOFI finds, using the same evidence, that the EU has been wrong to make this inference citing in the Italian market *"although two customers did receive discounts significantly lower than those received by the other customers, it is all the more significant that these low discounts were granted by Sony and BMG to precisely the same two customers, that they were at virtually the same level for both majors and that they varied in a parallel manner".*

In turn in the UK market the EUCOFI highlights that the Commission's own evidence shows

'that the list prices of the best selling albums appeared to be rather aligned and that transaction net prices were closely linked to gross prices".

Impala successfully appealed against Sony-BMG on the basis that the EU had not properly proved that the merger would not strengthen an existing collective dominance position. Essentially the EU, in its judgement had said such a collective dominance position did not exist.

In its belt-and-braces approach Impala also appealed on the basis that the Sony-BMG merger would create a collective dominance position. Here the EUCOFI concluded

(i) That the EU reached its decision that there would be no future collective dominance position by referring to its view that in the past there had been no collective dominance position. The EUCOFI states that this approach is inadequate and that a separate investigation of prospective effects of any such merger should be made. EUCOFI notes that the EU reached its decision despite noting that *"the markets for recorded music displayed certain features which indicated a conduciveness to collective dominance".*

(ii) Impala also argued in its case that the extent to which the level of symmetry in the market would increase (Sony BMG and Universal similar market shares and EMI and Time Warner similar market shares) would make tacit collusion easier to maintain. In the end EUCOFI did not rule on this point but it is relevant to see where further objections to a future proposed EMI-WMG tie up might lie.

The implications of this

- The stock market has, in our view, taken the view that the annulment of the Sony-BMG merger by the European Court of First Instance is mainly an inconvenience and is a decision likely to be reversed. This derives, we think, from much of the press commentary at the time which focused on flaws in the EU's methodology of investigation as being the main problem in the blocking of Sony-BMG. The implication therefore was that, once the flaws in the process were ironed out, the Sony-BMG merger would be allowed and that would in turn provide a spring board for an EMI-WMG deal.

- The probability that a further merger, that of EMI and Warner subsequently being allowed can from that point be no more than 50%.
- The overall prospect of both mergers being allowed (assuming EMI-Warner is necessarily contingent on Sony-BMG being passed) is no more than 30%.
- Timing on such permission could easily be 18 months to two years away.
- On this basis the market should now act as if the prospect of an EMI-WMG deal is effectively dead.

EMI: Will they make the full year forecasts?

Risks on the downside

In its trading statement ahead of the half year results EMI stressed that it *"confirms confidence in its expectations for the full year"*. More specifically it highlights,

"The strength of upcoming releases, together with continuing strong momentum at EMI Music Publishing and further good progress on the cost savings initiatives announced in April 2006, give the Board confidence that the group is on track to deliver results in line with its expectations for the full year".

EMI, however, is not explicit over what its full year expectations are.

Looking at the components of our forecasts.

Music Publishing: Full year forecasts look achievable

In Music Publishing we look for 3.8% revenue growth for the full year to £435m which compares with a first half flat outturn on a constant currency basis. After H1 predicted revenues of £203m this implies H2 revenues of £232m (H2 2004/5 £210m, H2 2005/6 £215m), which looks relatively demanding despite EMI's assertions of its strong H2 music publishing release schedule. This is balanced by EMI Music Publishing's margin performance where the H1 margin is expected to be 25% versus our full year forecast of 24.8%. Assuming the margin can be held in the second half, our overall EBITA forecast of £108m for the year (+2.5%) appears reasonable.

Recorded Music: Full year forecasts more vulnerable

The key assumptions in our full year forecasts for Recorded Music are:

- We look for recorded music market growth of 2% in each of 2006/7, 2007/8 and 2008/9.
- We assume that EMI can hold its market share at 13.1% in each year.
- We feed £30m of cost savings into the business at the rate of £10m in 2006/7, £15m in 2007/8 and £5m in 2008/9.

IFPI numbers suggest 2% music market growth may be optimistic

The first challenge to these numbers is the condition of music markets. The IFPI numbers for the first half of calendar 2006 (includes only one quarter of the EMI 2006/7 financial year) were relatively poor. Despite a 106% rise in digital music sales in the first half, a 10% decline in physical music sales meant a 4% fall in the overall trade value of music to $8.4bn. Within this the US was down 7%, France down 9% and Germany down 4%. The difference between US retail sales (down around 2%) and the 7% wholesale decline reflects the post-Christmas stock hangover.

Q3 calendar sales are also identified by most of the music majors as likely to be weak, attributed by most to a relatively weak release schedule. Vivendi's Universal Music group, which reported on November 7, showed Q3 constant currency sales growth of just 0.8% (although nine month sales were up 1.4%). Most of the majors are relying on a substantial release schedule in Q4 to see the market pick up.

The key point, however, is that the figures for the overall music market continue to be weak with the surge in physical sales still not replacing the decline in physical sales three years after the introduction of the Apple iPod and the iTunes store and despite their proliferation around the world. Assuming that 2006 as a whole remains in negative territory it will be the sixth successive year of value decline in the global music market. We have shown this type of analysis before (see *'Pop Will Eat Itself'* - October 14 2005). If the physical music business (which still represents around 90% of industry sales) declines by 5% pa to the end of the decade and the digital market expands by $1.8bn pa each year until 2010 (a compound growth rate of 73%) then the value of the global recorded music market will grow by just 0.26% pa 2005-2010.

Our reading of the full EUCOFI decision is much more negative, we feel, for the prospect of future merger activity in the recorded music industry. We think:

- That the original thinking of the EU concluded that a position of collective dominance amongst five music majors could already exist.
- That there is sufficient transparency on pricing and indeed evidence of parallel pricing in the music industry to allow for the possible existence already of a collective dominance position.
- That the EU did not manage to disprove its original thesis of the existence of a collective dominance position in the music industry.
- And that, before a merger can be allowed, the EU must in turn prove that the reshaping of the industry will not result in a future collective dominance position.

Critically the issue is not one of poor process in proving the absence of collective dominance by the EU. Rather the EUCOFI's point appears to be that, in its evidence, the EU established that a collective dominance position probably did exist but that, over a short timescale at a late stage in its deliberations, it changed its mind and declared that a collective dominance position did not exist. The EUCOFI's view is that this late change was wrong - the suggestion being that a collective dominance position probably did already exist (or could not be ruled out) and that such a collective dominance position might be strengthened or created by further consolidation through the Sony-BMG merger.

The specific implication of this is:

- It is by no means certain that the Sony-BMG merger will be retrospectively permitted. The EUCOFI appears to lean towards a condition of collective dominance with five music majors (Universal, Sony, EMI, BMG, Warner) and is reluctant to see this move to four majors.
- The main impetus of allowing the Sony-BMG merger is that defacto it exists already. If permission is granted for Sony-BMG to continue in its present form this is likely to be accompanied by relatively stringent conditions on the behaviour of the merged entity and its counterparts in the music industry.
- In turn this would appear to explain the delay in Sony-BMG applying once more to the EU to have its merger permitted. The process is that Sony-BMG must apply once more to the EU and the EU must consider its verdict afresh. It will require much more robust evidence for Sony BMG and the EU to prove opaque market structure and non-collective dominance in the past. There will also be the necessity for Sony-BMG and the EU, for the first time, to model the future industry to prove that collective dominance will not be caused by allowing the industry to move from five to four players. This puts a substantial burden on the applicants. It could take them many months to collect such data as well as the 6 - 7 month EU formal process once the application is in. It could yet be twelve months before the EU is ready to make its decision. In turn a positive decision, if forthcoming, is again likely to be appealed by Impala, further lengthening the uncertainty.
- Even if the Sony-BMG merger is eventually allowed the nature of the Impala complaint and the investigation process on collective dominance makes it clear that permission to move an industry from five players to four does not provide carte blanche for further industry consolidation. An attempt to move from four players to three would require separate investigation as to its effects on the symmetry of the industry.

  This may explain why thus far Sony-BMG has failed to resubmit its merger to the EU authorities. Thus far it has contented itself with an appeal against the EUCOFI decision (October 5). This will be held by the European Court of Justice and such cases usually last more than a year.
- When, and if, Sony BMG resubmits its application to the EU, the EU can approve it, reject it or ask the companies to make remedies to deal with outstanding concerns.

Put plainly our view is:

- The prospect of the Sony-BMG merger eventually being allowed is in our view no more than 60%, but with stringent conditions likely to be attached.

- Revenue synergies would be relatively slight but there would be some modest benefits in broadening both the geographical reach and the diversity of artists in the combined group.

- Commentary from the managements of both EMI and WMG suggest that cost savings in the combined group could be in the order of £200m, attractive against a joint EBITA base of around £470m in 2006.

- There are potential tax benefits from the combination. Notably EMI had unused tax losses of £441.5m available for offset against future profits at its March 2006 balance sheet date. We believe much of these losses are in the US and it is possible that a combined WMG-EMI could use these losses more readily than EMI alone.

The stock market has assumed in relation to EMI either that at some stage a WMG bid for EMI is revived (it last offered 315p) or that EMI revives its bid for WMG to capture synergies (we have previously calculated EMI could pay up to $35 per WMG share and still create value).

The Regulatory Obstacles look Substantial

We have spenT some time looking at the European Court of First Instance's decision to block the Sony-BMG merger. It is our view, and appears to be that of the EMI and WMG managements, that renewed permission for this deal would be a necessary precursor for any revival of plans to combine WMG and EMI.

The issue on which the European Court of First Instance annulled the Sony-BMG merger relates chiefly to the issue of *'collective dominance'*.

The background to this is that the EU, under Mario Monti as Competition Commissioner, used regularly to reject business mergers and takeovers on the basis of the reduction in competition that would be deemed to ensue through the *'collective dominance'* of the remaining players. The ability of the EU to block industry consolidation simply on the basis of the reduction in the number of industry players was overturned by the European Court of First Instance's decision on the First Choice / Airtours merger in 2002. This ruled that the travel industry was allowed to consolidate from three to two players and set more stringent criteria on the definition of industry behaviour that would be required to stop consolidation activity.

In the light of the Court's decision Sony-BMG announced their Recorded Music merger in 2003, reducing the number of global music majors from five to four. The EU's decision to allow the merger in July 2003 was appealed by IMPALA (the Independent Music Publishers and Labels Association) in December 2003 and the EU Court of First Instance's decision was made in July 2006.

The European Court of First Instance (EUCOFI) has annulled the EU's positive decision to allow the Sony-BMG merger on two grounds:

- First that the EU had not disproved the existence already of a collective dominance position amongst the music majors.

- Second that the EU is required to prove that a collective dominance position would not be created by the Sony-BMG merger and that it failed to do so.

Looking at the EUCOFI decision, the key points are:

(i) The EU had concluded initially that there were *'some indications of coordinated behaviour [on pricing] which were as such, however, not sufficient to establish collective dominance'* (note 265).

(ii) The EUCOFI noted that the EU's decision to declare that there was no established collective dominance was made very late in the investigation process. EUCOFI comments,

"The fundamental u-turn in the Commission's position may indeed appear surprising, particularly in view of the late stage at which it was made".

(iii) In deciding on whether a position of collective dominance exists, the transparency of the market is key, in that it allows co-ordination of pricing. The EUCOFI observes that in previous EU reports, notably on the 2000-1 EMI-Warner merger the market had been described as *'very transparent'* and that the UK OFT in its report of September 2002 had similarly regarded the market as possessing *'a high degree of transparency'*. Indeed the initial finding of the EU on Sony BMG in May 2004 had also concluded provisionally that the transaction was incompatible with the common market notably because it would strengthen a collective dominant position on the market for recorded music. In coming to this decision the Commission initially

Exhibit 9
EMI Recorded Music: Historical Record

Recorded Music	2001	2002	2003	2004	IFRS 2005	IFRS 2006	CAGR %
Turnover	2282	2029.4	1774.2	1723	1601	1660	-6.2
Costs	-2054.5	-1946.3	-1623.1	-1575	-1475	-1515	
Operating profit	227.5	83.1	151.1	147	126	145	
Less licence income	-5.7	0	0	0	0	0	
Operating profit ex licence income	221.8	83.1	151.1	147.4	126	145	-8.1

Source: Company data, Morgan Stanley Research

Will private equity bid for EMI?

There has been consistent bid speculation in EMI for the last ten years. During that period the company has held talks with *Polygram (1997)* and *Seagram (1997)*, has attempted a merger with Warner Music (2000 - 2001), has studied a merger with Bertelsmann Music Group (2001), has made an offer for Warner Music Group (2006) and has been in receipt simultaneously of an offer from WMG at an indicated level of first 315p and then 320p in cash.

With the Warner Music situation in abeyance following the EU Court of First Instance's unexpected decision to disallow the 2003 merger of the Sony-BMG recorded music activities, the stock market's attention has turned towards whether private equity may bid for EMI. The instigation for this appears to be the interest shown by private equity in the BMG Music Publishing (MP) assets. The concept appears to be that private equity would buy EMI to capture its Music Publishing business with the intention that it should be possible at some stage to job on the Recorded Music business to Warner.

The impending departure of Marty Bandier, the former CEO of EMI Music Publishing, who is due to leave the EMI Group in April 2007 has raised the intensity of consideration of the future structure of EMI. Bandier commented in October this year:

"What this notice does is allow me to explore opportunities with the usual suspects and some unusual suspects and even EMI"

noting about private equity,

"I think there are opportunities in that area as well".

The factors in favour of a private equity bid for EMI would be:

- It would attract minimal regulatory attention.
- The strong cashflow characteristics of music publishing would be appealing to private equity.
- It should be possible for private equity to refinance EMI's debt more cheaply.

The key potential obstacles would be (i) the still unattractive prospects for the recorded music business even with the help of the digital impetus (ii) the problem of the destination of the recorded music business - the only conceivable industry buyer is WMG, who may not receive regulatory permission to buy it.

There have been consistent reports in the press (the Financial Times 7th November et passim) that the Dubai government investment agency Istithmar is interested in buying a controlling stake in EMI.

The private equity element of Istithmar has an extensive property portfolio plus investments in around 30 different companies worldwide. These are focused on four industry areas, Consumer, Industrial, Financial Services and Real Estate. Notably Istithmar bought a 2.7% stake in Standard Chartered recently for $1bn and in total has spent more than $12.5bn on foreign assets this year, including P&O for $6.8bn. Istithmar also has a 2.39% stake in Time Warner and was, for a while, supportive of the Icahn plan to put pressure on Time Warner management.

Istithmar's CEO is Muneef Tarnoom. He has stated, *"We do have a preference for majority ownership stakes in order to control our investments and actively to manage our investee companies to maximise shareholder value"*.

He stresses that currently the *'consumer products'* vertical focus is on retail, healthcare and media.

In an interview with Gulf News the joint - CEO David Jackson revealed in mid-October that Istithmar has earmarked $7bn

Exhibit 10

The Global Music Market: Another Depiction of Growth

$bn	2005	2006e	2007e	2008e	2009e	2010e
Physical	31.92	28.7	27.3	25.9	24.6	23.4
Change %	-5	-10	-5	-5	-5	-5
Digital	1.8	3.6	5.4	7.2	9.0	10.8
Change %	350	100	50	33	25	20
Total	33.72	32.33	32.69	33.11	33.61	34.17
Change %	-0.8	-4.1	1.1	1.3	1.5	1.7

e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

The more recent evidence from the US Soundscan numbers point towards the expected Q4 pick up beginning to occur. Up to November 4 album sales (including digital track equivalents) were down just 1% year on year at the retail level.

Against this background, however, 2% annual growth in the market in the next three years looks relatively challenging. As an indicator each one point difference in global recorded market growth is equivalent to around £4m on or off our EBITA forecast for EMI Recorded Music, equivalent in turn to 2.3% off group pre-tax.

Market share assumptions also optimistic

EMI's music market share rose from 12.9% in 2004/5 to 13.1% in 2005/6. This was to be expected given the weak comparable (Recorded Music Sales dropped 10.4% in 2004/5 with global share falling from 13.5% to 12.9%) and the benefit of the delayed albums (Coldplay, Gorillaz) from 2004/5. Overall EMI had 20 artists who sold over 1 million albums in 2005/6 and 3 albums which sold over 5 million units including one, Coldplay's X & Y which sold almost 10 million units.

Exhibit 11 shows the outline of the release schedule for 2006/7.

Exhibit 11

Release Schedule 2006/7 - 21 potential one million plus sellers

	Potential 5m units plus		
1	Norah Jones	2	Robbie Williams
	Potential 3-5m units		
3	Keith Urban	6	RBD
4	The Beatles	7	Joss Stone
5	Janet Jackson		
	Potential one - three million units		
8	Hikaru Utada	15	Tiziano Ferro
9	KT Tunstall	16	Trace Adkins
10	Lenny Kravitz	17	Dierks Bentley
11	Chingy	18	Underoath
12	Relient K	19	Bubba Sparx
13	Renaud	20	Herbert Grunemeyer
14	Stacie Orrico	21	Renaud

Source: Company data, Morgan Stanley Research

Broadly this shows that EMI has 21 potential one-million plus sellers in 2006/7 versus 20 in 2005/6. Overall, against a tough comparative in 2005/6 the release schedule looks reasonably good. Notably:

- EMI has two albums which we expect to sell more than 5 million units in 2006/7, being Robbie Williams (released in late October, 2 million units sold already) and Norah Jones (due to be released in fiscal Q4, ie post Christmas). This is a weaker line up than in 2005/6 when three albums, Coldplay, Gorillaz, Robbie Williams sold 22 million albums between them.

- We anticipate EMI will have five albums selling between 3 and 5 million units. All of these albums with the exception of Joss Stone should be available in the Q3 Christmas quarter. In 2005/6 EMI had no albums selling between 2 million and 5 million units.

- At present we can identify around 14 albums from EMI which should sell between one million and three million albums versus 17 such albums last year.

Overall the album release schedule should emerge as similar to 2005/6 (albeit with some risk on the late release of the Norah Jones and Joss Stone albums) and broadly enable EMI to hold, but probably not to advance, market share.

Exhibit 12

EMI -The relationship between major albums, market share and Recorded Music sales

	Global market share %	Recorded Music sales £m	1m+sellers (ex compilations)	3m+ sellers	5m+ sellers	Total 1m+sellers (ex comps)	Total 1m+sellers (inc comps)	Major albums
1997	14.3	na	16	2	2	20	25	Spice Girls (9.5m), George Michael (5m)
1998	14.8	2115	21	3	3	27	32	Spice Girls (11m), Garth Brooks (6m), The Verve (5m)
1999	13.5	2057	18	3	2	23	27	Garth Brooks (6.1m),Beastie Boys (5.5m)
2000*	12.5	2033	25	2	0	27	30	Utada (4.8), Backstreet Boys (3.0)
2001	14.1	2282	19	3	2	24	31	Beatles 1 (21.6m), Lenny Kravitz (8.7m)
2002	13.4	2029	20	4	3	27	27	Robbie Williams(5.4m), Pink Floyd (5.1m),Janet Jackson (5.1m)
2003	12.6	1774	13	2	4	19	19	Norah Jones (11.6m), R Williams (5.8m),Coldplay (5.6m), Rolling Stones (5.5m)
2004	13.2	1723	15	3	2	20	20	Norah Jones (7.5m,5.5m)
2005	12.9	1601	16	0	1	17	17	Robbie Williams (6m)
2006	13.1	1660	17	0	3	20	20	Coldplay (9.9m), Robbie Williams (6.2m),Gorillaz (5.9m)
2007e	13.1	1681	14	5	2	21	21	Norah Jones, Robbie Williams

*Full breakdown not available
e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

Put more simply our full year forecast for Recorded Music EBITA is, including the £9m hit from the Brazilian fraud, £149m. In the first half we expect this figure to be £11m. This requires EMI Recorded Music to contribute £138m of EBITA in H2. Exhibit 13 shows the half year contributions of the EMI Recorded Music business going back to 1997/8. Only twice in the last nine years has H2 Recorded Music EBITA exceeded the £138m we anticipate this year. The best H2 profit recently experienced by EMI was in 2000/1 when its £162m of EBITA was bolstered by the sale of 21.6 million Beatles *'One'* albums. The other occasion was the £138.9m profits of 1997/98 when 11 million Spice Girls album units (and 6 million Garth Brooks were sold). In the last five years the second half profits of EMI Recorded Music have ranged between £91m and £123m. Even taking cost savings into account this implies we could yet be £15m high on our Recorded Music numbers for the current year.

Exhibit 13

Recorded Music EBITA - Historic Record

	H1	H2	FY
1998	112.6	138.9	251.5
1999	51.5	130.7	182.2
2000	78.4	91.9	170.3
2001	59.9	161.9	221.8
2002	-8.1	91.2	83.1
2003	28	123.1	151.1
2004	28.2	119.2	147.4
2005	28.4	97.6	126
2006	36.3	108.7	145
2007e	11	138	149

e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

For the moment we content ourselves with reducing our full year forecasts for the fraud in Brazil. Our revised numbers are shown in Exhibit 14 *below*.

Exhibit 14
EMI- Forecasts Reduced

Y/e 31/3			2006e	2007e	2008e	2009e
Turnover	Was	£m	2079	2126	2182	2237
	Is	£m	2079	2116	2182	2237
	Change	%	0.0	-0.5	0.0	-
EBITA	Was	£m	250.5	266.4	289.2	302.8
	Is	£m	250.5	257.4	289.2	302.8
	Change	%	0.0	-3.4	0.0	-
EBITA margin		%	12.0	12.2	13.3	13.5
Pre Tax Profit	Was	£m	159.3	178.4	203.2	218.8
	Is	£m	159.3	169.4	203.2	218.8
	Change	%	0.0	-5.0	0.0	-
Net EPS Diluted	Was	£m	15.7	16.4	18.6	20.0
	Is	£m	15.7	15.6	18.6	20.0
	Change	%	-0.1	-4.7	-0.0	-
Net EPS Growth		%	19.8	-0.3	18.7	7.6

e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

Our view is, however, that there is considerable risk in these forecasts, chiefly related to the Recorded Music operations. At its simplest level, if we were to assume flat music market growth in each of 2006/7 to 2008/9 and EMI holding market share, our forecasts would drop by £8m (5% of group) in 2006/7, £17m in 2007/8 (8%) and £26m (12% of group in 2008/9).

Valuing EMI

A valuation of EMI must combine a number of factors, notably the possibility of a revival of the merger proposals with Warner Music Group.

We look at the standalone valuation of EMI in two ways.

Sum of the parts

We outlined our sum of the parts earlier in this note. Based on current forecasts, a DCF valuation for Recorded Music and a valuation derived from the lower end of the implied Vivendi-BMG multiples, we arrive at a sum of the parts valuation of 295p per share (see Exhibit 8).

On a comparative basis at 277p EMI's valuation is broadly in line with that of the UK Media sector, although we would regard the vulnerability of forecasts at EMI to be greater than in the rest of the sector. The stock trades on:

- An EV/Sales ratio of 1.58x calendarised in 2006 dropping to 1.50x in calendar 2008. This remains amongst the lowest in our coverage (DMGT, Premiere, WPP, Taylor Nelson, Havas are lower). We estimate the average EV/Sales for UK media in 2006 and 2007 to be 2.3x and 2.2x.
- An EV/EBITDA multiple of 11.8x calendar 2006, dropping to 10.8x 2007 and 10.2x 2008. The average EV/EBITDA multiple of UK media is at a discount to this at 10.9x 2006 dropping to .9.94x 2008.
- A P/E of 17.9x 2006 calendar dropping to 15.5x 2007 and 14.3x 2008. This is again a modest premium to the UK media sector on 17.3x, 15.5x and 13.7x in the next three years.
- EMI's free cashflow remains relatively weak, impacted in 2006/7 and 2007/8 by £30m of incremental restructuring costs in either year. After £58m in 2005/6 we look for £95m of free cashflow in 2006/7 and £126m in 2007/8. Much of this free cashflow is absorbed by the £63m annual cost of the dividend. The FCF yield is unimpressive against the sector at 3.6% in calendar 2006 rising to 6.5% in 2008.

Exhibit 15
EMI: Free Cash Flow

	2004	2005	2006	2007e	2008e	2009e
Operating Profit	249.3	226	251	257	289	303
Depreciation	35	24	25	25	25	25
EBITDA	284.3	250	276	282	314	328
Less						
Working Capital	58.3	25.2	-27.8	0	0	0
Capex	-51.3	-29.9	-30	-30	-25	-25
Interest Paid	-95.4	-101.6	-102.3	-88	-86	-84
Tax	-30.6	-32.7	-39.8	-39.0	-48.7	-50.3
Restructuring	-36.1	-70.7	-17.9	-30	-30	0
Provisions	0	7.8	0	0	0	0
Musicmaker	0	0	0	0	0	0
Free Cash Flow	129	48	58	95	126	168
Dividend Cost	-63	-63	-63	-63	-63	-63
Available for EMI uses	66.5	-15.2	-5.1	32.6	63.6	105.6
FCF per Share	10.47	5.47	8.62	10.94	14.48	19.28
FCF Yield %	6.7	2.2	2.7	4.5	5.9	7.9
Price/FCF	14.9	44.8	37.0	22.4	16.9	12.7

e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

- EMI's yield premium against the sector has been heavily eroded. EMI yields 2.9% on a dividend likely to be maintained but not increased and is now in line with the yield of the All share. EMI continues to struggle with its debt burden and there is no prospect of incremental cash returns.

- Our conclusion is that on a comparative standalone basis EMI at current prices looks fully valued. The market must also be wary that these forecasts appear to be based on demanding assumptions both for the Recorded Music market and for EMI's own performance.

Exhibit 16
EMI Multiples

Y/e 31/3		2005	2006	2007e	2008e	2009e
Turnover	£m	2001	2079	2116	2182	2237
EBITDA	£m	250	276	282	315	329
Pretax Profits	£m	134.5	159	169	203	219
Net Eps (FD)	p	13.1	15.7	15.6	18.6	20.0
FCF Per share	p	5.5	6.6	10.9	14.5	19.3
Net Dividend	p	8.0	8.0	8.0	8.0	8.0
EV/Sales	x	1.68	1.60	1.57	1.52	1.49
EV/EBITDA	x	13.3	12.1	11.0	10.5	10.1
P/e	x	21.4	17.9	17.9	15.1	14.0
FCF Yield	%	2.0	2.4	3.9	5.2	6.9
Dividend Yield	%	2.9	2.9	2.9	2.9	2.9
Calendarised						
Turnover		2060	2107	2168	2223	
EBITDA		269	281	307	325	
Pretax Profits		153	167	195	215	
Net Eps (FD)		15	16	18	20	
FCF Per share		6	10	14	18	
Net Dividend		8	8	8	8	
EV/Sales		1.61	1.58	1.53	1.50	
EV/EBITDA		12.35	11.84	10.83	10.21	
P/e		18.6	17.9	15.7	14.3	
FCF Yield		2.3	3.5	4.9	6.5	
Dividend Yield		2.86	2.86	2.86	2.86	

e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

Exhibit 17

EMI - Divisional Forecasts

Year ending March Recorded Music	2004	IFRS 2005	IFRS 2006	IFRS 2007e	IFRS 2008e	IFRS 2009e
Turnover	1723	1601	1660	1681	1727	1762
Costs	-1575	-1475	-1515	-1532	-1551	-1577
Operating profit	147	126	145	149	176	185
Less licence income	0	0	0	0	0	0
Operating profit ex licence income	147.4	126	145	149	176	185
Turnover growth %	-2.9	-7.1	3.7	1.3	2.7	2.0
Cost growth %	-2.9	-8.4	2.7	1.1	1.3	1.7
Operating growth cum licence income %	-2.4	-14.9	15.7	3.0	17.8	4.8
Operating profit growth ex licence income %	-2.4	-14.9	15.7	3.0	17.9	4.9
Operating margin (%)	8.5	7.8	8.7	8.9	10.2	10.5
Margin including licence income (%)	8.6	7.8	8.7	8.9	10.2	10.5
Music Publishing						
Turnover	397.9	400.7	419	435	455	475
Costs	-217	-215.7	-229	-244	-263	-282
Net publishing share	181	185	190	191	192	193
Costs	-79	-84.6	-84.6	-83	-79	-75
Operating profit	101.9	100.2	105.4	108	113	118
Turnover growth %	-0.8	0.7	4.6	3.8	4.6	4.4
Costs growth %	3.5	7.2	-0.2	-1.9	-4.0	-5.1
Operating profit growth %	-1.6	-1.7	5.2	2.5	4.8	4.4
NPS margin %	45.5	46.2	45.3	43.9	42.2	40.6
Operating margin %	25.6	25.0	25.2	24.8	24.8	24.8
Total Group						
Turnover	2120.7	2001	2079	2116	2182	2237
Costs	-1871.4	-1776	-1829	-1859	-1893	-1934
Operating profit ex licence income	249.3	226	251	257	289	303
Turnover growth %	-2.5	-5.6	3.9	1.8	3.1	2.5
Operating profit growth %	-2.1	-9.5	11.0	2.8	12.3	4.7
Margin %	11.8	11.3	12.0	12.2	13.3	13.5

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

Exhibit 18

EMI: Income Statement

Year ending March £m unless stated	IFRS 2005	IFRS 2006	IFRS 2007e	IFRS 2008e	IFRS 2009e
Recorded Music revenues	1600.5	1660.3	1681.5	1727.4	1761.9
Music Publishing revenues	400.7	419.0	435.0	455.0	475.0
Total EMI Music revenues	2001.2	2079.3	2116.5	2182.4	2236.9
Total Revenues	2001.2	2079.3	2116.5	2182.4	2236.9
% chg		3.9%	1.8%	3.1%	2.5%
Recorded Music Costs	(1,475.0)	(1,515.1)	(1,532.0)	(1,551.2)	(1,577.1)
Recorded Music Operating Profit	125.5	145.1	149.4	176.2	184.8
Margin	7.8%	8.7%	8.9%	10.2%	10.5%
Music Publishing Costs	(301.1)	(313.6)	(327.0)	(342.0)	(357.0)
Music Publishing Operating Profit	99.6	105.4	108.0	113.0	118.0
Margin	24.9%	25.2%	24.8%	24.8%	24.8%
Headline Operating Profit	225.1	250.5	257.4	289.2	302.8
Other	(17.5)				
Total Operating Costs	(1,793.6)	(1,828.7)	(1,859.0)	(1,893.2)	(1,934.1)
Operating Profit	207.6	250.5	257.4	289.2	302.8
of which associates	0.0	0.0	0.0	0.0	0.0
Operating Exceptionals	0.0	0.0	0.0	0.0	0.0
Non-operating Exceptionals	(0.8)	0.0	0.0	0.0	0.0
Associates	1.1	1.0	0.0	0.0	0.0
Net interest	(61.7)	(92.2)	(88.0)	(86.0)	(84.0)
HMV result	0.0	0.0	0.0	0.0	0.0
PBT	147.0	159.3	169.4	203.2	218.8
PBT Pre-Exceptionals	141.1	159.3	169.4	203.2	218.8
Continuing tax	(23.9)	(28.1)	(39.0)	(46.7)	(50.3)
Minorities	(0.5)	(3.9)	(3.5)	(4.0)	(4.5)
Minorites post-amortisation/exceps	(0.5)	(3.9)	(3.5)	(4.0)	(4.5)
Net income pre-amortisation	122.6	127.3	127.0	152.4	164.0
Net income pre-exceptionals	118.7	127.3	127.0	152.4	164.0
Amortisation of Music Copyrights	(48.0)	(49.3)	(50.5)	(51.8)	(53.1)
Amortisation of Goodwill	0.0	0.0	0.0	0.0	0.0
Group Net Income	74.6	78.1	76.5	100.7	110.9
Exceptionals	(13.5)	0.0	0.0	0.0	0.0
Amortisation of music copyrights	48.0	49.3	50.5	51.8	53.1
Minorities	(4.1)	0.0	0.0	0.0	1.0
Convertible bond adjustment	9.0	9.5	9.5	9.5	9.5
Headline Net Income	114.0	136.8	136.5	161.9	174.5
Weight av. shares	785.6	785.6	785.6	785.6	786.6
Options dilution	8.4	8.4	8.4	8.4	8.4
Convertible dilution	78.9	78.9	78.9	78.9	78.9
Fully Diluted shares	872.9	872.9	872.9	872.9	873.9
Basic EPS	9.6	9.9	9.7	12.8	14.1
% chg		3.3%	-2.1%	31.6%	10.0%
Headline EPS	13.1	15.7	15.6	18.6	20.0
		20.0%	-0.3%	18.7%	7.6%
EBITDA	250.2	275.5	282.4	314.2	327.8
Adj. EBITDA	250.2	274.5	282.4	314.2	327.8

e = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

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Overweight/Buy	801	38%	309	44%	39%
Equal-weight/Hold	942	45%	308	44%	33%
Underweight/Sell	345	17%	78	11%	23%
Total	2,088		695		

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Industry Coverage:Media & Internet

Company (Ticker)	Rating (as of)	Price (11/08/2006)
Edward Hill-Wood		
CTC Media (CTCM.O)	E-V (07/11/2006)	US$23.90
DMGT (DMGOa.L)	O (10/18/2006)	650p
Havas (EURC.PA)	E (09/20/2004)	€3.92
Johnston Press (JPR.L)	E (03/15/2006)	422p
Publicis Groupe (PUBP.PA)	E (10/23/2003)	€29.06
Taylor Nelson Sofres (TNN.L)	O (01/27/2006)	205p
Trinity Mirror (TNI.L)	O (10/18/2006)	489p
Yell (YELL.L)	O (01/25/2006)	589p
Javier Martin, CFA		
Enro (ENRO.ST)	NA (09/26/2005)	SKr 85.75
Grupo Media Capital (MCP.LS)	E (09/01/2005)	€8.34
Grupo Prisa (PRS.MC)	NA (11/02/2005)	€13.09
Impresa (IPR.LS)	O (09/01/2005)	€4.30
PagesJaunes (PAJ.PA)	E (05/24/2005)	€23.52
Seat Pagine Gialle (PG.MI)	O (11/25/2004)	€0.44
Sogecable (SGC.MC)	O (05/25/2006)	€25.17
TPI (TPI.MC)	E-V (03/15/2006)	€8.33
Tiscali (TIS.MI)	E (10/13/2004)	€2.40
Trader Media East (TMEq.L)	NA-V (03/24/2006)	US$8.18
Anna Poulter		
GCap Media (GCAP.L)	E (10/18/2006)	210p
Gestevision Telecinco (TLS.MC)	E (07/14/2005)	€20.72
M6 (MMTP.PA)	U (11/06/2006)	€24.40
Sarah Simon		
Antena 3 (A3TV.MC)	U (11/06/2006)	€16.55
BSkyB (BSY.L)	E (05/11/2006)	554p
Eutelsat Communications (ETL.PA)	O-V (04/07/2006)	€14.44
ITV (ITV.L)	O (10/18/2006)	106p
JCDecaux (JCDX.PA)	O (10/05/2006)	€20.36
Lagardere (LAGA.PA)	O (02/01/2006)	€56.65
Mediaset (MS.MI)	E (11/06/2006)	€9.11
Premiere (PREGn.DE)	E-V (05/22/2006)	€13.70
Pro Sieben (PSMG_p.DE)	O (11/06/2006)	€23.00
SES Global (SESFd.PA)	E (05/15/2006)	€12.86
TF1 (TFFP.PA)	U (02/03/2004)	€27.72
Louise Singlehurst		
Informa (INF.L)	O (09/19/2005)	549p
Patrick Wellington		
EMAP (EMA.L)	E (09/07/2006)	780p
EMI (EMI.L)	E (05/30/2006)	277p
Pearson (PSON.L)	O (01/20/2006)	773p
Reed Elsevier NV (ELSN.AS)	E (08/03/2004)	€13.59
Reed Elsevier PLC (REL.L)	E (08/03/2004)	597p
Reuters (RTR.L)	O-V (03/08/2006)	455p
United Business Media (UBM.L)	O (10/04/2006)	686p
Vivendi Universal (VIV.PA)	E (07/03/2003)	€29.43
WPP Group Plc (WPP.L)	E (02/23/2006)	677p
Wolters Kluwer (WLSNc.AS)	E (01/06/2005)	€22.20

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ModelWare EPS illustrates the approach. It represents ModelWare EPS as ModelWare net income divided by average fully diluted shares outstanding. ModelWare net income sums net operating profit after tax (NOPAT), net financial income or expense (NFE) and other income or expense. ModelWare adjusts reported net income to improve comparability across companies, sectors and regions. Among these adjustments: We exclude goodwill amortization and items deemed by analysts to be "one-time" events; we capitalize operating leases where their use is significant (e.g., in transportation and retail); and we convert inventory to FIFO accounting when LIFO costing is used. For more information on these adjustments and others, as well as additional background, please see *Morgan Stanley ModelWare (ver. 1.0): A Road Map for Investors*, by Trevor Harris and team, August 2, 2004.

EXHIBIT CO 0966

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May 17, 2006

Stock Rating
Equal-weight-V

Industry View
Attractive

Warner Music Group

EMI Bid Makes Long-Term Cost Cuts Look Credible

What's Changed

Rating	Underweight-V to Equal-weight-V
Price Target	$17.00 to $25.00

Conclusion: We are upgrading WMG to Equal-weight-V with a new, $25 price target. EMI's recent $28.50 bid has shaped a consensus in the industry and among investors that cost-cuts at WMG can be sustained for the long term. With or without another bid by EMI, this should help support the stock even though our theoretical intrinsic value shows we still question whether marketing and G&A cost reductions are sustainable over long periods. Our new, $25 price target lies halfway between our base-case estimate of intrinsic value and a bull case premised on $250 million in cost synergies as part of an EMI acquisition. Our new rating and target are intended to be a clear admission that our valuation and operating forecasts were wrong for the next 12-24 months.

What's New- Revenues: F2Q06 showed we were wrong about two key near-term trends. Lower physical sales have been offset by better than expected digital revenues. Digital sales, $54 million greater than our estimates, offset shortfalls in physical revenue in 1H06. The digital revenue base is small and unpredictable, but we have increased our F2006-2010 forecast.

What's New- Margins: Operating margins were also better than expected in 1H06. EBITDA margins were 17.1% versus 13.5% in our forecast. The upside was driven by lower A&R and royalty expenses. However, marketing was higher was than expected. We warn against fully extrapolating trends from any one quarter into the long term, and believe that trailing two quarters, or even trailing four quarters results are more reliable. While we have adjusted our F2006-2010 A&R and royalty expense forecasts, we would caution that these cuts could put long-term revenue growth at risk.

Key Ratios and Statistics

Reuters: WMG.N Bloomberg: WMG.N
Entertainment, United States of America

Price Target	$25.00
Stk price close (May 16, 2006)	$27.69
Mkt cap, o/s (mm)	$4,141
52 Week Range	$28.00-14.70

Fiscal Year (Sep)	2005	2006e	2007e	2008e
ModelWare EPS ($)*	$0.82	$1.12	$1.04	$1.01
Prior ModelWare EPS ($)	$1.[illegible]	$0.91	$0.89	$0.63
P/E	22.5	24.8	26.9	27.6
Consensus EPS ($)	$0.25	$0.12	$0.29	$0.35
Div yld (%)	28.1	2.0	2.0	2.0

* Please see explanation of Morgan Stanley ModelWare later in this note.
e = Morgan Stanley Research estimates

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Investment Case

Summary & Conclusions

We are upgrading shares of Warner Music Group from Underweight-V to Equal-weight-V based on apparent prospects for consolidation in the music industry. However, we remain skeptical that marketing and G&A cost reductions are sustainable over long periods of time. The bullish view of the music industry is that consolidation will drive marketing and G&A cost reductions. We do not disagree with this thesis in the short-term, but we are skeptical of the sustainability of further cost reductions in the long-term. We have also increased our estimate of intrinsic value from $17 to $22 and our price target from $17 to $25. Our increased digital forecast adds $2 to our valuation; changes to our A&R, royalties, and licensing cost forecasts drive another $3 to our valuation. The $3 premium between our $22 intrinsic value estimate and our $25 price target relates to the possibility that EMI could come back with a new bid for the company, above the earlier reported bid of $28.50 level.

Our new rating and target are intended to be a clear admission that our valuation and operating forecasts were wrong for the next 12-24 months. We believe that the primary downside risk to our target price is that operating performance deteriorates more quickly than our revised forecast. The primary upside risk is a significantly increased bid from EMI.

WMG confirmed through a press release on May 3, that the board had rejected a bid valued at $28.50 per share from EMI. If we assume that consolidation could lead to approximately $250 million of synergies over the combined company, then the intrinsic value of Warner (i.e. excluding an acquisition premium) is approximately $29. The two companies have a relatively equal revenue base, which implies $125 million allocated to WMG and translates into $75 million on an after-tax basis. Applying a 15-16x multiple to the after-tax synergies would result in an approximately $29 per share intrinsic value. The rest of the synergies are assumed to accrue to EMI. However, if EMI believes that it could generate $250 million or more in synergies, it may be willing to pay $30 per share or more. Given, the level of EMI's recent bid and historical interest in owning Warner Music, we must recognize that there is a possibility that EMI will make a further bid.

In order to maintain a 4.5 net debt to EBITDA ratio after a $30 per share bid composed of 75-100% cash, EMI would need to 1) generate synergies of approximately $250-300 million and 2) maintain margin gains on the WMG recorded music business, and 3) sell the Warner publishing business (also a likely regulatory constraint). Looking at an EMI bid from a debt-holder's perspective, EMI could bid $30 per share composed of 50% cash and 50% stock while maintaining a 4.3x net debt to EBITDA ratio without material synergies. We believe that 4.5x net debt to EBITDA is at the high-end of the range that where the fixed income markets will continue to fund the company at a reasonable interest rate. If EMI funded an acquisition with 75% cash and 25% stock, then the pre-synergies debt/ EBITDA ratio would rise to 5.6x. However, after the synergies are added to the operating results the debt to EBITDA ratio would be only 4.3x. While incremental leverage would add financial risk to the inherent operating risk, a greater level of leverage would also be accretive to the EMI shareholders if the combined company was able to achieve and maintain long-term cost reductions over both historical entities. (see Exhibit 2, 3, and 4)

Despite EMI's greater size, WMG could justify an acquisition if it believes in material synergies. If WMG is willing to bet on the long-term sustainability of synergies and cost reductions, it could justify an acquisition. Nonetheless,

Company Description

Warner Music Group Inc. commenced public trading in May 2004. It generated $3.4 billion in revenue in FY2004. Its operation includes Music Publishing (a copyright management business with a catalog of more than one million copyrights worldwide) and Recorded Music (CD production and distribution which includes record labels Atlantic, Bad Boy, Elektra, Lava, Maverick, Nonesuch, Reprise, Rhino, Sire, Warner Bros. and Word). Warner Music International operates through 37 affiliates and numerous licensees in more than 70 countries.

Industry View: Attractive

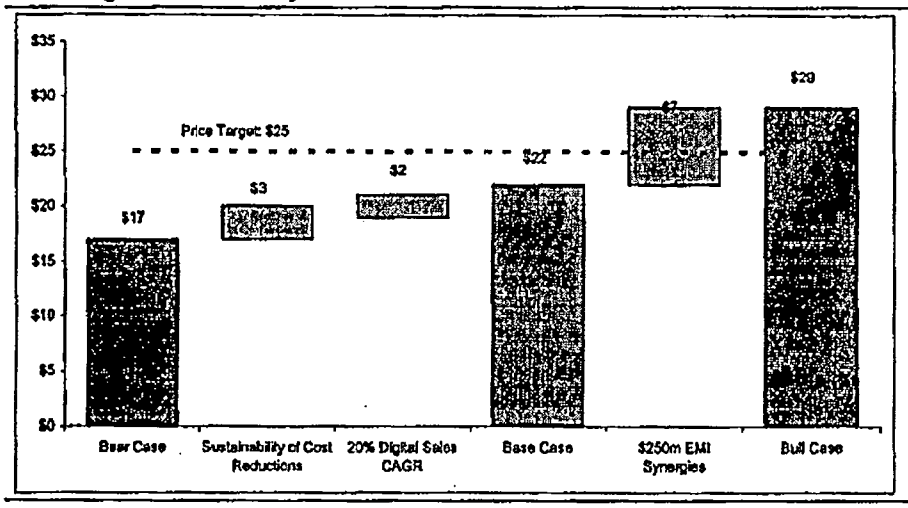
Two factors should create upside for Entertainment stocks in 2006: increased payout ratios and higher EPS growth achieved through optimization of asset bases and capital structures.

GICS Sector: Consumer Discretionary

Strategist's Recommended Weight: 5.6%
S&P 500 Weight: 104%

we believe that WMG shares would react negatively towards a reversed bid, and believe there is a low likelihood that WMG would do so. In order to make a bid for EMI with equivalent pre-tax unleveraged free cash flow multiple to the $30 WMG bid, WMG would need to bid approximately $7.15 or 380 pence per EMI share. Before synergies, on a 50% cash deal, the combined company would have a 7.1 net debt/ EBITDA ratio and would need to generate approximately $500 million in synergies to maintain a 4.5 net debt/ EBITDA ratio. WMG's holdco notes have a 4.25x debt/ Adjusted EBITDA (GAAP EBITDA excluding non-cash compensation) leverage incurrence test. While this could be a minor issue, it is unlikely to inhibit a transaction. (see Exhibit 5)

Exhibit 1
Price Target Scenario Analysis



Source: Company data, Morgan Stanley Research

Exhibit 2

EMI Acquisition Scenario Analysis- $30 per share (50% Cash/ 50% Stock)

	FY2007E	FY2007E					
	EMI	WMG	WMG Purchase Transaction (50% Cash/50% Stock)	Sale of WMG Publishing	Combined Company- Pre Synergies	Synergies	Combined Company- Post Synergies
Recorded Music							
Revenue	$3,085	$2,991			$6,075		
EBITDA	307	403			710		
Publishing							
Revenue	823	600		(600)	823		
EBITDA	222	150		(150)	222		
Corporate/ Eliminations							
Revenue	-	(29)			(29)		
EBITDA	-	(93)			(93)		
Total							
Revenue	3,908	3,562		(600)	6,870		6,870
EBITDA	529	459		(150)	838	250	1,088
Depreciation	47	42		(15)	74		74
Net Debt	1,130	1,787	2,303	(1,650)	3,569		3,569
Interest rate	13.3%	9.4%	6.5%	6.5%	10.1%		10.1%
Interest Expense	151	168	149	(107)	360		360
Other	11	(18.0)			(7)		(7)
Pre-tax Profit	320	232	(149)	(28)	411	250	661
Effective Tax rate	22.6%	31.5%	22.6%	36.4%	24.7%	50%	34.3%
Tax Expense	72	73	(34)	(10)	101	125	226
Net Income	248	159			309		434
Diluted Shares	872.9	153.5	448.6		1,322		1,322
EPS	0.28	1.03			0.23		0.33
Debt/ EBITDA	2.1x	3.9x			4.3x		3.3x
EMI Share Price in $	$5.13				$5.13		$5.13
Implied Multiple	18.1x				21.9x		15.6x
Exchange Rate ($/£)- 5/15/2006	1.88						

Source: Company data, Morgan Stanley Research

Exhibit 3

EMI Acquisition Scenario Analysis- $30 per share (75% Cash/ 25% Stock)

	FY2007E EMI	FY2007E WMG	WMG Purchase Transaction (75% Cash/25% Stock)	Sale of WMG Publishing	Combined Company- Pre Synergies	Synergies	Combined Company- Post Synergies
Recorded Music							
Revenue	$3,085	$2,991			$6,075		
EBITDA	307	403			710		
Publishing							
Revenue	823	600		(600)	823		
EBITDA	222	150		(150)	222		
Corporate/ Eliminations							
Revenue	-	(29)			(29)		
EBITDA	-	(93)			(93)		
Total							
Revenue	3,908	3,562		(600)	6,870		
EBITDA	529	459		(150)	838	250	1,088
Depreciation	47	42		(15)	74		74
Net Debt	1,130	1,787	3,454	(1,650)	4,721		4,721
Interest rate	13.3%	9.4%	6.5%	6.6%	9.2%		9.2%
Interest Expense	151	168	223	(107)	435		435
Other	11	(18.0)			(7)		(7)
Pre-tax Profit	320	232	(223)	(28)	336	250	586
Effective Tax rate	22.6%	31.5%	22.6%	35.4%	25.2%	50%	35.8%
Tax Expense	72	73	(51)	(10)	85	125	210
Net Income	248	159			252		377
Diluted Shares	872.9	153.5	224.3		1,097		1,097
EPS	0.28	1.03			0.23		0.34
Debt/ EBITDA	2.1x	3.9x			5.6x		4.3x
EMI Share Price in $	$5.13				$5.13		$5.13
Implied Multiple	18.1x				22.4x		15.0x
Exchange Rate ($/£)- 5/15/2006	1.88						

Source: Company data, Morgan Stanley Research

Exhibit 4

EMI Acquisition Scenario Analysis- $30 per share (100% Cash)

	FY2007E EMI	FY2007E WMG	WMG Purchase Transaction (100% Cash)	Sale of WMG Publishing	Combined Company- Pre Synergies	Synergies	Combined Company- Post Synergies
Recorded Music							
Revenue	$3,085	$2,991			$6,075		
EBITDA	307	403			710		
Publishing							
Revenue	823	600		(600)	823		
EBITDA	222	150		(150)	222		
Corporate/ Eliminations							
Revenue	-	(29)			(29)		
EBITDA	-	(93)			(93)		
Total							
Revenue	3,908	3,562		(600)	6,870		
EBITDA	529	459		(150)	838	250	1,088
Depreciation	47	42		(15)	74		74
Net Debt	1,130	1,787	4,605	(1,650)	5,872		5,872
Interest rate	13.3%	9.4%	6.5%	6.5%	8.7%		8.7%
Interest Expense	151	168	299	(107)	509		509
Other	11	(18.0)			(7)		(7)
Pre-tax Profit	320	232	(298)	(28)	262	250	512
Effective Tax rate	22.6%	31.5%	22.6%	36.4%	25.9%	50%	37.7%
Tax Expense	72	73	(67)	(10)	68	125	193
Net Income	248	159			194		319
Diluted Shares	872.9	153.5	0.0		873		873
EPS	0.28	1.03			0.22		0.37
Debt/ EBITDA	2.1x	3.8x			7.0x		5.4x
EMI Share Price in $	$5.13				$5.13		$5.13
Implied Multiple	18.1x				23.1x		14.0x
Exchange Rate ($/£)- 5/15/2006	1.83						

Source: Company data, Morgan Stanley Research

Exhibit 5

EMI Acquisition Scenario Analysis- $30 per share (50% Cash/ 50% Stock)

	FY2007E EMI	FY2007E WMG	WMG Purchase Transaction (50% Cash/50% Stock)	Sale of WMG Publishing	Combined Company- Pre Synergies	Synergies	Combined Company- Post Synergies
Recorded Music							
Revenue	$3,085	$2,991			$6,075		
EBITDA	307	403			710		
Publishing							
Revenue	823	600		(600)	823		
EBITDA	222	150		(150)	222		
Corporate/ Eliminations							
Revenue	-	(29)			(29)		
EBITDA	-	(93)			(93)		
Total							
Revenue	3,908	3,562		(600)	6,870		6,870
EBITDA	529	459		(150)	838	250	1,088
Depreciation	47	42		(15)	74		74
Net Debt	1,130	1,787	2,303	(1,650)	3,569		3,569
Interest rate	13.3%	9.4%	6.5%	6.5%	10.1%		10.1%
Interest Expense	151	168	149	(107)	360		360
Other	11	(18.0)			(7)		(7)
Pre-tax Profit	320	232	(149)	(28)	411	250	661
Effective Tax rate	22.6%	31.5%	22.6%	36.4%	24.7%	50%	34.3%
Tax Expense	72	73	(34)	(10)	101	125	226
Net Income	248	159			309		434
Diluted Shares	872.9	153.5	448.6		1,322		1,322
EPS	0.28	1.03			0.23		0.33
Debt/ EBITDA	2.1x	3.9x			4.3x		3.3x
EMI Share Price in $	$5.13				$5.13		$5.13
Implied Multiple	18.1x				21.9x		15.6x
Exchange Rate ($/£)- 5/15/2006	1.83						

Source: Company data, Morgan Stanley Research

Exhibit 6

WMG Acquisition of EMI Scenario Analysis- £3.80 ($7.16) per share (50% Cash/ 50% Stock)

	FY2007E EMI	FY2007E WMG	EMI Purchase Transaction (50% Cash/ 50% Stock)	Sale of WMG Publishing	Combined Company- Pre Synergies	Synergies	Combined Company- Post Synergies
Recorded Music							
Revenue	$3,085	$2,991			$6,075		
EBITDA	307	403			710		
Publishing							
Revenue	823	600		(600)	823		
EBITDA	222	150		(150)	222		
Corporate/ Eliminations							
Revenue	-	(29)			(29)		
EBITDA	-	(93)			(93)		
Total							
Revenue	3,908	3,562		(600)	6,870		
EBITDA	529	459		(150)	838	250	1,088
Depreciation	47	42		(15)	74		74
Net Debt	1,130	1,787	4,680	(1,650)	5,946		5,946
Interest rate	13.3%	9.4%	6.5%	6.5%	8.6%		8.6%
Interest Expense	151	168	303	(107)	514		514
Other	11	(18.0)			(7)		(7)
Pre-tax Profit	320	232	(303)	(28)	257	250	507
Effective Tax rate	23.0%	31.5%	23.0%	36.4%	26.0%	50%	37.8%
Tax Expense	74	73	(70)	(10)	67	125	192
Net Income	246	159			190		315
Diluted Shares	872.9	153.5	54.6		208		208
EPS	0.28	1.03			0.91		1.51
Debt/ EBITDA	2.1x	3.9x			7.1x		5.5x
WMG Share Price in $		$28.49			$28.49		$28.49
Implied Multiple		27.6x			31.2x		18.8x

Exchange Rate ($/£)- 5/15/2006 1.88

Source: Company data, Morgan Stanley Research

Exhibit 7

Fiscal First Half 2006 Results vs. MS Estimates: Revenue and EBITDA

Consolidated

	Warner Music Group			Morgan Stanley Estimates			
	F1H06A	F1H05A	% Change	F1H06E	Actuals vs. Estimates	% Deviation	MS Exp. Change
Recorded Music	1,596	1,561	2.2%	1,570	26	2%	0.6%
Physical	1,446	1,509	-4.2%	1,487	(41)	-3%	-1.4%
Digital	150	52	188.5%	83	67	80%	60.0%
Publishing	260	283	-8.1%	297	(37)	-12%	4.9%
Traditional	251	275	-8.7%	275	(24)	-9%	0.0%
Digital	9	8	12.5%	22	(13)	-59%	175.0%
Divested Publishing Operations	-	26	n.m.	-	-	n.m.	n.m.
Corporate Eliminations	(16)	(15)	6.7%	(15)	(1)	7%	0.0%
Total Revenue	1,840	1,855	-0.8%	1,852	(12)	-1%	-0.1%
Recurring EBITDA, Including FAS 123, Excluding Non-Recurring Items							
Recorded Music	295	266	10.9%	231	64	28%	-13.1%
Publishing	68	71	-4.2%	71	(3)	-4%	-0.3%
Divested Publishing Operations	-	-	n.m.	-	-	n.m.	n.m.
Corporate Eliminations	(49)	(54)	-9.3%	(52)	3	-6%	-4.6%
Adj. EBITDA, Including FAS 123	314	283	11.0%	251	63	25%	-11.5%

Comments

Digital music sales have generated the entire upside to our estimates, while physical sales have lagged slightly.

We have been wrong about timing of cost reacceleration. However, we continue to believe that cost reductions are unsustainable over the long-term.

Consolidated

	F1H06A	F1H05A	% Change	F1H06E	Actuals vs. Estimates	% Deviation	MS Exp. Change
Total Revenue	1,840	1,855	-0.8%	1,852	(12)	-1%	-0.1%
Royalty Expenses	528	544	-2.9%	570	(42)	-7%	4.7%
A&R Expenses	83	80	3.7%	99	(16)	-16%	23.2%
Product Costs	308	290	6.2%	310	(2)	-1%	6.9%
Other Costs	20	67	-70.2%	40	(20)	-50%	-40.1%
Total COGS	939	981	-4.3%	1,019	(80)	-8%	3.8%
Marketing	292	265	10.2%	274	18	7%	3.3%
G&A	317	357	-11.2%	296	22	7%	-17.2%
Total SG&A	609	622	-2.1%	569	40	7%	-8.6%

F1H06A excludes $8 million severance charge in the recorded music segment
F1H05A excludes $11 million of management fee expense.
Source: Company data, Morgan Stanley Research

Key Changes to Our Model

Near-term Revisions

We have examined Warner's operating results from the first half of 2006 and believe that there were three key deviations from our prior forecast. Due to the lumpiness inherent in accounting practices in the music industry, we examine trailing two quarter trends and believe that ultimately trailing four quarter trends may eventually prove to be even more meaningful. We believe it is also important to revisit our fundamental thinking after two quarters of operating results.

1) Traditional revenues were weaker than expected both in the US and internationally despite reported market share gains. Total recorded music sales were $26 million ahead of our forecasts as digital sales were better than expected, but physical sales lagged. The $44 million negative impact of exchange rates in the recorded music business in 1H06 underscores Warner's susceptibility to fluctuations in various currencies. Without currency fluctuations, sales would have increased by $79 million. However, exchange rates did not drive a meaningful deviation from our forecast. Publishing revenues were also significantly lower than our estimates, which excluded divested sheet music operations.

2) Digital sales were significantly stronger than we had expected in both F1Q06 and F2Q06. Our initial forecast was too conservative and we have increased our long-term digital forecast and near-term growth. We have increased our 2H06 forecast by $45 million, raising our F2006 full year estimate by approximately $90 million.

3) Consolidated EBITDA was $63 million above expectations. WMG drove margins by reducing its artist royalties, A&R expenses, and licensing costs relative to our forecast. We continue to believe that cuts to A&R expenses are unsustainable over long periods of time and may put market shares at risk in 2007-2010. However, the reductions to royalties and licensing are most likely sustainable and we have therefore adjusted our forecast. Decreases in licensing and royalties expenses appear to be due to mix shift. Conversely, marketing and general and administrative costs were actually greater than we would have expected in 1H06. We continue to believe that marketing should grow as a percentage of revenue over the next several years.

We warn against extrapolating trends from any one quarter into the long-term. It is important to separate one time impacts from the long-term changes in the company's strategy.

1. Digital revenues are booked on a cash basis in many territories and therefore are inherently lumpy. The relative weakness in any one quarter and strength in another should not be extrapolated. Similarly, the market share improvements at the core Warner labels are probably more sustainable than the share additions at ADA.

2. The deviations in cost drivers in any one or two quarters also should not be fully extrapolated. We believe that investments in A&R for both the recorded music business and publishing are crucial. Reductions in recorded music A&R will boost F2006 profit margins but in our opinion put F2007-2009 market shares at risk. In publishing, immediate increases in royalty advances are probably necessary to boost sales. In both businesses, payments to proven artists are capitalized and are then amortized against revenues. Thus, the initial investments flow through working capital. For new artists the initial payments are expensed as they are incurred.

Long-term Revisions

Increasing digital forecasts

F1H06 total digital revenues of $159 million outperformed our expectations for $105 million. We have increased our F2006 digital forecast to reflect the company's expectations that F3Q06 and F4Q06 revenues should remain at approximately F2Q06 levels. This has provided about $100-150 million of upside to digital revenue forecasts in F2006-2010. (see Exhibit 8).

Given that the digital market is still in its infancy and the F2005 base numbers are low, the deviations in forecasts prior to F2Q06 can be viewed as noise. In many markets digital revenues are booked on a cash basis - in other words as they are collected. Thus, quarterly growth patterns are volatile. However, the deviations in the first half of F2006 were big enough to warrant, for the first time, a material set of revisions to our long-term forecast.

Exhibit 8

Morgan Stanley WMG Digital Revenue Forecasts

	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Forecast from 6/20/05						
Recorded Music	145	213	289	379	465	540
Publishing	22	48	77	105	124	148
Total Digital Revenues	167	261	366	484	589	688
% Change		56.3%	40.2%	32.2%	21.7%	16.8%
Forecast from 10/21/05						
Recorded Music	143	238	323	423	518	602
Publishing	22	48	77	105	124	148
Total Digital Revenues	165	286	400	528	642	750
% Change		73.3%	39.9%	32.0%	21.6%	16.8%
Forecast from 1/27/06						
Recorded Music	137	215	277	344	403	452
Publishing	20	48	75	96	108	128
Total Digital Revenues	157	263	352	440	511	580
% Change		67.5%	33.8%	25.0%	16.1%	13.5%
Forecast from 5/8/06						
Recorded Music	137	312	402	497	582	653
Publishing	20	42	65	82	93	109
Total Digital Revenues	157	354	466	579	675	762
% Change		125.6%	31.7%	24.2%	16.4%	13.0%

Source: Company data, Morgan Stanley Research

Market Share

In calendar 2005, WMG gained 105 bps in albums market share. However, two thirds of this gain was driven by the Alternative Distribution Alliance which gained 70 bps over that period (see Exhibit 9). ADA is focused on the young independent artists and typically has short-term (i.e., one year) contracts with its artists. We believe that the A&R investment on ADA releases is relatively low. However, it also appears that ADA's market share is more volatile than traditional labels. Nevertheless, we have assumed that the market share gains at Warner are permanent.

Exhibit 9

Market Shares in Physical and Digital Album Sales

Total Albums (Physical+	2004	2005	Change	1Q05	1Q06	Change
WMG	16.3%	17.4%	1.1%	17.2%	18.4%	1.2%
BMG/Sony	29.8%	27.4%	-2.4%	27.6%	26.6%	-1.1%
UMG	29.6%	31.8%	2.2%	31.7%	31.1%	-0.6%
EMI	10.9%	10.2%	-0.7%	10.0%	9.9%	-0.1%
All Others	13.4%	13.2%	-0.2%	13.5%	14.0%	0.5%
Total	100.0%	100.0%	0.0%	100.0%	100.0%	0.0%

Source: Company data, Morgan Stanley Research, Nielsen Media Research

Lower Publishing Revenue

We also lowered our F2006-2010 publishing revenue forecasts by $30-50 million per year following the $37 million shortfall in publishing revenues relative to our expectations. The deceleration in Publishing growth relative to our forecasts is somewhat worrying: if WMG chooses to reaccelerate Publishing growth, it would require a meaningful upfront cash investment, since publishing contracts with artists are typically structured in a way that artists receive the estimated royalty payments for the life of the contract as a lump sum upfront, and the company amortizes royalty payments in increments over the life of the contract.

Higher Short-term Margins

WMG's unexpectedly high EBITDA margin in F1H06 (17.1% including FAS 123R expense versus our expectations for 13.5%) was due primarily to lower A&R / royalties expenses. WMG's total A&R and royalties expenditures in F1H06 were $58 million below our forecast. Marketing costs were actually $68 million higher than we had expected over 1H06.

We had not anticipated that Warner would be able to reduce its licensing and royalty costs. The portion of the cost reduction that is related to A&R (i.e. the music industry's version of R&D) is in our view difficult to predict and potentially unsustainable. However, the reductions to cost of sales are clearly related to management's release strategy and in the absence of contrary evidence, we do believe these cost reductions are sustainable.

Mechanics of Booking A&R and Royalties Expenses

As WMG's F1H06 results demonstrate, the swings in A&R and royalties expenses can provide surprises to the reported results. The companies provide different levels of detail about the composition of their operating expenses and the definitions of A&R and royalties varies as well. Warner provides commentary on the changes in its expenses (in the MD&A section of the 10Q's) but does not give the base amount. EMI reports the base levels of expenditures but, it makes sense to look at the A&R and royalties expenses combined. In essence, A&R expenses represent advances paid to unproven artists, while royalties represent advances and regular payments paid to proven artists. Thus, the performance of a new album by an unproven artist will not have an impact on the amount of A&R expenses - these would have already been booked. The swings in combined A&R and royalty expenses are caused by two factors: 1) the performance of the proven artists' albums, and 2) the accounting treatment of the advances on the new contracts with proven artists.

Let's look at a specific example when WMG signs a new contract with a proven artist. Suppose that under this contract, the artist should release 4 albums, it is expected that each album will sell 1 million units and the royalty to be paid to the artist is $2.00 per unit sold. Thus, the total payment to the artist over the life of the contract is $8 million. Typically, the artist would receive half of the expected royalty payments upfront. The $4 million advance would be capitalized initially

and then expensed over the expected revenue from the albums. The future payments would be capitalized and then amortized as well.

If any of the albums exceed the original projections used to establish an amortization ration, then the unit forecasts are updated and a new amortization ratio for future periods is calculated. In contrast, if an album fails to meet expectations then the forecast is updated, but the amortization ratio is not changed. Instead, the unrecoverable costs are determined and then written off.

Exhibit 10

Changes to Our Consolidated 2006-2007 Forecasts

	2006E				2007E			
	Prior	Current	Change	% Change	Prior	Current	Change	% Change
Gross Sales Net of Returns	2,578	2,551	(27)	-1.0%	2,475	2,449	(26)	-1.0%
Digital Sales	263	354	91	34.5%	352	466	114	32.4%
Other Sales/Allowances	525	501	(24)	-4.6%	531	507	(24)	-4.6%
Total Revenue ex. Licensing	3,367	3,407	40	1.2%	3,358	3,422	64	1.9%
% Change	0	0	0	85.4%	(0)	0	0	-276.0%
Licensing Revenue	159	145	(14)	-8.8%	153	139	(13)	-8.5%
Divested Operations and Merger Accounting Adj.	0	0	0	NM	0	0	0.0%	NM
Total Revenue	3,526	3,552	26	0.7%	3,511	3,562	5086.0%	1.4%
% Change	0.7%	1.4%	0.7%	108.0%	-0.4%	0.3%	0.7%	-163.8%
Product Costs	567	584	16	2.9%	546	563	16	3.0%
Royalties	1,071	1,020	(51)	-4.8%	1,087	1,042	(45)	-4.1%
A&R	189	185	(4)	-2.2%	212	204	(8)	-4.0%
Licensing Costs/Other Recurring Expenses	96	92	(4)	-3.7%	92	76	(16)	-17.6%
Divested Operations and Merger Accounting Adj.	0	0	0	NM	0	0	0	NM
Total COGS	1,923	1,881	(43)	-2.2%	1,937	1,884	(53)	-2.7%
Gross Profit	1,603	1,672	69	4.3%	1,574	1,678	104	6.6%
Gross Margin	45.5%	47.1%	1.6%	3.5%	0	0	0	5.1%
Distribution								
Variable Marketing	412	446	34	8.2%	406	457	51	12.6%
Selling Overhead	79	81	2	2.9%	81	84	3	3.4%
Marketing Overhead	127	136	9	7.1%	129	141	12	9.2%
G&A Overhead	479	506	27	5.6%	488	521	33	6.7%
Additional OIBDA Cost Reserve	0	0	0	NM	0	0	0	NM
Other Recurring Expenses	(23)	(48)	(25)	108.9%	(23)	(48)	(26)	114.5%
Divested Operations and Merger Accounting Adj.	0	0	0	NM	0	0	0	NM
Total Selling, Gen. & Admin. Exp. (excl. Mgmt. Fees)	1,141	1,187	46	4.0%	1,147	1,219	72	6.3%
EBITDA before FAS 123 Stock Compensation	462	485	23	5.0%	427	459	32	7.5%
EBITDA Margin, %	13.1%	13.6%	0.6%	4.2%	0	0	0	6.0%
Management Fees	0	0	0	NM	0	0	0	NM
FAS 123 Stock Compensation	(28)	(19)	9	-32.1%	(28)	(19)	9	-32.1%
EBITDA after FAS 123 Stock Compensation	434	466	32	7.4%	399	440	41	10.3%
EBITDA Margin, %	12.3%	13.1%	0.8%	6.6%	11.4%	12.4%	0	8.7%

Source: Company data, Morgan Stanley Research

Exhibit 11

Changes to Our Consolidated 2010 Forecasts

	2010E			
	Prior	Current	Change	% Change
Gross Sales Net of Returns	2,329	2,305	(24)	-1.0%
Digital Sales	580	762	182	31.4%
Other Sales/Allowances	583	556	(26)	-4.5%
Total Revenue ex. Licensing	3,492	3,623	132	3.8%
% Change	0	0	0	20.8%
Licensing Revenue	144	131	(13)	-8.8%
Divested Operations and Merger Accounting Adj.	0	0	0	NM
Total Revenue	3,636	3,755	119	3.3%
% Change	1.9%	2.3%	0.4%	22.1%
Product Costs	518	536	17	3.3%
Royalties	1,173	1,144	(29)	-2.5%
A&R	248	249	2	0.7%
Licensing Costs/Other Recurring Expenses	87	71	(15)	-17.6%
Divested Operations and Merger Accounting Adj.	0	0	0	NM
Total COGS	2,026	2,000	(26)	-1.3%
Gross Profit	1,610	1,755	145	9.0%
Gross Margin	44.3%	46.7%	2.4%	5.5%
Distribution				
Variable Marketing	409	473	64	15.7%
Selling Overhead	87	91	4	4.9%
Marketing Overhead	137	154	16	12.0%
G&A Overhead	524	565	41	7.7%
Additional OIBDA Cost Reserve	0	0	0	NM
Other Recurring Expenses	(22)	(50)	(28)	129.9%
Divested Operations and Merger Accounting Adj.	0	0	0	NM
Total Selling, Gen. & Admin. Exp. (excl. Mgmt. Fees)	1,197	1,294	97	8.1%
EBITDA before FAS 123 Stock Compensation	413	461	48	11.6%
EBITDA Margin, %	11.4%	12.3%	0.9%	8.1%
Management Fees	0	0	0	NM
FAS 123 Stock Compensation	(28)	(19)	9	-32.1%
EBITDA after FAS 123 Stock Compensation	385	442	57	14.8%
EBITDA Margin, %	10.6%	11.8%	1.2%	11.2%

Source: Company data, Morgan Stanley Research

Exhibit 12

Fiscal 1H06 Consolidated Cost Analysis

CONSOLIDATED WMG	F1H05A	Change, excl. FX impact	FX Impact	F1H06A	1H05 % of Revenue	1H06 % of Revenue	Change
Revenue	1,855	43	(58)	1,840			
Product Costs	288	24	(11)	301	15.5%	16.4%	0.9%
Royalties	545	(16)	(20)	510	29.4%	27.7%	-1.7%
A&R	80	3	(3)	80	4.3%	4.4%	0.0%
Other Recurring Expenses	50	(1)	(2)	47	2.7%	2.6%	-0.1%
Divested Operations	17	(16)	(1)	0	0.9%	0.0%	-0.9%
Total COGS	981	(6)	(36)	939	52.9%	51.0%	-1.9%
Marketing	303	27	(8)	322	16.3%	17.5%	1.2%
G&A Overhead	270	(5)	(7)	258	14.6%	14.0%	-0.5%
Divested Operations	9	(9)	(0)	(0)	0.5%	0.0%	-0.5%
Management Fees	5	(5)	(0)	(0)	0.3%	0.0%	-0.3%
FAS 123 Stock Compensation	9	(1)	(0)	8	0.5%	0.4%	-0.1%
Depreciation	28	(6)	(0)	22	1.5%	1.2%	-0.3%
Total Overhead Expenses	624	1	(16)	609	33.6%	33.1%	-0.5%
Total Expenses	1,605	(5)	(52)	1,548	86.5%	84.1%	-2.4%
EBITA before Non-Recurring Expenses	250	48	(6)	292	13.5%	15.9%	2.4%

Source: Company data, Morgan Stanley Research

Exhibit 13

Fiscal 1H06 Segment Cost Analysis

RECORDED MUSIC	F1H05A	Change, excl. FX Impact	FX Impact	F1H06A			
Revenue	1,561	79	(44)	1,596			
Product Costs	288	24	(11)	301	18.4%	18.9%	0.4%
Royalties	384	(12)	(14)	358	24.6%	22.4%	-2.1%
A&R	70	1	(3)	68	4.5%	4.3%	-0.2%
Other Recurring Expenses	50	-	(2)	48	3.2%	3.0%	-0.2%
Divested Operations	-	-	-	-	0.0%	0.0%	0.0%
Total COGS	792	13	(29)	776	50.7%	48.6%	-2.1%
Marketing	302	27	(6)	323	19.3%	20.3%	0.9%
G&A Overhead	196	5	(3)	198	12.5%	12.4%	-0.2%
Divested Operations	-	-	-	-	0.0%	0.0%	0.0%
FAS 123 Stock Compensation	6	(2)	(0)	4	0.4%	0.2%	-0.1%
Depreciation	18	(4)	(0)	14	1.2%	0.9%	-0.3%
Total Overhead Expenses	522	26	(9)	539	33.4%	33.8%	0.3%
Total Expenses	1,314	39	(39)	1,315	84.2%	82.4%	-1.8%
EBITA before Non-Recurring Expenses	247	40	(5)	281	15.8%	17.6%	1.8%

PUBLISHING	F1H05A	Change, excl. FX Impact	FX Impact	F1H06A			
Revenue, excl. Discontinued Ops.	283	(9)	(14)	260			
Discontinued Operations	26	(26)	(0)	-			
Total Revenue	309	(35)	(14)	260			
Product Costs	-	-	-	-	0.0%	0.0%	0.0%
Royalties	177	(2)	(6)	169	57.2%	64.9%	7.7%
A&R	10	2	(0)	12	3.3%	4.5%	1.3%
Other Recurring Expenses	-	-	-	-	0.0%	0.0%	0.0%
Discontinued Operations	17	(17)	-	0	5.5%	0.0%	-5.5%
Total COGS	204	(17)	(6)	180	66.0%	69.4%	3.4%
Marketing	1	-	(0)	1	0.2%	0.2%	0.0%
G&A Overhead	24	(9)	(6)	9	7.6%	3.4%	-4.2%
Divested Operations	9	(9)	-	-	2.9%	0.0%	-2.9%
FAS 123 Stock Compensation	1	-	-	1	0.3%	0.4%	0.1%
Depreciation	2	-	(0)	2	0.6%	0.7%	0.1%
Total Overhead Expenses	36	(18)	(6)	12	11.7%	4.7%	-7.0%
Expenses, excl. Discontinued Ops.	214	(9)	(12)	193	69.3%	74.1%	4.8%
Discontinued Operations	26	(26)	-	0	8.4%	0.0%	-8.4%
Total Expenses	240	(35)	(12)	193	77.7%	74.1%	-3.6%
EBITA before Non-Recurring Expenses	69	(0)	(2)	66	22.3%	25.5%	3.2%

Source: Company data, Morgan Stanley Research

Key Long-term Drivers and Assumptions

Recorded music physical sales. We assume that the decline in the US total physical music market abates in 2006 and returns to the average rate of 5% decline in unit sales in 1999-2004 (1999 was the first year of music sales declines in the US). We use unit trends as a proxy for revenue trends since we do not have enough information to predict the mix of pricing versus unit changes. We expect WMG to outperform the industry in F1H:06 due to the stronger release schedule at the Atlantic Electra, which was on a depressed schedule in F1H:05. A normalized release schedule started in F3Q05 and starting with F3Q06 growth rates should converge with industry trends. We expect WMG's physical recorded music sales in US to decline 2% in F2H06, resulting in a 1.5% decline for the whole year F2006.

We use similar assumptions for the international physical music market projections. We expect total international market for physical music to be down by about 5% in F2006 in local currency. Overall, we expect WMG's physical recorded music sales (US and international combined) 3-4% decline for the whole year F2006.

WMG's share of the U.S. physical music sales increased by 110 bps to 17.3% in calendar 2005 versus calendar 2004, according to Nielsen Soundscan. However, while this data is useful for analyzing WMG's historical performance, we do not think it can be used for forecasts. Unless market share shifts are sustainable and significant, we view them more as a reflection of the current release schedule than an indication of the future growth potential.

Publishing. We project 2% growth in the traditional publishing revenues in F2006-2010, and growth in digital should improve total publishing revenue growth to 5% in F2006-2010. Publishing EBITDA margins declined in F2005 to 25.3% from 27% in F2004, primarily due to an increase in royalties as percent of sales. In F2006, we expect royalties as percent of sales to remain approximately flat at the level of F2005 but G&A overhead growth is likely to lead to another 50-60 bps of margin deterioration. EBITDA margins at Publishing segment are likely to remain at 24.0-25.0%, and EBITA margins at about 22% (after the allocation of corporate overhead). The normalized publishing EBITDA margins at EMI are around 24% and at UMG are about 27% (please see the section on the comparative costs analysis starting on page 21 for more details).

Major cost assumptions. WMG has reduced its marketing expenses (including selling overhead) from $750 million, which we estimate it had been spending annually prior to its split from Time Warner, to $614 million in F2005. We have cautioned previously that the sustainability of the cost cuts at WMG is among the key risks to WMG's business model and to its stock valuation. The higher than expected marketing expenses in 1H06 (both in dollar terms and as a percent of revenue) highlight this risk of WMG's business model. While it appears that we were wrong about the near-term trends, we continue to believe that marketing, A&R and royalties expenses will continue to grow over the next several years. Additionally, due to the nature of the music business, maintaining A&R cost reductions for longer periods of time could have incrementally more negative impact on future revenues compared to our forecast.

Exhibit 14

Music Albums: Quarterly Market Share Shifts

Physical Albums									
WEA	15.3%	13.8%	14.6%	14.9%	14.9%	13.7%	15.5%	15.7%	15.1%
ADA	1.4%	1.6%	1.7%	1.7%	2.3%	2.3%	2.7%	2.0%	3.0%
Total WMG	16.7%	15.4%	16.3%	16.6%	17.3%	16.0%	18.2%	17.7%	18.1%
BMG/Sony	31.3%	31.5%	28.9%	28.2%	27.7%	27.9%	25.9%	28.0%	26.8%
UMG	26.6%	27.6%	30.9%	32.1%	31.8%	32.3%	31.1%	31.7%	30.7%
EMI	11.9%	11.8%	10.0%	10.2%	10.1%	10.8%	11.2%	9.8%	10.3%
All Others	13.4%	13.7%	13.9%	12.9%	13.2%	13.1%	13.7%	12.8%	14.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Digital Album Equivalents									
WMG					16.2%	16.7%	17.1%	21.9%	20.2%
BMG/Sony					26.8%	28.7%	27.5%	24.3%	25.6%
UMG					29.6%	34.5%	32.5%	35.5%	32.9%
EMI					7.5%	7.6%	7.8%	8.3%	8.1%
All Others					20.0%	12.5%	15.1%	10.1%	13.2%
Total					100.0%	100.0%	100.0%	100.0%	100.0%
Total Albums (Physical + Digital)									
WMG	16.7%	15.4%	16.3%	16.6%	17.2%	16.1%	18.1%	17.9%	18.4%
BMG/Sony	31.3%	31.5%	28.9%	28.2%	27.6%	27.9%	26.0%	27.8%	26.6%
UMG	26.6%	27.6%	30.9%	32.1%	31.7%	32.4%	31.1%	31.9%	31.1%
EMI	11.9%	11.8%	10.0%	10.2%	10.0%	10.6%	11.0%	9.7%	9.9%
All Others	13.4%	13.7%	13.9%	12.9%	13.5%	13.0%	13.8%	12.7%	14.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Nielsen Soundscan, Morgan Stanley Research

Exhibit 15

WMG: Sum-of-the-Parts Fair Market Value Analysis

US$ Millions *Fiscal Year End - September*	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Recorded Music	3,838	3,909	4,005	4,119	4,247	4,382
Music Publishing	2,034	2,107	2,182	2,258	2,336	2,414
Corporate Overhead and Eliminations	(992)	(1,017)	(1,043)	(1,069)	(1,096)	(1,123)
FAS 123 Stock Option Expense	(108)	(105)	(102)	(99)	(95)	(91)
IRS Code Section 338 Tax Shield	343	356	359	361	360	354
Total	5,115	5,250	5,401	5,570	5,753	5,936
Cash	288	395	471	525	577	654
Total Debt	(2,246)	(2,251)	(2,257)	(2,266)	(2,276)	(2,282)
Equity Value	3,157	3,394	3,614	3,828	4,054	4,309
Common Shares Outstanding	152.2	153.3	152.8	152.1	151.5	150.7
Value per Share	$20.74	$22.14	$23.66	$25.16	$26.76	$28.59
Enterprise Value	5,115	5,250	5,401	5,570	5,753	5,936
Enterprise Value / Concurrent EBITDA	10.4x	10.8x	11.8x	12.4x	12.9x	12.9x
Enterprise Value / Forward EBITDA	10.6x	11.4x	12.0x	12.5x	12.5x	12.3x
Enterprise Value	5,115	5,250	5,401	5,570	5,753	5,936
Present Value of Tax Shield	(343)	(356)	(359)	(361)	(360)	(354)
Adjusted Enterprise Value	4,772	4,894	5,042	5,209	5,392	5,582
Enterprise Value / Concurrent EBITDA	9.7x	10.1x	11.0x	11.6x	12.1x	12.1x
Enterprise Value / Forward EBITDA	9.8x	10.7x	11.2x	11.7x	11.7x	11.6x

E = Morgan Stanley Research Estimates
Source: Company Reports, Morgan Stanley Analysis

Exhibit 18

FCF/Share Multiple Valuation

US$ Millions							
Fiscal Year End - September	F2005	F2006E	F2007E	F2008E	F2009E	F2010E	F2011E
EBITDA	490	485	459	448	445	461	481
Capital Expenditures	(30)	(40)	(40)	(41)	(41)	(42)	(43)
Total Interest Expense, Net	(147)	(136)	(134)	(133)	(133)	(133)	(130)
Cash Taxes	(55)	(70)	(73)	(87)	(86)	(75)	(77)
FAS 123 Stock Option Expense	(25)	(19)	(19)	(19)	(19)	(19)	(19)
Increase in Working Capital	19	13	9	12	14	17	20
Minority Interests & Preferred Dividends	(5)	0	0	0	0	0	0
Free Cash Flow	247	232	202	181	180	208	231
Add: Cash Taxes	55	70	73	87	86	75	77
Subtract: Total Tax Provision	(73)	(92)	(98)	(97)	(99)	(110)	(119)
Adjusted Free Cash Flow	229	210	177	172	168	174	189
FCF/Share	$1.87	$1.51	$1.32	$1.19	$1.18	$1.37	$1.53
Adjusted FCF/Share	$1.74	$1.37	$1.15	$1.12	$1.10	$1.15	$1.25
Recurring Dividends/Share	$0.00	$0.54	$0.54	$0.54	$0.54	$0.54	$0.54
Target Multiple of Forward FCF/Share	11.6x	15.1x	17.0x	19.0x	20.0x	20.0x	
Intrinsic Value before Tax Shield & Dividends	$15.87	$17.39	$19.06	$20.89	$22.90	$25.10	
Present Value of Tax Shield	2.25	2.32	2.35	2.37	2.38	2.35	
Present Value of Dividends through F2010	2.06	1.72	1.35	0.94	0.49	0.00	
Intrinsic Value per Share	$20.18	$21.44	$22.76	$24.20	$25.77	$27.45	
Target Return on Equity	9.6%						

E = Morgan Stanley Research Estimates
Source: Company Reports, Morgan Stanley Analysis

Exhibit 17

Annual Income Statement

US$ Millions	Pro Forma F2004	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Gross Sales Net of Returns	2,692	2,639	2,351	2,449	2,376	2,328	2,305
Digital Sales	32	137	354	456	579	673	762
Other Sales/Allowances	513	524	501	527	517	534	556
Total Revenue ex. Licensing	3,237	3,320	3,407	3,422	3,473	3,537	3,623
% Change		2.6%	2.6%	0.5%	1.5%	1.8%	2.5%
Licensing Revenue	141	148	145	139	135	133	131
Divested Operations and Merger Accounting Adj.	58	34	0	0	0	0	0
Total Revenue	3,436	3,502	3,552	3,562	3,608	3,669	3,755
% Change		1.9%	1.4%	0.3%	1.3%	1.7%	2.3%
Total COGS	1,843	1,850	1,881	1,884	1,919	1,959	2,000
Gross Profit	1,593	1,652	1,672	1,678	1,689	1,710	1,755
Gross Margin	44.4%	47.2%	47.1%	47.1%	46.8%	46.6%	46.7%
Distribution	93	72	67	64	62	61	61
Variable Marketing	420	418	446	457	460	466	473
Selling Overhead	89	77	81	84	86	89	91
Marketing Overhead	165	126	136	141	146	150	154
G&A Overhead	469	495	506	521	535	550	565
Additional OIBDA Cost Reserve	0	0	0	0	0	0	0
Other Recurring Expenses	(46)	(27)	(49)	(48)	(49)	(49)	(50)
Divested Operations and Merger Accounting Adj.	22	12	0	0	0	0	0
Total Selling, Gen. & Admin. Exp. (excl. Mgmt.)	1,214	1,162	1,187	1,219	1,241	1,266	1,294
EBITDA before FAS 123 Stock Compensation	379	490	485	459	448	443	461
EBITDA Margin, %	11.0%	14.0%	13.6%	12.9%	12.4%	12.1%	12.3%
Management Fees	(10)	(6)	0	0	0	0	0
FAS 123 Stock Compensation	0	(25)	(19)	(19)	(19)	(19)	(19)
EBITDA after FAS 123 Stock Compensation	369	459	466	440	429	424	442
EBITDA Margin, %	10.7%	13.1%	13.1%	12.4%	11.9%	11.6%	11.8%
Depreciation	67	51	44	42	39	36	37
Amortization of Intangible Assets	178	187	191	186	186	186	186
EBIT before Nonrecurring Expenses	124	221	231	212	204	203	219
Nonrecurring Expenses	0	(137)	(8)	(8)	(8)	(8)	(8)
EBIT after Nonrecurring Expenses	124	84	223	204	196	195	211
Interest Expense, net	(150)	(181)	(170)	(165)	(167)	(166)	(167)
Minority Interest	0	(5)	0	0	0	0	0
Equity in the Losses of Equity-Method Affiliates	(14)	(3)	1	1	1	1	1
Other Income/(Expense)	(1,136)	(11)	2	2	2	2	2
Pre-Tax Income	(1,176)	(114)	56	40	32	32	47
Cash Tax (Expense) / Benefit	NA	(55)	(70)	(73)	(87)	(84)	(75)
Deferred Tax (Expense) / Benefit	NA	0	(8)	0	17	17	0
Total Tax Provision (Expense) / Benefit	275	(55)	(78)	(73)	(70)	(70)	(75)
Effective Tax Rate	23%	-48%	140%	184%	217%	216%	160%
Net Income	(901)	(169)	(22)	(33)	(31)	(37)	(28)
Minority Interest	0	0	0	0	0	0	0
Preferred Dividends to Investors	0	0	0	0	0	0	0
Net Income Available to Common	(901)	(169)	(22)	(33)	(31)	(37)	(28)
Average Basic Shares Outstanding	140.1	120.9	140.9	140.2	140.2	140.2	140.2
Net Income per Avg. Basic Share	($6.43)	($1.40)	($0.16)	($0.24)	($0.22)	($0.27)	($0.20)
Average Diluted Shares Outstanding	140.1	126.8	143.2	140.2	140.2	140.2	140.2
Net Income per Avg. Diluted Share	($6.43)	($1.33)	($0.16)	($0.24)	($0.22)	($0.27)	($0.20)
Reported Net Income Available to Common	(901)	(169)	(22)	(33)	(31)	(37)	(28)
Add: Amortization of Intangible Assets	178	187	191	186	186	186	186
Add: Nonrecurring Losses per Share	1,157	182	40	40	40	40	40
Subtract: Nonrecurring Gains per Share	(1)	0	0	0	0	0	0
Tax Prov./(Benefit) Related to Non-recurring Item	(467)	(16)	(33)	(33)	(33)	(33)	(33)
Adjusted Net Income	(34)	114	175	159	155	155	164
Adjustment for Additional Com. Share Equivalents	0.0	12.0	12.6	13.3	12.7	12.0	11.2
Adjusted Average Diluted Shares Outstanding	140.1	138.7	155.8	153.5	152.9	152.2	151.5
Adj. Net Income per Adj. Avg. Diluted Share	($0.24)	$0.82	$1.12	$1.04	$1.01	$1.02	$1.09

E = Morgan Stanley Research estimates Source: Morgan Stanley Research

Exhibit 18

Quarterly Income Statement

US$ Millions	2005					2006			
	1Q	2Q	3Q	4Q		1Q	2Q	3QE	4QE
Gross Sales Net of Returns	846	557	518	646	-	829	562	509	652
Digital Sales	23	39	44	53	-	69	90	91	104
Other Sales/Adjustments	129	131	160	124	-	112	116	141	126
Total Revenue ex. Licensing	1,040	723	698	863	-	1,017	768	741	882
% Change	-7.8%	6.3%	2.5%	15.0%		-2.3%	6.2%	6.7%	2.2%
Licensing Revenue	33	33	40	42	-	28	28	44	46
Divested Operations and Merger Accounting Adj.	12	11	8	0		0	0	0	0
Total Revenue	1,088	767	742	905	-	1,044	796	784	928
% Change	-7.6%	4.6%	2.3%	13.6%		-4.0%	3.8%	5.7%	2.5%
Total COGS	581	400	396	473	-	530	405	430	512
Gross Profit	507	367	346	432	-	514	387	355	416
Gross Margin	46.6%	47.8%	46.6%	47.7%		49.2%	48.6%	45.3%	44.8%
Distribution	26	13	13	18	-	23	15	13	17
Variable Marketing	120	84	96	118	-	127	90	106	122
Selling Overhead	21	16	16	24	-	20	19	18	25
Marketing Overhead	32	29	27	37	-	38	33	29	35
G&A Overhead	125	123	108	135	-	121	133	117	135
Additional ODDA Cost Reserve	0	0	0	0	-	0	0	0	0
Other Restoring Expenses	(17)	(2)	3	(11)	-	(22)	(17)	(4)	(6)
Divested Operations and Merger Accounting Adj.	5	4	3	0	(0)	0	(0)	0	0
Total Selling, Gen. & Admin. Exp. (excl. Mgmt. I	313	270	267	313	-	306	273	280	329
EBITDA before FAS 123 Stock Compensation	193	98	79	119	-	208	114	75	88
EBITDA Margin, %	17.9%	12.7%	10.6%	13.1%		19.9%	14.3%	9.6%	9.4%
Management Fees	(3)	(1)	(1)	0	-	0	0	0	0
FAS 123 Stock Compensation	(7)	(7)	(9)	(7)	-	(6)	(7)	(6)	(6)
EBITDA after FAS 123 Stock Compensation	190	89	69	112	-	202	102	70	82
EBITDA Margin, %	17.5%	11.5%	9.3%	12.4%		19.3%	12.8%	8.9%	8.8%
Depreciation	16	14	12	13	-	11	11	11	11
Amortization of Intangible Assets	46	47	47	47	-	47	48	48	48
EBIT before Nonrecurring Expenses	130	27	10	54	(0)	144	53	11	23
Nonrecurring Expenses	0	0	(102)	(35)	-	0	(8)	0	0
EBIT after Nonrecurring Expenses	130	27	(92)	19	(0)	144	45	11	23
Interest Expense, net	(34)	(53)	(49)	(42)	-	(45)	(45)	(45)	(35)
Minority Interest	(3)	0	0	0	-	0	0	0	0
Equity in the Losses of Equity-Method Affiliates	(1)	0	0	0	-	0	1	0	0
Other Income/(Expense)	(18)	39	(34)	2	-	0	2	0	0
Pre-Tax Income	68	14	(175)	(21)	(0)	99	3	(34)	(12)
Cash Tax (Expense) / Benefit	(35)	(5)	(0)	(7)	-	(31)	(7)	(14)	(18)
Deferred Tax (Expense) / Benefit	3	(5)	4	(2)	-	1	(3)	(2)	(4)
Total Tax Provision (Expense) / Benefit	(32)	(10)	(4)	(9)	-	(30)	(10)	(16)	(22)
Effective Tax Rate	47%	71%	-2%	-43%		30%	333%	-47%	-184%
Net Income	36	4	(179)	(30)	(0)	69	(7)	(51)	(34)
Minority Interest	0	0	0	0	-	0	0	0	0
Preferred Dividends to Investors	0	0	0	0	-	0	0	0	0
Net Income Available to Common	36	4	(179)	(30)	(0)	69	(7)	(51)	(34)
Average Basic Shares Outstanding	107.3	107.9	127.0	141.2		141.4	141.9	140.2	140.2
Net Income per Avg. Basic Share	$0.33	$0.04	($1.41)	($0.21)		$0.49	($0.05)	($0.36)	($0.24)
Average Diluted Shares Outstanding	115.3	123.5	127.0	141.2		150.5	141.9	140.2	140.2
Net Income per Avg. Diluted Share	$0.31	$0.03	($1.41)	($0.21)		$0.46	($0.05)	($0.36)	($0.24)
Reported Net Income Available to Common	36	4	(179)	(30)		69	(7)	(51)	(34)
Add: Amortization of Intangible Assets	45	47	47	47		47	48	48	48
Add: Nonrecurring Losses per Share	31	(36)	37	1		3	1	3	3
Subtract: Nonrecurring Gains per Share	0	0	1	2		0	0	1	1
Tax Pre-(Benefit) Related to Non-recurring Items	(22)	(4)	(30)	(17)		(17)	(17)	(18)	(18)
Adjusted Net Income	90	11	(124)	2		101	25	(17)	(0)
Adjustment for Additional Com. Share Equivalents	0	0	1	2		0	0	1	1
Adjusted Average Diluted Shares Outstanding	115.3	123.5	128.0	143.2		150.5	141.9	141.2	141.2
Adj. Net Income per Adj. Avg. Diluted Share	$0.69	$0.09	($0.97)	$0.02		$0.67	$0.17	($0.12)	($0.00)

E = Morgan Stanley Research estimates Source: Morgan Stanley Research

Exhibit 19

Annual Balance Sheet

US$ Millions Fiscal Year End - September	Pro Forma F2004	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Current Assets:							
Cash & Marketable Securities	555	288	395	471	525	577	654
Accounts Receivable	571	637	646	648	656	667	683
Inventories	65	52	53	53	54	55	56
Royalty Advances Expected to be Recouped With	223	190	193	193	196	199	204
Deferred Tax Assets	38	36	37	38	38	39	40
Other Current Assets	86	39	40	40	40	41	42
Current Assets	1,538	1,242	1,363	1,442	1,509	1,579	1,679
Royalty Advances Expected to be Recouped After	223	190	193	193	196	199	204
Investments	8	21	42	63	84	105	126
Gross PP&E	225	241	255	266	273	275	277
Accumulated Depreciation	(36)	(84)	(102)	(115)	(120)	(118)	(115)
Net Prop., Plant, & Equip.	189	157	153	151	152	157	163
Goodwill	978	869	869	869	869	869	869
Intangible Assets Subject to Amortization, Net	1,937	1,815	1,624	1,438	1,252	1,066	880
Intangible Assets Not Subject to Amortization	100	100	100	100	100	100	100
Other Assets	117	104	105	106	107	109	112
Total Assets	5,090	4,498	4,449	4,362	4,269	4,184	4,132
Liabilities:							
Accounts Payable	226	247	251	252	256	262	267
Accrued Royalties	1,003	1,057	1,072	1,075	1,089	1,108	1,133
Taxes and Other Withholdings	10	23	23	24	25	25	26
Current Portion of Long-term Debt & Short-term	12	17	17	17	17	17	0
Note Payable to Shareholders	342	0	0	0	0	0	0
Accrued Liabilities	283	306	313	321	327	333	341
Fair Value of Warrants	155	0	0	0	0	0	0
Other Current Liabilities	149	98	99	100	101	103	105
Current Liabilities (excl. ST Debt & Prog. Liab.)	2,180	1,748	1,776	1,788	1,815	1,847	1,872
Long Term Debt	1,828	2,229	2,234	2,240	2,249	2,259	2,282
Deferred Taxes	265	201	209	209	192	175	175
Other Liabilities	333	231	234	235	238	242	248
Minority Interests	204	0	0	0	0	0	0
Common Stock	0	0	0	0	0	0	0
Additional Paid-In Capital	512	548	558	564	567	567	567
Retained Earnings	(238)	(480)	(582)	(695)	(812)	(927)	(1,032)
Accumulated Other Comprehensive Income (Loss)	6	21	21	21	21	21	21
Total Equity	280	89	(3)	(110)	(224)	(339)	(444)

E = Morgan Stanley Research estimates Source: Morgan Stanley Research

Exhibit 20

Annual Sources and Uses of Cash

US$ Millions	Pro Forma						
Fiscal Year End - September	F2004	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Net Income (Loss)		(169)	(22)	(33)	(38)	(37)	(28)
Depreciation	0	51	44	42	39	36	37
Amortization		187	191	186	186	186	186
Deferred Taxes		0	8	0	(17)	(17)	0
Equity in Profits (Losses) of Affiliated Companies, Net		1	(1)	(1)	(1)	(1)	(1)
Minority Interests		5	0	0	0	0	0
Unrealized Loss on Warrants		(17)	0	0	0	0	0
Noncash Interest Expense		68	17	19	20	22	6
Noncash Compensation Expense		25	10	6	3	0	0
Other Losses/(Gains)		35	0	0	0	0	0
Cash From Operations Before Changes in Oper. Assets/Liab.		186	246	218	193	190	199
Changes In Operating Assets and Liabilities:							
Accounts Receivable		(58)	(9)	(2)	(8)	(11)	(16)
Inventories		(3)	(1)	(0)	(1)	(1)	(1)
Royalty Advances		0	(5)	(1)	(5)	(7)	(9)
Accounts Payable and Accrued Liabilities		10	19	3	18	24	31
Other		70	9	8	8	9	12
Total		19	13	9	12	14	17
Net Cash From Operations		205	259	227	205	204	216
Capital Expenditures	0	(30)	(40)	(40)	(41)	(41)	(42)
Acquisitions		(78)	0	0	0	0	0
Investments		54	(20)	(20)	(20)	(20)	(20)
Net Cash From Investing		(54)	(60)	(60)	(61)	(61)	(62)
Change in Short-term Debt		5	0	0	0	0	(17)
Change in Long-term Debt		333	(12)	(12)	(12)	(12)	17
Sale of Stock (Repurchase)		6	0	0	0	0	0
Proceeds from IPO		517	0	0	0	0	0
Dividends (cash only)	0	(584)	(80)	(80)	(79)	(78)	(77)
Repayment of Note Payable to Shareholders		(342)	0	0	0	0	0
Repurchase Subsidiary Preferred Stock		(200)	0	0	0	0	0
Repayment of Warrants	0	(138)	0	0	0	0	0
Other, Net	555	(13)	0	0	0	0	0
Net Cash From Financing		(416)	(92)	(92)	(91)	(90)	(77)
Beginning Cash Balance		555	288	395	471	525	577
Exchange Movement on Opening Cash Balance		(2)	0	0	0	0	0
Net Increase/(Decrease) in Cash		(265)	107	75	54	53	77
Ending Cash Balance		288	395	471	525	577	654

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 21

WMG Debt Analysis

US$ Millions	Pro Forma						
Fiscal Year End - September	F2004	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Revolver, Libor +200bps, 37.5bps commitment fe	-	-	-	-	-	-	-
Term Loan (USD), Libor +250bps	1,194.0	1,430.0	1,418.0	1,406.0	1,394.0	1,382.0	1,382.0
Senior Subordinated Debt, 7.375%	465.0	465.0	465.0	465.0	465.0	465.0	465.0
Senior Subordinated Debt (GBP), 8.125%	181.0	177.0	177.0	177.0	177.0	177.0	177.0
HoldCo Notes (Cash Pay), Libor +438bps	-	-	-	-	-	-	-
HoldCo Discount Notes (5-yr Accretion), 9.5%	-	174.0	190.9	209.5	229.9	252.2	257.9
HoldCo Notes (10-yr PIK), Libor +700bps	-	-	-	-	-	-	-
Total Debt	1,840.0	2,246.0	2,250.9	2,257.5	2,265.9	2,276.2	2,281.9
Current Portion of Long Term Debt	12.0	17.0	17.0	17.0	17.0	17.0	-
Long-term Debt	1,828.0	2,229.0	2,233.9	2,240.5	2,248.9	2,259.2	2,281.9
Cash Interest							
Revolver, Libor +200bps, 37.5bps commitment fe	0.8	0.8	0.9	0.9	0.9	0.9	0.9
Term Loan (USD), Libor +250bps	36.4	72.2	78.3	77.7	77.0	76.3	76.0
Senior Subordinated Debt, 7.375%	20.3	34.3	34.3	34.3	34.3	34.3	34.3
Senior Subordinated Debt (GBP), 8.125%	7.0	14.5	14.4	14.4	14.4	14.4	14.4
HoldCo Notes (Cash Pay), Libor +438bps	-	9.2	-	-	-	-	-
HoldCo Discount Notes (5-yr Accretion), 9.5%	-	-	-	-	-	-	19.4
HoldCo Notes (10-yr PIK), Libor +700bps	-	-	-	-	-	-	-
Total Cash Interest Expense	64.5	131.1	127.9	127.3	126.6	125.9	145.0
Noncash Interest							
Revolver, Libor +200bps, 37.5bps commitment fee							
Term Loan (USD), Libor +250bps							
Senior Subordinated Debt, 7.375%							
Senior Subordinated Debt (GBP), 8.125%							
HoldCo Notes (Cash Pay), Libor +438bps							
HoldCo Discount Notes (5-yr Accretion), 9.5%		15.7	16.9	18.6	20.4	22.4	5.7
HoldCo Notes (10-yr PIK), Libor +700bps		10.5	-	-	-	-	-
Total Noncash Interest Expense		26.2	16.9	18.6	20.4	22.4	5.7
Interest							
Libor		3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Revolver, Libor +200bps		5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Term Loan (USD), Libor +250bps		5.50%	5.50%	5.50%	5.50%	5.50%	5.50%
Senior Subordinated Debt, 7.375%		7.38%	7.38%	7.38%	7.38%	7.38%	7.38%
Senior Subordinated Debt (GBP), 8.125%		8.13%	8.13%	8.13%	8.13%	8.13%	8.13%
HoldCo Notes (Cash Pay), Libor +438bps		7.38%	7.38%	7.38%	7.38%	7.38%	7.38%
HoldCo Discount Notes (5-yr Accretion), 9.5%		9.50%	9.50%	9.50%	9.50%	9.50%	9.50%
HoldCo Notes (10-yr PIK), Libor +700bps		10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Total Interest Expense		7.7%	6.44%	6.5%	6.5%	6.5%	6.6%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 22

Annual Segment Operating Forecast

Fiscal Year End - September	Pro Forma F2004	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Music	2,850	2,924	3,009	2,991	3,008	3,043	3,089
Publishing	552	573	572	600	629	655	694
Divested Publishing Operations	56	34	0	0	0	0	0
Other Divestitures and Adjustments	2	0	0	0	0	0	0
Corporate Eliminations	(24)	(29)	(29)	(29)	(29)	(29)	(29)
Total Revenue	3,436	3,502	3,552	3,562	3,608	3,669	3,755
% Change		1.9%	1.4%	0.3%	1.3%	1.7%	2.3%
Music	1,479	1,474	1,517	1,501	1,515	1,537	1,551
Publishing	350	382	393	412	432	451	478
Divested Publishing Operations	35	23	0	0	0	0	0
Other Divestitures and Adjustments	4	0	0	0	0	0	0
Corporate Eliminations	(24)	(29)	(29)	(29)	(29)	(29)	(29)
Total Cost of Revenues	1,843	1,850	1,881	1,884	1,919	1,959	2,000
% of Revenue	53.6%	52.8%	52.9%	52.9%	53.2%	53.4%	53.3%
Music	1,371	1,450	1,492	1,490	1,493	1,506	1,538
Publishing	202	191	179	188	196	205	217
Divested Publishing Operations	21	11	0	0	0	0	0
Other Divestitures and Adjustments	(2)	0	0	0	0	0	0
Corporate Eliminations	0	0	0	0	0	0	0
Total Gross Profit	1,593	1,652	1,672	1,678	1,689	1,711	1,755
% Change		3.7%	1.2%	0.4%	0.7%	1.3%	2.6%
% Margin	46.4%	47.2%	47.1%	47.1%	46.8%	46.6%	46.7%
Music	1,071	1,004	1,059	1,087	1,106	1,127	1,150
Publishing	53	45	37	38	40	41	43
Divested Publishing Operations	18	12	0	0	0	0	0
Other Divestitures and Adjustments	4	0	0	0	0	0	0
Corporate Eliminations	68	101	91	93	96	98	100
Total Selling, General, and Admin. Expenses	1,214	1,162	1,187	1,219	1,241	1,266	1,294
Depreciation Expense	67	51	44	42	39	36	37
Management Fees	10	6	0	0	0	0	0
FAS 123 Stock Compensation	0	25	19	19	19	19	19
Reported Total Selling, General, and Admin. Exp.	1,291	1,244	1,250	1,280	1,300	1,321	1,349
% Change		-3.6%	0.5%	2.4%	1.6%	1.7%	2.1%
% of Revenue	37.6%	35.5%	35.2%	35.9%	36.0%	36.0%	35.9%
Music	300	446	433	403	387	379	388
Publishing	149	146	143	150	157	164	174
Divested Publishing Operations	3	(1)	0	0	0	0	0
Other Divestitures and Adjustments	(5)	0	0	0	0	0	0
Corporate Eliminations	(68)	(101)	(91)	(93)	(96)	(98)	(100)
Total EBITDA before Mgmt. Fees & Stk. Comp	379	490	485	459	448	445	461
% Change		29.3%	-1.1%	-5.2%	-2.4%	-0.8%	3.6%
% Margin	11.0%	14.0%	13.6%	12.9%	12.4%	12.1%	12.3%
Music	-	(17)	(13)	(13)	(13)	(13)	(13)
Publishing	-	(3)	(2)	(2)	(2)	(2)	(2)
Corporate	-	(5)	(4)	(4)	(4)	(4)	(4)
FAS 123 Expense	-	(25)	(19)	(19)	(19)	(19)	(19)
Music	300	429	420	390	374	366	375
Publishing	149	143	140	147	155	161	171
Divested Publishing Operations	3	(1)	0	0	0	0	0
Other Divestitures and Adjustments	(5)	0	0	0	0	0	0
Corporate Eliminations	(78)	(112)	(92)	(97)	(99)	(102)	(104)
Total EBITDA after Mgmt. Fees, after Stk. Comp	369	459	466	440	429	426	442
% Change		24.4%	1.4%	-5.4%	-2.5%	-0.8%	3.8%
% Margin	10.7%	13.1%	13.1%	12.4%	11.9%	11.6%	11.8%

E = Morgan Stanley Research estimates Source: Morgan Stanley Research

Exhibit 23

Quarterly Segment Operating Forecast

	2005					2006E			
Fiscal Year End - September	1Q	2Q	3Q	4Q		1Q	2Q	3QE	4QE
Music	940	623	568	775	-	920	636	631	782
Publishing	140	143	153	137	-	131	129	143	152
Divested Publishing Operations	13	11	8	0	-	0	0	0	0
Other Divestitures and Adjustments	0	0	0	0	-	0	0	0	0
Corporate Eliminations	(2)	(1)	(2)	(2)	-	(2)	(2)	(2)	(1)
Total Revenue	1,092	797	743	995	-	1,044	796	774	928
% Change	-7.0%	4.4%	2.2%	11.6%		-4.4%	3.6%	5.7%	2.8%
Music	475	337	336	396	-	437	337	317	426
Publishing	104	85	111	84	-	100	81	110	92
Divested Publishing Operations	9	6	6	0	-	0	0	0	0
Other Divestitures and Adjustments	0	0	0	0	-	0	0	0	0
Corporate Eliminations	(2)	(1)	(2)	(2)	-	(2)	(2)	(2)	(1)
Total Cost of Revenue	581	423	396	473	-	530	409	430	512
% of Revenue	53.4%	53.2%	53.4%	52.5%		50.9%	51.4%	54.9%	55.2%
Music	465	304	302	379	-	483	339	314	356
Publishing	36	60	42	53	-	31	48	40	60
Divested Publishing Operations	4	3	2	0	-	0	0	0	0
Other Divestitures and Adjustments	0	0	0	0	-	0	0	0	0
Corporate Eliminations	0	0	0	0	-	0	0	0	0
Total Gross Profit	507	367	346	432	-	514	387	355	416
% Change	-4.3%	5.0%	3.9%	14.9%		1.4%	5.4%	2.5%	-3.7%
% Margin	46.4%	47.5%	44.6%	47.7%		49.2%	48.6%	45.9%	44.8%
Music	270	227	230	274	-	254	248	244	251
Publishing	15	11	11	10	-	9	8	14	13
Divested Publishing Operations	5	4	3	0	-	0	0	0	0
Other Divestitures and Adjustments	0	0	0	0	-	0	0	0	0
Corporate Eliminations	24	27	23	27	-	23	24	29	24
Total Selling, General, and Admin. Expense	313	270	267	313	-	306	275	280	329
Depreciation Expense	14	14	12	11	-	11	11	11	11
Management Fees	2	2	1	0	-	0	0	0	0
FAS 123 Stock Compensation	2	7	9	7	-	6	2	6	6
Reported Total Selling, General, and Admin. Exp.	331	293	289	331	-	323	286	296	345
% Change	-15.3%	-7.7%	-4.7%	2.9%		-2.4%	-2.4%	2.4%	4.2%
% of Revenue	30.4%	36.8%	38.9%	33.4%		29.3%	34.5%	33.8%	33.4%
Music	195	77	72	103	-	209	91	68	65
Publishing	23	48	31	43	-	22	47	27	47
Divested Publishing Operations	1	(1)	(1)	0	-	0	0	0	0
Other Divestitures and Adjustments	0	0	0	0	-	0	0	0	0
Corporate Eliminations	(22)	(27)	(23)	(27)	-	(23)	(24)	(29)	(24)
Total EBITDA before Mgmt. Fees & Stk. Comp	195	98	79	119	-	208	114	75	88
% Change	22.3%	89.0%	7.3%	51.3%		6.9%	16.3%	-5.0%	-26.3%
% Margin	17.9%	12.3%	10.6%	11.9%		19.9%	14.3%	9.6%	9.4%
Music	(3)	(3)	(3)	(3)	-	(3)	(2)	(3)	(3)
Publishing	-	(1)	(1)	(1)	-	(1)	-	(1)	(1)
Corporate	(1)	(1)	(1)	(1)	-	(1)	-	0	(1)
FAS 123 Expense	(3)	(7)	(9)	(7)	-	(6)	(2)	(6)	(6)
Music	194	72	66	98	-	206	89	63	62
Publishing	23	48	30	42	-	21	47	26	46
Divested Publishing Operations	1	(1)	(1)	0	-	0	0	0	0
Other Divestitures and Adjustments	0	0	0	0	-	0	0	0	0
Corporate Eliminations	(23)	(31)	(24)	(28)	-	(23)	(24)	(29)	(25)
Total EBITDA after Mgmt. Fees, after Stk. Comp	190	88	69	112	-	202	112	70	82
% Change									
% Margin	17.5%	11.5%	9.3%	11.6%		19.3%	14.1%	8.9%	8.8%

E = Morgan Stanley Research estimates Source: Morgan Stanley Research

Exhibit 24

Annual Recorded Music Operating Forecast

					Fiscal Years Ending September 30th		
Fiscal Year End - September	2004	2005	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	2,692	2,639	2,551	2,449	2,376	2,328	2,305
Digital Sales	32	137	312	402	497	582	653
Other Sales/Allowances	(15)	-	-	-	-	-	-
Total Revenue ex. Licensing	2,709	2,776	2,864	2,851	2,873	2,910	2,958
% Change		2.5%	3.2%	-0.4%	0.8%	1.3%	1.6%
Licensing Revenue	141	148	145	139	135	133	131
Total Revenue	2,850	2,924	3,009	2,991	3,008	3,043	3,089
% Change		2.6%	2.9%	-0.6%	0.6%	1.2%	1.5%
Product Costs	528	543	584	563	548	539	536
Royalties	672	704	687	690	702	717	732
A&R	201	147	154	172	192	209	212
Other	78	80	92	76	74	72	71
Total COGS	1,479	1,474	1,517	1,501	1,515	1,537	1,551
Gross Profit	1,371	1,450	1,492	1,490	1,493	1,506	1,538
% Change		5.7%	2.9%	-0.1%	0.2%	0.9%	2.1%
Gross Margin	48.1%	49.6%	49.6%	49.8%	49.6%	49.5%	49.8%
Distribution	95	72	67	64	62	61	61
Variable Marketing	418	409	444	456	459	465	472
Selling Overhead	89	77	81	84	86	89	91
Marketing Overhead	161	123	133	138	143	147	150
G&A Overhead	352	350	382	394	404	415	426
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	(44)	(27)	(48)	(48)	(49)	(49)	(50)
Total Operating Expenses	1,071	1,004	1,059	1,087	1,106	1,127	1,150
% Change		-6.3%	5.5%	2.6%	1.7%	1.9%	2.1%
EBITDA	300	446	433	403	387	379	388
% Change		48.5%	-2.9%	-6.9%	-3.9%	-2.0%	2.2%
EBITDA Margin, %	10.5%	15.3%	14.4%	13.5%	12.9%	12.5%	12.5%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 25

Quarterly Recorded Music Operating Forecast

	2005					2006E			
Fiscal Year End - September	1Q	2Q	3Q	4Q		1Q	2Q	3QE	4QE
Gross Sales Net of Returns	886	557	510	686	-	829	562	509	652
Digital Sales	21	31	38	47	-	64	86	78	85
Other Sales/Allowances	-	-	-	-	-	-	-	-	-
Total Revenue ex. Licensing	907	588	548	733	-	893	648	587	736
% Change	-8.8%	6.4%	1.9%	17.6%		-1.6%	10.2%	7.1%	0.4%
Licensing Revenue	33	33	40	42	-	28	28	44	46
Total Revenue	940	621	588	775	-	920	676	631	782
% Change	-8.6%	4.9%	1.9%	18.9%		-2.1%	8.9%	7.3%	0.9%
Product Costs	166	121	112	142	-	159	142	123	160
Royalties	250	134	125	196	-	233	125	134	195
A&R	35	35	33	44	-	24	44	38	48
Other	24	26	16	14	-	21	27	22	23
Total COGS	475	317	286	396	-	437	337	317	426
Gross Profit	465	304	302	379	-	483	339	314	356
% Change	-5.8%	7.2%	5.0%	23.5%		3.9%	11.4%	4.0%	-6.0%
Gross Margin	49.5%	48.9%	51.4%	48.9%		52.5%	50.1%	49.8%	45.5%
	173	129	138	168		183	141	152	182
Distribution	26	15	13	18	-	22	15	13	17
Variable Marketing	120	83	96	110	-	127	90	106	121
Selling Overhead	21	16	16	24	-	20	19	18	25
Marketing Overhead	32	29	26	35	-	37	32	28	35
G&A Overhead	88	86	76	101	-	90	108	85	99
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-	-	-
Other	(17)	(2)	3	(11)	-	(22)	(17)	(4)	(6)
Total Operating Expenses	270	227	230	276	-	274	248	246	291
% Change									
EBITDA	195	76	72	103	-	209	91	68	65
% Change	22.0%	238.5%	7.9%	99.2%		7.5%	19.0%	-5.2%	-37.2%
EBITDA Margin, %	20.7%	12.3%	12.2%	13.3%		22.7%	13.5%	10.8%	8.3%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 28

Annual U.S. Recorded Music Operating Forecast

Fiscal Year End - September	2004	2005	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	1,266	1,246	1,228	1,179	1,144	1,121	1,110
Digital Sales	26	105	227	296	370	434	487
Other Sales/Allowances	(1)	-	-	-	-	-	-
Total Revenue ex. Licensing	1,291	1,351	1,455	1,475	1,513	1,555	1,597
% Change		4.7%	7.7%	1.3%	2.6%	2.8%	2.7%
Licensing Revenue	45	50	50	48	46	45	45
Total Revenue	1,336	1,401	1,505	1,522	1,559	1,600	1,642
% Change		4.9%	7.4%	1.1%	2.4%	2.6%	2.6%
Product Costs	307	313	337	325	317	312	310
Royalties	229	282	279	292	308	324	338
A&R	120	76	82	92	106	117	120
Other	36	31	43	29	28	27	27
Total COGS	692	702	741	737	759	780	794
Gross Profit	644	699	764	785	801	820	847
% Change		8.5%	9.3%	2.7%	2.0%	2.5%	3.3%
Gross Margin	48.2%	49.9%	50.8%	51.6%	51.3%	51.3%	51.6%
Distribution	41	27	25	24	23	22	22
Variable Marketing	170	181	221	229	235	241	248
Selling Overhead	42	38	41	42	44	45	46
Marketing Overhead	91	63	69	73	76	79	81
G&A Overhead	203	223	256	263	271	279	288
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	(19)	(2)	(26)	(26)	(27)	(28)	(28)
Total Operating Expenses	528	530	586	604	622	639	656
EBITDA	116	169	178	180	179	181	191
% Change		45.0%	5.7%	1.1%	-0.9%	1.5%	5.2%
EBITDA Margin, %	8.7%	12.1%	11.9%	11.9%	11.5%	11.3%	11.6%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 27

Annual International Recorded Music Operating Forecast

Fiscal Year End - September	2004	2005	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	1,426	1,393	1,323	1,270	1,232	1,208	1,196
Digital Sales	6	32	85	106	128	148	166
Other Sales/Allowances	(14)	-	-	-	-	-	-
Total Revenue ex. Licensing	1,418	1,425	1,408	1,377	1,360	1,355	1,361
% Change		0.5%	-1.2%	-2.2%	-1.2%	-0.3%	0.4%
Licensing Revenue	96	98	96	92	89	87	87
Total Revenue	1,514	1,523	1,504	1,469	1,449	1,443	1,448
% Change		0.6%	-1.2%	-2.4%	-1.3%	-0.4%	0.3%
% Change excluding FX Impact		-3.5%	2.9%	-2.4%	-1.3%	-0.4%	0.3%
Product Costs	221	230	247	238	231	227	226
Royalties	443	422	407	398	394	393	394
A&R	81	71	72	80	86	92	93
Other	42	49	49	47	46	45	45
Total COGS	787	772	776	763	757	757	757
Gross Profit	727	751	728	705	692	686	691
% Change		3.3%	-3.0%	-3.1%	-1.8%	-0.9%	0.7%
Gross Margin	48.0%	49.3%	48.4%	48.0%	47.8%	47.5%	47.7%
Distribution	54	45	42	41	40	39	38
Variable Marketing	248	228	224	227	224	224	225
Selling Overhead	47	39	40	41	43	44	45
Marketing Overhead	70	60	63	65	67	68	69
G&A Overhead	145	125	127	131	133	136	138
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	(25)	(25)	(23)	(22)	(22)	(22)	(22)
Total Operating Expenses	539	472	474	483	484	488	494
EBITDA	188	279	254	222	208	198	197
% Change		48.5%	-8.8%	-12.6%	-6.4%	-5.0%	-0.5%
EBITDA Margin, %	12.4%	18.3%	16.9%	15.1%	14.4%	13.7%	13.6%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 28

Annual Publishing Operating Forecast

Fiscal Year End - September	2004	2005	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	-	-	-	-	-	-	-
Digital Sales	-	20	42	65	82	93	109
Other Sales/Allowances	552	553	530	536	546	563	585
Total Revenue ex. Licensing	552	573	572	600	629	655	694
% Change		3.8%	-0.1%	4.9%	4.8%	4.2%	6.0%
Licensing Revenue	-	-	-	-	-	-	-
Total Revenue	552	573	572	600	629	655	694
% Change		3.8%	-0.1%	4.9%	4.8%	4.2%	6.0%
Product Costs	(1)	-	-	-	-	-	-
Royalties	322	358	362	380	399	416	441
A&R	29	24	30	32	34	35	37
Other	-	-	-	-	-	-	-
Total COGS	350	382	393	412	432	451	478
Gross Profit	202	191	179	188	196	205	217
% Change		-5.6%	-6.0%	4.7%	4.6%	4.2%	5.8%
Gross Margin	36.6%	33.3%	31.4%	31.3%	31.2%	31.2%	31.2%
Distribution	-	-	-	-	-	-	-
Variable Marketing	1	1	0	0	0	0	0
Selling Overhead	-	-	-	-	-	-	-
Marketing Overhead	-	-	-	-	-	-	-
G&A Overhead	53	44	37	38	39	41	43
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	(1)	-	-	-	-	-	-
Total Operating Expenses	53	45	37	38	40	41	43
EBITDA	149	146	143	150	157	164	174
% Change		-1.9%	-2.3%	4.9%	4.9%	4.3%	6.2%
EBITDA Margin, %	27.0%	25.5%	24.9%	24.9%	25.0%	25.0%	25.0%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 29

Quarterly Publishing Operating Forecast

	2005				2006E			
Fiscal Year End - September	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE
Gross Sales Net of Returns	-	-	-	-	-	-	-	-
Digital Sales	4	4	6	6	5	4	13	20
Other Sales/Allowances	136	139	147	131	126	125	148	132
Total Revenue ex. Licensing	140	143	153	137	131	129	161	152
% Change	-1.4%	5.9%	7.0%	3.8%	-6.4%	-9.8%	4.9%	10.7%
Licensing Revenue	-	-	-	-	-	-	-	-
Total Revenue	140	143	153	137	131	129	161	152
% Change	-1.4%	5.9%	7.0%	3.8%	-6.4%	-9.8%	4.9%	10.7%
Product Costs	-	-	-	-	-	-	-	-
Royalties	100	77	105	77	96	73	110	82
A&R	4	6	7	7	4	7	10	9
Other	-	-	-	-	-	-	-	-
Total COGS	104	83	111	84	100	81	120	92
Gross Profit	36	60	42	53	31	48	40	60
% Change	-7.3%	5.1%	-3.9%	-15.3%	-14.5%	-19.6%	-3.3%	12.9%
Gross Margin	25.8%	42.0%	27.2%	38.8%	23.6%	37.5%	25.1%	39.6%
Distribution	-	-	-	-	-	-	-	-
Variable Marketing	0	0	0	0	0	-	-	-
Selling Overhead	-	-	-	-	-	-	-	-
Marketing Overhead	-	-	-	-	-	-	-	-
G&A Overhead	13	11	10	10	9	1	14	13
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-	-
Total Operating Expenses	13	11	11	10	9	1	14	13
EBITDA	23	49	31	43	22	47	27	47
% Change	-11.4%	13.6%	-0.7%	-11.4%	-4.3%	-4.1%	-13.6%	9.0%
EBITDA Margin, %	16.4%	34.3%	20.3%	31.4%	16.8%	36.4%	16.7%	30.9%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 30

Annual U.S. Publishing Operating Forecast

Fiscal Year End - September	2004	2005	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	-	-	-	-	-	-	-
Digital Sales	-	8	20	33	44	49	61
Other Sales/Allowances	220	215	193	195	199	205	213
Total Revenue ex. Licensing	220	223	213	227	243	253	273
% Change		1.5%	-4.8%	7.0%	6.7%	4.3%	8.0%
Licensing Revenue	-	-	-	-	-	-	-
Total Revenue	220	223	213	227	243	253	273
% Change		1.5%	-4.8%	7.0%	6.7%	4.3%	8.0%
Product Costs	-	-	-	-	-	-	-
Royalties	102	115	111	121	130	136	148
A&R	13	11	13	14	14	15	16
Other	-	-	-	-	-	-	-
Total COGS	115	126	124	134	145	151	165
Gross Profit	105	97	88	93	98	102	109
% Change		-7.2%	-9.0%	5.2%	5.4%	3.9%	6.9%
Gross Margin	47.6%	43.5%	41.6%	40.9%	40.4%	40.2%	39.8%
Distribution	-	-	-	-	-	-	-
Variable Marketing	-	0	-	-	-	-	-
Selling Overhead	-	-	-	-	-	-	-
Marketing Overhead	-	-	-	-	-	-	-
G&A Overhead	17	11	4	4	4	4	5
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-
Total Operating Expenses	17	11	4	4	4	4	5
OIBDA	88	86	85	89	94	97	104
% Change		-1.6%	-1.8%	5.1%	5.3%	3.9%	6.9%
OIBDA Margin, %	39.8%	38.6%	39.8%	39.1%	38.6%	38.5%	38.0%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 31

Annual International Publishing Operating Forecast

Fiscal Year End - September	2004	2005	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	-	-	-	-	-	-	-
Digital Sales	-	12	22	32	38	44	48
Other Sales/Allowances	331	338	338	341	348	358	373
Total Revenue ex. Licensing	331	350	360	373	386	402	421
% Change		5.6%	2.9%	3.7%	3.5%	4.2%	4.7%
Licensing Revenue	-	-	-	-	-	-	-
Total Revenue	331	350	360	373	386	402	421
% Change		5.6%	2.9%	3.7%	3.5%	4.2%	4.7%
% Change excluding FX Impact		1.5%	7.0%	3.7%	3.5%	4.2%	4.7%
Product Costs	-	-	-	-	-	-	-
Royalties	218	243	251	260	269	280	293
A&R	15	13	18	18	19	20	21
Other	-	-	-	-	-	-	-
Total COGS	233	256	269	278	288	299	313
Gross Profit	98	94	91	95	99	103	108
% Change		-3.9%	-2.9%	4.2%	3.8%	4.4%	4.8%
Gross Margin	29.5%	26.8%	25.3%	25.4%	25.5%	25.6%	25.6%
Distribution	-	-	-	-	-	-	-
Variable Marketing	1	1	0	0	0	0	0
Selling Overhead	-	-	-	-	-	-	-
Marketing Overhead	-	-	-	-	-	-	-
G&A Overhead	29	28	29	30	31	32	34
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-
Total Operating Expenses	30	29	29	30	31	33	34
OIBDA	67	65	62	65	67	70	74
% Change		-3.6%	-4.3%	4.4%	3.9%	4.5%	4.8%
OIBDA Margin, %	20.3%	18.5%	17.2%	17.4%	17.4%	17.5%	17.5%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

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(as of April 30, 2006)

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Total	1,963		640		

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Industry Coverage:Entertainment

Company (Ticker)	Rating (as of)	Price (05/16/2006)
Richard A. Bilotti		
CBS Corporation (CBS.N)	O (01/17/2006)	$28.33
Discovery Holding Company (DISCA.O)	U-V (08/30/2005)	$14.40
Dreamworks Animation (DWA.N)	E (09/13/2005)	$26.13
Liberty Media (L.N)	E (07/08/2003)	$8.70
News Corp. (NWSa.N)	O (04/13/2005)	$19.11
Time Warner Inc. (TWX.N)	E-V (04/28/2005)	$17.62
Viacom (VIAb.N)	O (01/17/2006)	$38.41
Walt Disney (DIS.N)	E (05/18/2004)	$30.35
Warner Music Group (WMG.N)	Equal-weight–V (05/17/2006)	$27.88

Stock Ratings are subject to change. Please see latest research for each company.

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EXHIBIT CO 0967

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January 27, 2006

Stock Rating
Underweight-V

Industry View
Attractive

Warner Music Group

Lowered Digital Forecasts Don't Justify a Premium: Going to Underweight-V

What's Changed	
Rating	Equal-weight-V to Underweight-V
Price Target	$19.00 to $17.00
F2006e EPS	From $0.89 To $0.91
F2008e EPS	From $0.69 To $0.63

Conclusion: We are downgrading our rating to Underweight-V from Equal-weight-V and our price target to $17 from $19. We value WMG as a stand-alone entity and under its current cost containment strategies. WMG will probably have the lowest revenue, FCF, and adjusted net income growth among diversified entertainment conglomerates. Our research challenges the two main rationales we can imagine for owning WMG — strong digital market growth and industry consolidation. We see neither.

Lowered forecasts for digital music out to 2010. We lowered our estimates of the retail digital market to $2.9 billion in F2005, increased the estimates of the share of revenue retained by the music companies to $1.1 billion, and lowered 2006E-2010E growth rates. This reflects lowered forecasts for international online downloads, reduced estimates of the global mobile market in 2005, and a slower rate of 3G adoption according to our telecom analysts.

Cost, capital structures don't justify consolidation. Our apples-to-apples analysis of EBITA margins by division at EMI, UMG and WMG suggests very limited operating benefits from further consolidation. There also appears to be limited debt financing capacity to fund a merger of WMG and EMI.

Implications: WMG looks expensive at 23-24x price to F2006E EPS and 17-18x 2006E free cash flow — modest premiums to similar multiples for the North American Entertainment group.

Key Ratios and Statistics

Reuters: WMG.N Bloomberg: WMG.N
Entertainment / United States of America

Price target	$17.00
Shr price, close (Jan 26, 2006)	$20.94
Mkt cap, curr (mm)	$3,568
52-Week Range	$21.79-14.70

Fiscal Year (Sep)	2005	2006e	2007e	2008e
ModelWare EPS ($)*	0.82	0.91	0.69	0.63
Prior ModelWare EPS ($)	-	0.89	0.69	0.69
P/E	22.5	23.1	30.2	33.2
Div yld (%)	26.1	2.8	2.8	2.8

* = Please see explanation of Morgan Stanley ModelWare later in the note.
e = Morgan Stanley Research estimates

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Please see analyst certification and other important disclosures starting on page 63.

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Investment Case

We are lowering our investment rating for Warner Music Group (WMG) to Underweight-V from Equal-weight-V and are reducing our 12-month price target to $17 from $19. Our price target is based on the valuation of Warner Music Group as an ongoing standalone entity. We do not estimate the strategic value that WMG may represent to a potential partner. In addition, our valuation assumes modest increases in WMG's cost base from the level of F2005 (i.e., after the considerable cost cuts in F2004-2005) rather than significant positive or negative changes to WMG's cost base. WMG will probably have lower revenue, free cash flow, and adjusted net income growth than all of the diversified entertainment conglomerates. As a result, we believe the stock is becoming expensive at a current multiple of 23–24 times price to F2006 EPS and 17–18 times 2006 FCF per share — modest premiums to the similar multiples for the North American entertainment industry.

Both WMG and EMI (EMI.L, 260p, Underweight, price target 225p, covered by Patrick Wellington, In-Line industry view) trade above our estimates of fair value. The market may be reacting to the potential of consolidation in a way that, we think, is unwarranted by the synergies we can estimate from a hypothetical WMG merger with EMI. Of course, a merger transaction may occur on terms that are not warranted by fair value estimates. For example, a transaction may be premised on deeper cost cuts than those we have identified in our scenario analyses. But, in our view, such cuts would endanger the long-term sustainability of the business.

In our opinion, WMG's relative valuation premium to the group is unwarranted for the following key reasons:

- *The market overestimates the digital music market's growth potential*, in our view. We expect digital sales to slightly more than offset the decline in physical sales in F2006–10, but total revenue growth is unlikely to exceed 2% in any given year. We have reduced our estimates of retail and wholesale digital music markets based on a detailed geographic and product breakdown of the business in 2005. In addition, we have lowered our 2006–10 digital revenue forecasts for both the industry and WMG.

- *On a standalone basis, we see minimal potential for WMG to reduce costs further* on a sustainable basis. We believe that WMG has proved the viability of its current recorded music segment cost structure, which is $250–300 million lower than the expense base when it was part of Time Warner. Based on more complete cost disclosures for F2005, we have increased our long-term forecasts for A&R costs. In our view, more aggressive cost-cutting than we reflect in our model would endanger the long-term sustainability of the business model.

- *We believe that further industry consolidation would be unlikely to yield meaningful cost savings* that exceed 1% of revenues if EMI and WMG tried to form a combined company that equaled the scale of Universal Music Group (UMG) or Sony/BMG, as suggested in recently published news stories. It is possible that a combined EMI and WMG could use much deeper cost cuts to justify a transaction premium paid in a merger. However, going beyond the margins attained by UMG would entail long-term risks that the franchise value would be harmed.

- *We see little incremental debt capacity in the event of a combination of WMG and EMI.* On our calculations, the combined entity could not exceed a 4.0 debt-to-EBITDA ratio and still expect to attain a debt rating above single B.

Lower forecasts for global digital music revenue; growth to only slightly offset lower physical music sales. We lowered our estimates of the retail digital market to $2.9 billion in F2005, increased the estimates of the share of revenue

Company Description

Warner Music Group, Inc. commenced public trading in May 2005. Its operation includes Music Publishing (a copyright management business with a catalog of more than one million copyrights worldwide) and Recorded Music (CD production and distribution which includes record labels Atlantic, Bad Boy, Elektra, Lava, Maverick, Nonesuch, Reprise, Rhino, Sire, Warner Bros. and Word). Warner Music International operates through 37 affiliates and numerous licensees in more than 50 countries.

Industry View: Attractive

Two factors should create upside for Entertainment stocks in 2006: increased payout ratios and higher EPS growth achieved through optimization of asset bases and capital structures.

GICS Sector: Consumer Discretionary

Strategist's Recommended Weight: 8.2%
S&P 500 Weight: 10.9%

retained by the music companies to $1.1 billion in F2005, and lowered the forecasted 2006–10 growth rates. This reflects lowered forecasts for international online downloads, reduced estimates of the global mobile market in 2005, and a slower rate of 3G adoption, according to our telecom analysts.

We currently forecast that WMG's digital sales will grow from $157 million in F2005 to $580 million by F2010, down from our previous estimate of $730–740 million. Our current digital revenue forecasts imply that WMG maintains its digital music market share at 15–16%. We feel quite confident in our forecasts for the online download market. The mobile market, however, can prove to be a wild card in the digital music forecast. The penetration of G2.5+ cell phones (capable of downloading mastertones) is still very low in the US and only slightly higher internationally. The speed of the adoption of the G2.5+ phones and the consumers' willingness to spend on mobile music are very difficult to forecast. Morgan Stanley telecom team estimates that global 3G phones penetration will remain in low single-digit percentages over the next two-three years and will likely not exceed 400-500 million subscribers by 2010. At that point, it is possible that mobile downloads will begin to cannibalize internet downloads.

The key variable in our overall revenue forecast is whether growth in digital sales will be sufficient to offset declines in physical music sales and to create positive total revenue growth. We expect digital sales to slightly more than offset the decline in physical sales in F2006–10, but total revenue growth is unlikely to exceed 2% in any given year. We expect WMG's physical music sales in F2006–10 to decline at an annual rate of roughly 1% ($55–60 million), which is significantly better than the 5% global industry declines in the past five years.

To reach 3–4% growth in WMG's total revenue in F2006–10 — which could warrant a more positive view on the stock — WMG's digital revenues would have to grow to $1.0–1.2 billion by F2010. Our updated analysis of the digital music market indicates that this is an unlikely scenario.

Music companies' cost and capital structures do not justify further consolidation, we believe. Published stories in the financial media suggest continued market conjecture regarding a potential merger of WMG and EMI, especially given WMG's current premium valuation: a price-to-F2006 EPS multiple of 23–24 times versus EMI's 16–17 times 2006 EPS, on Morgan Stanley's estimates. On EV/2006 EBITDA multiple, WMG is also more expensive: 12-13 times compared to 10-11 times for EMI (see Exhibit 3). Our P/E multiples calculations are based on the adjusted prices (i.e., market price less the estimated value of unconsolidated assets) and adjusted EPS that exclude amortization of intangibles on an after-tax basis. Although we cannot be certain whether such a merger will occur, we analyze several possible scenarios, reflecting different levels of leverage and different potential cost savings.

Exhibit 1
Summary Cost Comparisons

in $ Millions	EMI 10/1/04-9/30/05 12Months	WMG 10/01/04 9/30/05 F2005	UMG 7/1/04-6/30/05 12Months
Recorded Music			
Net Revenue	3,043	2,924	5,961
Reported EBITA	251	399	767
Reported EBITA Margin	8.3%	13.6%	12.9%
Adjustments for Joint Ventures	2.0%	0.0%	0.0%
Corporate Overhead Allocation	0.0%	-3.1%	-1.0%
Allocation of Division Overhead to Publishing	0.0%	0.0%	0.2%
Stock Option Expenses	0.0%	0.0%	-0.3%
Adjusted EBITA Margin	10.3%	10.5%	11.8%
Music Publishing			
Net Revenue	768	544	421
Reported EBITA	185	137	132
Reported EBITA Margin	24.0%	25.2%	31.4%
Corporate Overhead Allocation	0.0%	-3.1%	-1.0%
Allocation of Division Overhead to Publishing	0.0%	0.0%	-3.2%
Stock Option Expenses	0.0%	0.0%	-0.3%
Adjusted EBITA Margin	24.0%	22.1%	27.0%
Total Group			
Net Revenue	3,811	3,468	6,382
Reported EBITA	436	427	899
Reported EBITA Margin	11.4%	12.3%	14.1%
Adjusted EBITA Margin	**13.0%**	**12.3%**	**12.8%**

Note: WMG reports EBITDA excluding FAS 123R expense and EBIT including FAS 123R expense
Source: Company data, Morgan Stanley Research

We see no significant sustainable operating benefits from further consolidation, based on our apples-to-apples analysis of EBITA margins by division at EMI, UMG and WMG (after adjusting for the companies' differing accounting treatments of items including joint ventures, overhead allocation, and stock options expense). WMG by itself already has a rather lean cost structure, after its F2004–05 cost cutting initiatives. EMI has also restructured its labor and marketing expenses in recent years. If WMG and EMI were to merge, the "New Co" would be about the same size as UMG in Recorded Music and about three times larger than UMG in Music Publishing. We estimate that the normalized EBITA margins at UMG's Recorded Music segment are only

about 130–140 bps higher than the Recorded Music EBITA margins at EMI and WMG.

In Publishing, margins do not depend as much on the size of the company, since royalties, by far the largest cost component, are truly variable costs. Thus, we would not expect any major cost savings from the consolidation of the Publishing segments of EMI and WMG. In addition, it is likely that the New Co would have to dispose of some of its publishing assets, potentially of the entire WMG publishing. In the failed proposed merger of EMI and Warner Music in 2000, the EU informed the companies that one of their publishing operations would have to be sold as their combined market shares would exceed 35% on a global basis. We analyze the cost structures of WMG, EMI, and UMG in the last section of this report starting on page 21.

The enterprise values of EMI and WMG are about $5.1 billion and $5.3 billion, respectively. If the acquiring party paid a 15-30% premium for the target, the combined entity would have an enterprise value of $12.0-13.0 billion. The combined entities would have an EV/EBITDA ratio of about 12.5-14.0x, before synergies and asset sales. After incorporating synergies but before asset sales, the multiple would only drop to 11.75-13.25x.

There also appears to be limited debt financing capacity to fund a merger of WMG and EMI. The high level of debt at both companies is likely to prohibit an all-cash acquisition of either EMI or WMG by the alternate party. If the combined enterprise sold WMG's publishing unit for $1.9 billion (13.0 times F2006 EBITDA), their 2006 debt/EBITDA would be 2.6 times, before the assumption of any new debt. We believe that the tax basis assigned under Section 338 of the Tax code in the original buyout of WMG would shield most of the proceeds from taxes. To maintain a single-B debt rating or better, we believe that the New Co would have to keep its debt-to-F2006E EBITDA ratio at 4.0 times or lower. This implies only $1.1 billion in the incremental debt capacity which could be borrowed for an acquisition. Under 3.5x and 3.0x debt/F2006 EBITDA scenarios, the incremental debt capacity would only be $700 million and $300 million, respectively. Thus, under these assumptions, neither WMG nor EMI could finance an all cash bid for the other company without completing a large public or private placement of new equity.

If either WMG or EMI were to propose a stock-financed acquisition, it could lead to a 'vicious cycle.' If the market agreed with our skeptical opinion of the benefits from scale, the transaction would be viewed as highly dilutive to the acquiring party's adjusted EPS and free cash flow per share. A rapid decline in the buyer's shares would lead to compression in the merger price. In the worst case, if the deal had collar mechanisms that adjusted the exchange ratio if the acquirer's share price declined, then this could keep repeating until the low end of the collar was reached.

Exhibit 2
Incremental Debt Capacity if EMI and WMG Merged

(In $ Millions)			
WMG's Net Debt, September 2005	1,958		
EMI's Net Debt, September 2005	1,884		
Total Net Debt	3,842		
WMG's EBITDA, F2006	434		
EMI's EBITDA, F2006	508		
Total EBITDA	942		
Debt/EBITDA Before Sale of WMG Publishing	**4.1 x**		
WMG's Publishing EBITDA, F2006	145		
Total EBITDA, excl. WMG Publishing	796		
Publishing Acquisition Multiple	13.0 x		
Cash Raised in Sale of WMG Publishing	1,891		
Tax Basis	1,500		
Proceeds from Sale of Publishing, at 40% Tax	1,735		
Debt After Sale of WMG Publishing	2,107		
Debt/EBITDA After Sale of WMG Publishing	**2.6 x**		
Debt/EBITDA	4.0 x	3.5 x	3.0 x
Incremental Debt Capacity	**1,078**	**679**	**281**

Source: Company data, Morgan Stanley Research

Valuation Methodology and Risks

Our 12-month price target for WMG of $17 per share is based on the valuation of Warner Music Group as an ongoing standalone entity rather than an estimate of the strategic value that WMG may represent to a potential partner. In addition, our valuation assumes modest increases in WMG's cost base from the level of F2005 (already after the considerable cost cuts in F2004-2005) rather than significant positive or negative changes to WMG's cost base.

Our $17 price target for WMG is based on triangulation of two valuation methodologies: discounted cash flow-based sum-of-the-parts and FCF/share multiples. Our "sum of the parts analysis" is based on a discounted cash flow appraisal of each of the operating segments. We estimate WMG's fair enterprise value at $4.4 billion in F2006. We separately value five components of the WMG business: (1) recorded music (valued at $3.1 billion), (2) music publishing (valued at $2.2

billion), (3) corporate overhead and eliminations (negative impact on the enterprise value of $1.0 billion); (4) FAS 123 stock option expense (negative impact on the enterprise value of $155 million), and (5) the tax shield benefit estimated at $300 million).

The discounted cash flow model uses an 8.0% discount rate, which is a blended average of 9.6% required return on equity and the 6.4% actual WMG average borrowing rate. For the recording music business, we use terminal multiples of 18.6 times F2014E FCF/share. For the music publishing business, we use a higher exit multiple of 20.5 times F2014E FCF per share. Music publishing in effect is an annuity business. We believe that the high predictability of this business should command a higher multiple. The tax shield benefit stems from WMG's ability to use Section 338 of the IRS tax code. Please see our June initiation of coverage report on WMG for more details regarding the calculation of the tax shield.

FCF/share multiples analysis supports the $17 price target. We estimate that WMG will generate nearly $1.0 billion in free cash flow in F2005–10. However, net cash available for acquisitions and for return to shareholders should amount to roughly $400 million over this period. WMG is committed to dividends of nearly $80 million per year, or roughly a third of its free cash flow, which over F2005–10 should amount to nearly $400 million. We estimate the company will spend another $50 million in total on debt repayment over this period and $150 million on investments in associated companies.

For the FCF/share multiple valuation, we use adjusted FCF/share. Because Section 338 allows WMG to lower its cash taxes paid, we normalize FCF to account for the cash taxes as if the regular tax rate were used — i.e., the adjusted FCF/share is lower than the reported FCF/share. We then treat the tax shield benefit as an unconsolidated asset. We apply a 20 multiple to the terminal (F2011E) FCF/share and discount it back at the 9.6% target return on equity. We also add the present value of the dividends for F2006-11E.

Risks to our valuation, in addition to the concerns mentioned above, include weakness in revenue growth as digital cannibalizes physical sales; piracy crowding out legitimate sales; shifts in the retail channel that reduce catalog, non-mainstream music sales; and cost reductions not proving to be sustainable.

Exhibit 3

WMG and EMI Multiples Analysis

	WMG (YE September 30th)		EMI (YE March 31)		
	F2005	F2006	F2005	F2006	F2007
I. P/E Multiple Calculation					
Reported Net Income Available to Common	(169)	(49)	75	65	72
Average Basic Shares	121	136	786	786	786
Average Diluted Shares	127	136	873	873	873
Reported Basic EPS	($1.40)	($0.36)	£0.09	£0.09	£0.09
Reported Diluted EPS	($1.33)	($0.36)	£0.09	£0.09	£0.09
Reported Net Income Available to Common	(169)	(49)	75	65	72
Add: Amortization of Intangible Assets	187	188	48	49	51
Add: Nonrecurring Losses per Share	182	34	0	1	2
Subtract: Nonrecurring Gains per Share	0	0	(18)	0	0
Tax Prov./(Benefit) Related to Non-recurring Items	(86)	(34)	0	1	2
Convertible Bond Adjustment	0	0	2	2	2
Adjusted Net Income	114	139	114	125	136
Adjustment for Additional Com. Share Equivalents	12	17	0	1	2
Adjusted Average Diluted Shares Outstanding	139	153	873	874	875
Adj. Net Income per Adj. Avg. Diluted Share	$0.82	$0.91	£0.13	£0.14	£0.16
Current Price	$21.10		£2.58		
P/E Multiple	25.7 x	23.3 x	19.7 x	18.0 x	16.6 x
II. EV/EBITDA Calculation					
Current Price		$21.10		£2.58	
Shares outstanding		151		786	
Market Capitalization		3,196		2,025	
Short-Term Debt		17		31	
Long-Term Debt		2,234		1,069	
Cash & Marketable Securities		(369)		(301)	
Unconsolidated Assets		(38)		(9)	
Present Value of the Tax Shield		303		0	
Enterprise Value		$5,343		£2,816	
EBITDA		434		270	281
EV/EBITDA Multiple		12.3 x		10.4 x	10.0 x

Source: Company Reports, Morgan Stanley Research

Key Long-Term Forecast Revisions

Revised revenue forecasts: higher in F2006-07 due to the stronger physical revenue, lower in F2008-10 due to the downwards revision of digital music revenues.
WMG's F4Q05 revenue of $905 million was $63 million above our estimates and $90 million above the consensus forecast. The upside was driven by the strength in physical music sales, while digital sales slightly underperformed expectations. Our assumptions on physical revenue growth rates in F2006-2010 remained virtually unchanged, but the higher physical sales base in F2005 translated into roughly $30 million upside to physical sales projections in each year in F2006-2010. Our digital sales forecasts are now significantly lower: by $23 million in F2006 and by $170 million in F2010 (please see the section on digital music).

Nielsen Soundscan data shows that WMG gained 1.9% in market share in physical album sales in F4Q05 versus F4Q04 and 1.3% in F1Q06 versus F1Q05 (see Exhibit 5). This strength was primarily driven by the turnaround at the Atlantic Records Group. The impact of this turnaround will disappear in F2H:06. Our forecasts already reflect the positive contribution from the turnaround in F1H:06. The actual share gain was probably even higher, as Soundscan's data is delayed and does not reflect WMG's large shipments at the end of F4Q05. There is a timing difference between the market share numbers reported by Nielsen Soundscan and actual sales reported by the companies. WMG reports sales based on the number of units shipped, whereas Soundscan reports sales based on the number of units scanned. In F4Q05, WMG had large shipments at the end of the quarter, which were not picked up by the Soundscan September data but were reflected by Soundscan in the October data. WMG's share was very strong in both months - 18.7% in September and 18.9% in October. However, then it dropped to 17.0% in November and 17.5% in December. We feel comfortable with our forecasts for the flat to slightly down physical revenues in F1Q06 and 2-3% decline in physical revenues in F2006.

Share shifts in any one quarter are not indicative of the long-term trends (see Exhibit 5), thus we do not view the strength of WMG's F4Q05 as a basis to change our view on the long-term growth prospects of the company. We would need to see several quarters of market share gains before assuming that the shift is permanent. We have maintained our growth rates forecasts for physical music sales and have reduced our digital revenue projections, which we discuss in the section on digital music. As a result, we now forecast 0.8% average CAGR for WMG's revenue growth in F2006-2010, below the previously expected 1.7% CAGR.

The Soundscan market share data implies that WMG's revenue, both domestically and internationally, should have been flat in F4Q05 vs. F4Q04 (see Exhibit 7). The total US physical units market was down 16% in F4Q04 and WMG gained 1.8% of market share. Multiplying the share gain by the total market change implies 0.3% decline in US physical sales at WMG in F4Q05. However, the reported US physical revenue was up 17.7%. About 2-3% of the difference can be attributed to changes in the average wholesale price per unit which generally follows the suggested retail price. Thus, about 15% of revenue growth at WMG in F4Q05 was not picked up by Soundscan in its C3Q05 numbers. This upside impacts C4Q05 share data reported by Soundscan, which shows that WMG's physical album sales were up 13% in October.

We increased our assumptions on WMG's *A&R expenses*. Based on the expense breakdown provided in F2005, which should be more accurate, our long-term forecasts now incorporate higher A&R expenses. We trued up WMG's expense breakdown based on the greater cost disclosure provided by WMG in F2005 10-K and in the subsequent investor presentations. The key change to our forecasts is a 100 bps increase in A&R expenses, 70-100 bps decrease in long-term EBIT margins, and $25-50 million decrease in long-term EBIT forecasts (see the section below for greater details).

We had previously assumed that A&R expenses represent roughly 4% of total revenues. In future years we increased A&R toward 6-7% of sales. Based on the new information, we estimate that A&R expenses were roughly 5% of total revenues in F2005 (see Exhibit 4). We continue to question the sustainability of A&R expenses at this level (in F2004 they represented 6.6% of revenue) and in our forecasts we continue to assume a gradual increase in A&R expenses to 6.5-7.0% of revenue by F2009-2010. *Royalties*, as percent of revenue, in F2005 were about 20 bps above our original estimates; however, we maintained our original 2006-2010 forecasts. *Variable marketing expenses* in F2005 of $411 million were about $10 million above our previous estimates; this is due to the higher than expected revenues generated in F4Q05. As a percent of revenue, variable marketing expenses were in line with our expectations. We maintained

our estimates for variable marketing expenses at 11.5-12.0% of revenue in 2006-10.

Exhibit 4
WMG Cost Structure

	F2005			F2010		
	Actual	Prior Estimate	Current vs. Prior	Current	Prior	Current vs. Prior
as % of Revenue:						
Product Costs	15.8%	16.1%	-0.2%	14.3%	13.5%	0.7%
Royalties	29.6%	29.4%	0.2%	32.3%	32.2%	0.0%
A&R Expenses	5.0%	4.1%	0.9%	6.8%	6.0%	0.8%
Marketing	15.3%	15.3%	0.1%	15.0%	15.3%	-0.3%
Distribution and Selling	4.2%	4.3%	0.0%	4.1%	4.4%	-0.3%
G&A	14.1%	14.4%	-0.3%	14.4%	14.4%	0.0%
Other Expenses	1.9%	2.6%	-0.6%	1.8%	1.7%	0.1%
Total Expenses	86.0%	86.0%	0.0%	88.6%	87.5%	1.1%

Source: Company data, Morgan Stanley Research

The revenue and expense revisions discussed above lead to a $12 million increase in recorded music EBITA in F2006. In contrast, our consolidated overall EBITA forecast for F2006 is $5 million lower due to the higher royalty expense ratios at publishing. Our long-term EBITA forecasts for F2007-2010 are also lower, primarily because of the reduction of our digital forecasts.

Key Model Assumptions

Recorded music physical sales. We revised our F2006-F2010 EBITDA forecasts downwards, given the increase in A&R expenses as percent of revenue. We assume that the decline in the US total physical music market abates in 2006 and returns to the average rate of 5% decline in unit sales in 1999-2004 (1999 was the first year of music sales declines in the US). We use unit trends as a proxy for revenue trends since we do not have enough information to predict the mix of pricing versus unit changes. We expect WMG to outperform the industry in F1H:06 due to the stronger release schedule at the Atlantic Electra, which was on a depressed schedule in F1H:05. A normalized release schedule started in F3Q05 and starting with F3Q06 growth rates should converge with industry trends. We expect WMG's physical recorded music sales in US to be flat in F1H:06 and to decline 3% in F2H:06, resulting in a 2.0% decline for the whole year F2006.

We use similar assumptions for the international physical music market projections. We expect total international market for physical music to be down by about 5% in F2006 in local currency. The strong release schedule at Atlantic Electra should also benefit WMG's international physical music sales. WMG's physical music sales outside of US in local currency should be flat in F1H:06 and decline by roughly 3% in F2H:06. The other factor is a likely negative impact from foreign exchange rates in F2006. We extrapolate current (F1Q06 to-date) exchange rates into F2006, which yields low to mid single digits negative impact on sales in each quarter F1Q06-F3Q06 and no impact in F4Q06. Thus, international physical music sales in US dollars should decline by 5% n F1H:06 and decline by 2-3% in F2H:06.

Overall, we expect WMG's physical recorded music sales (US and international combined) to be flat to slightly down in F1H:06 and to decline 3-4% in F2H:06, resulting in the 2% decline for the whole year F2006.

WMG's share of the U.S. physical music sales increased by 110 bps to 17.3% in calendar 2005 versus calendar 2004, according to Nielsen Soundscan. However, while this data is useful for analyzing WMG's historical performance, we do not think it can be used for forecasts. Unless market share shifts are sustainable and significant, we view them more as a reflection of the current release schedule than an indication of the future growth potential.

Digital music sales: We revised our F2006-2010 digital music forecasts downwards to reflect the revisions of our digital music market model. Digital music revenues in F4Q05 were $8 million below our expectations. We took our F2006 digital sales forecast down by $20-25 million to about $260-265 million and F2010 forecasts down by $170 million to $580 million.

Publishing. We project 2% growth in the traditional publishing revenues in F2005-2010, and growth in digital should improve total publishing revenue growth to 5% in F2005-2010. Publishing EBITDA margins declined in F2005 to 25.3% from 27% in F2004, primarily due to an increase in royalties as percent of sales. In F2006, we expect royalties as percent of sales to remain at the level of F2005 but G&A overhead growth is likely to lead to another 50-60 bps of margin deterioration. EBITDA margins at Publishing segment are likely to remain at 24.0-25.0%, and EBITA margins at about 22% (after the allocation of corporate overhead). The normalized publishing EBITDA margins at EMI are around 24% and at UMG are about 27% (please see the section on the comparative costs analysis starting on page 21 for more details).

Major cost assumptions. Our cost assumptions for F2006 COGS increased from $1.83 billion to $1.92 billion. Our estimates of $1.15 billion in selling, general and administrative expenses remained unchanged.

WMG has reduced its marketing expenses (including selling overhead) from $750 million, which we estimate it had been

spending annually prior to its split from Time Warner, to $614 million in F2005. We have cautioned previously that the sustainability of the cost cuts at WMG is among the key risks to WMG's business model and to its stock valuation. The higher than expected A&R expenses in F4Q05 (both in dollar terms and as a percent of revenue) highlight this risk of WMG's business model. We currently forecast that marketing expenses will grow by $4-8 million annually. A&R and royalties expenses were $1.2 billion in F2005, and we expect them to grow by roughly $50 million annually.

Exhibit 5

Music Albums: Quarterly Market Share Shifts

	1Q04	2Q04	3Q04	4Q04	1Q05	2Q05	3Q05	4Q05	Average over 8 Quarters
WMG	16.7%	15.4%	16.3%	16.4%	17.3%	16.0%	18.2%	17.7%	16.7%
BMG/Sony	31.3%	31.5%	28.9%	28.4%	27.7%	27.9%	25.9%	28.0%	28.7%
UMG	26.6%	27.6%	30.9%	32.0%	31.8%	32.3%	31.1%	31.7%	30.5%
EMI	11.9%	11.8%	10.0%	10.3%	10.1%	10.8%	11.2%	9.8%	10.7%
All Others	13.4%	13.7%	13.9%	13.0%	13.2%	13.1%	13.7%	12.8%	13.3%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Market Share Change, YoY									
WMG					0.5%	0.7%	1.9%	1.3%	
BMG/Sony					-3.6%	-3.6%	-3.0%	-0.4%	
UMG					5.2%	4.7%	0.1%	-0.2%	
EMI					-1.8%	-1.0%	1.2%	-0.5%	
All Others					-0.2%	-0.7%	-0.2%	-0.2%	
Total					0.0%	0.0%	0.0%	0.0%	
Market Share Change, Consecutively									
WMG		-1.3%	0.9%	0.1%	0.9%	-1.2%	2.1%	-0.5%	0.1%
BMG/Sony		0.2%	-2.6%	-0.5%	-0.7%	0.2%	-2.0%	2.1%	-0.5%
UMG		1.0%	3.4%	1.0%	-0.2%	0.5%	-1.2%	0.7%	0.7%
EMI		-0.1%	-1.8%	0.2%	-0.2%	0.7%	0.4%	-1.4%	-0.3%
All Others		0.3%	0.2%	-0.9%	0.2%	-0.1%	0.7%	-0.9%	-0.1%
Total		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

Source: Nielsen Soundscan, Morgan Stanley Research

Exhibit 6

F4Q05 Results vs. MS Estimates: Revenue and EBITDA

	Warner Music Group				Morgan Stanley Estimates			
	F4Q05A	Restated F4Q04A	Originally Reported F4Q04A	% Change (from Restated Results)	F4Q05E	Actuals vs. Estimates	% Deviation	MS Exp. Change
Recorded Music	775	662	652	17.1%	701	74	11%	7.5%
Publishing	137	131	132	4.6%	147	(10)	-7%	11.2%
Divested Publishing Operations	-	9	16	n.m.	-	-	n.m.	n.m.
Other Divestitures and Adjustments	-	2	2	n.m.	-	-	n.m.	n.m.
Corporate Eliminations	(7)	(6)	(5)	n.m.	(6)	(1)	17%	20.0%
Total Revenue	905	798	797	13.4%	842	63	7%	5.8%
Recurring EBITDA, before FAS 123 and Non-Recurring Items								
Recorded Music	103	60	52	71.7%	80	23	29%	54.3%
Publishing	43	45	49	-4.4%	59	(16)	-27%	21.7%
Divested Publishing Operations	-	1	1	n.m.	-	-	n.m.	n.m.
Other Divestitures and Adjustments	-	3	3	n.m.	-	-	n.m.	n.m.
Corporate Eliminations	(27)	(17)	(14)	n.m.	(28)	1	-4%	100.0%
Adj. EBITDA, before FAS 123 and Non-Recurring Items	119	92	91	29.3%	111	8	7%	22.5%

Source: Company data, Morgan Stanley Research

Exhibit 7

Drivers of F4Q05 Physical Sales Outperformance

	F4Q05		F4Q05				
WMG's Physical Music Sales	$ mm	% of Total	Market Change	WMG's Share Change	WMG's Revenue Change Implied by Mkt Share Shift	WMG's Revenue Change due to Timing Difference*	WMG's Reported Revenue Change
Domestic	352	46%	-16.0%	1.8%	-0.3%	18.0%	17.7%
International	400	52%	-10.0%	1.8%	-0.2%	11.3%	11.1%
Divested Operations & Corporate	13	2%	n.a.	n.a.	n.a.	n.a.	-153.8%
Total Physical Music Sales	765	100%	-12.6%	1.8%	-0.2%	11.6%	11.4%

Note: WMG reports revenues based on units shipped, whereas Soundscan reports unit sales based on units scanned.
Source: Company data, Nielsen Soundscan, Morgan Stanley Research

Exhibit 8

WMG Forecast Revisions

	CURRENT FORECAST						CURRENT VS PRIOR FORECAST (from October 21, 2005)					
	F2005	F2006E	F2007E	F2008E	F2009E	F2010E	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Gross Sales Net of Returns	2,639	2,578	2,475	2,401	2,353	2,329	13	31	30	29	28	28
Digital Sales	157	263	352	440	510	580	(8)	(23)	(48)	(89)	(152)	(170)
Other Sales/Allowances	524	525	531	542	559	583	53	66	50	48	47	46
Total Revenue ex. Licensing	3,320	3,367	3,358	3,383	3,422	3,492	58	75	32	(12)	(57)	(97)
% Change	2.6%	1.4%	-0.3%	0.7%	1.2%	2.0%	1.8%	0.5%	-1.3%	-1.3%	-1.3%	-1.1%
Licensing Revenue	148	159	153	148	145	144	5	6	6	5	5	5
Divested Operations and Merger Accounting Adj.	34	0	0	0	0	0	0	0	0	0	0	0
Total Revenue	3,502	3,526	3,511	3,531	3,568	3,636	63	80	37	(6)	(52)	(92)
% Change	1.9%	0.7%	-0.4%	0.6%	1.0%	1.9%	1.8%	0.5%	-1.2%	-1.3%	-1.3%	-1.1%
Product Costs	553	567	546	532	522	518	2	22	17	16	15	14
Royalties	1,036	1,071	1,087	1,111	1,136	1,173	26	29	16	1	(15)	(28)
A&R	174	189	212	227	243	248	35	37	34	31	28	25
Other Recurring Expenses	64	96	92	89	87	87	(20)	3	3	3	3	3
Divested Operations and Merger Accounting Adj.	20	0	0	0	0	0	0	0	0	0	0	0
Total COGS	1,850	1,923	1,937	1,959	1,989	2,026	42	90	71	51	30	14
Product Costs	15.8%	16.1%	15.6%	15.1%	14.6%	14.3%	-0.2%	0.3%	0.3%	0.5%	0.6%	0.7%
Royalties	29.6%	30.4%	30.9%	31.4%	31.8%	32.3%	0.2%	0.1%	0.1%	0.1%	0.0%	0.0%
A&R	5.0%	5.4%	6.0%	6.4%	6.8%	6.8%	0.9%	0.9%	0.9%	0.9%	0.9%	0.8%
Other Recurring Expenses	1.8%	2.7%	2.6%	2.5%	2.5%	2.4%	-0.6%	0.0%	0.1%	0.1%	0.1%	0.1%
Divested Operations and Merger Accounting Adj.	0.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total COGS	52.8%	54.5%	55.2%	55.5%	55.8%	55.7%	0.3%	1.4%	1.4%	1.5%	1.6%	1.7%
Gross Profit	1,652	1,603	1,574	1,572	1,579	1,610	21	(10)	(33)	(57)	(82)	(105)
Gross Margin	47.2%	45.5%	44.8%	44.5%	44.2%	44.3%	-0.3%	-1.4%	-1.4%	-1.5%	-1.6%	-1.7%
Distribution	72	68	65	63	62	61	(0)	(11)	(11)	(11)	(11)	(10)
Variable Marketing	413	412	406	404	406	409	10	(0)	(6)	(11)	(17)	(22)
Selling Overhead	77	79	81	83	85	87	2	(2)	(2)	(3)	(3)	(4)
Marketing Overhead	126	127	129	132	134	137	2	5	2	0	(2)	(4)
G&A Overhead	495	479	488	500	511	524	(0)	4	(1)	(5)	(9)	(13)
Additional OIBDA Cost Reserve	0	0	0	0	0	0	0	0	0	0	0	0
Other Recurring Expenses	(31)	(23)	(23)	(22)	(22)	(22)	(1)	(1)	(1)	(1)	(1)	(0)
Divested Operations and Merger Accounting Adj.	14	0	0	0	0	0	(0)	0	0	0	0	0
Total Selling, Gen. & Admin. Exp. (excl. Mgmt. Fees)	1,162	1,141	1,147	1,160	1,176	1,197	12	(4)	(19)	(30)	(42)	(54)
Distribution	2.0%	1.9%	1.9%	1.8%	1.7%	1.7%	0.0%	-0.4%	-0.3%	-0.3%	-0.3%	-0.2%
Variable Marketing	11.7%	11.7%	11.6%	11.4%	11.4%	11.3%	0.1%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%
Selling Overhead	2.2%	2.2%	2.3%	2.3%	2.4%	2.4%	0.0%	-0.1%	-0.1%	-0.1%	-0.1%	0.0%
Marketing Overhead	3.6%	3.6%	3.7%	3.7%	3.8%	3.8%	0.0%	0.1%	0.0%	0.0%	0.0%	0.0%
G&A Overhead	14.1%	13.6%	13.9%	14.2%	14.3%	14.4%	-0.3%	-0.2%	-0.2%	-0.1%	-0.1%	0.0%
Additional OIBDA Cost Reserve	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Other Recurring Expenses	-0.9%	-0.7%	-0.6%	-0.6%	-0.6%	-0.6%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Divested Operations and Merger Accounting Adj.	0.4%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total Selling, Gen. & Admin. Exp. (excl. Mgmt. Fees)	33.2%	32.4%	32.7%	32.8%	33.0%	32.9%	-0.2%	-0.9%	-0.9%	-0.8%	-0.7%	-0.6%
EBITDA before FAS 123 Stock Compensation	490	462	427	413	402	413	8	(6)	(14)	(27)	(40)	(51)
	14.0%	13.1%	12.2%	11.7%	11.3%	11.4%	0.0%	-0.5%	-0.5%	-0.7%	-0.9%	-1.1%
FAS 123 Stock Compensation	(23)	(28)	(28)	(28)	(28)	(28)	2	0	0	0	0	0
Depreciation	51	52	50	47	43	39	(1)	0	(0)	(1)	(1)	(1)
Amortization of Intangible Assets	187	188	186	186	186	186	0	0	0	0	0	0
EBITA before Nonrecurring Expenses	408	382	350	338	331	346	11	(6)	(13)	(26)	(39)	(50)
EBITA Margin	11.7%	10.8%	10.0%	9.6%	9.3%	9.5%	0.1%	-0.4%	-0.5%	-0.7%	-0.9%	-1.1%
EBIT before Nonrecurring Expenses	221	194	164	152	145	160	11	(6)	(13)	(26)	(39)	(50)
EBIT Margin	6.3%	5.5%	4.7%	4.3%	4.1%	4.4%	0.2%	-0.3%	-0.4%	-0.7%	-1.0%	-1.2%

E = Morgan Stanley Research Estimates
Source: Company data, Morgan Stanley Research

Digital Music Market: Lowered Forecasts from Our Global Model

We lowered our forecasts for WMG's digital music revenues based on the revisions of our global digital music market model. The key variable in our revenue forecast is whether growth in digital sales will be sufficient to offset declines in physical music sales and to create positive total revenue growth. We currently forecast that WMG's digital sales will grow from $157 million in F2005 to $580 million by F2010, down from our previous estimate of $730-740 million. Our current digital revenue forecasts imply that WMG maintains its digital music market share at 15-16%.

The lowering of our digital music forecast is the result of the following changes.

1) *We lowered our estimates of the retail digital market to $2.9 billion in F2005 from $4.3 billion*, based on the analysis of the digital revenues data reported by the music companies over the last six months. The major part of the reduction is related to the lowering of our estimates of the global mobile market in 2005 based on data from the music publishers.

2) *We increased our estimates of the share of revenue retained by the music companies (i.e., the wholesale market) in 2005 to $1.1 billion from $0.9 billion*, due to higher penetration of master tones in 2005 than we had originally assumed. We had previously estimated that the global mobile market in 2005 would still be mostly represented by ring tones (on which music companies typically receive only 9% of the retail revenue); our updated analysis shows that master tones account for roughly 40% of the global retail mobile market. On master tones, music companies typically receive about 60% of the retail revenue.

3) *We lowered our 2006-2010 forecasts for the mobile and download revenue growth.* Our analysis of the companies' reported data shows that the retail mobile music revenues in 2005 were about $2.0 billion, significantly below the $3.5 billion quoted by a number of industry sources. At the same time, the share of master tones in the mobile revenues was higher than we had originally estimated. Data from our telecommunications research team suggests that future growth in 3G phones is likely to be lower than commonly believed and by extension the growth in mobile music revenues is likely to be slower. We now expect mastertone market in its mature state to be below our previous forecasts, and we expect ringtone market to practically disappear by 2010. We also have lowered our forecasts of international online downloads based on the extrapolations of I-Pod and MP-3 player trends.

We expect digital sales to slightly more than offset the decline in physical sales in F2006-2010, but total revenue growth is unlikely to exceed 2% in any given year. We expect WMG's physical music sales in F2006-2010 to decline at an annual rate of roughly 1% ($55-60 million), which is significantly better than the 5% global industry declines in the past five years. To reach 3-4% growth in WMG's total revenue in F2006-F2010 - which could warrant a more positive view on the stock - WMG's digital revenues would have to grow to $1.0-1.2 billion by F2010. Our updated analysis of the digital music market indicates that this is an unlikely scenario.

We feel quite confident in our forecasts for the online download market. The key driver of the growth in this market will be the increase in MP3 player households and the dynamics for the average number of downloads per MP3 player household. Our analysis shows that most of the households with teenagers in the US already have an MP3 player, and growth in MP3 player penetration is likely to slow down. The average number of downloads per an MP3 player household is likely to decline as the new purchasers are likely to download incrementally less music than the early adopters. We use our US download model to extrapolate growth rates.

The mobile market, however, can prove to be a wild card in the digital music forecast. This market is still in its very early stages. The penetration of G2.5+ cell phones is still very low in the US and only slightly higher internationally. The 2.5G handsets are capable of downloading mastertones; 3.0G handsets are necessary to download complete songs. The speed of the adoption of the G2.5+ phones and the consumers' willingness to spend on mobile music are very difficult to forecast. The 3G handset market is still nascent, the global penetration of 3G handsets by the end of 2005 is in the low single-digit percentages. Morgan Stanley telecom team estimates that global 3G phones penetration will remain very low over the next two-three years and will likely not exceed 400-500 million subscribers by 2010. At that point, it is possible that mobile downloads will begin to cannibalize internet downloads.

Digital music market overview

Digital music is still a nascent market and data regarding its individual components is still very limited and sometimes

conflicting. At the retail level, there are five major sub-components of the market: 1) online downloads, 2) online subscriptions, 3) monophonic and polyphonic ringtones, 4) master tones and ringbacks, and 5) mobile downloads. Wholesale revenues (i.e., revenues received by music companies) include revenue streams mentioned above plus revenues received from the satellite radio companies. The latter are currently small, at roughly 5% of the total wholesale digital revenues, but their share is likely to grow. The download, mastertone, mobile download and satellite components of the digital music market create wholesale revenue streams for both the publishers and the recorded music labels. The ringtone market is unique as it only creates licensing revenue for the publishers.

We had previously estimated the size of the retail digital music market at $4.3 billion in 2005 — $0.6 billion from digital downloads, $0.2 billion from digital subscriptions and $3.5 billion from ringtones/mastertones. In our previous forecasts we did not try to split the mobile market into subcomponents. This forecast in turn lead to our estimate that wholesale market was $900 million in 2005 - $400 million from digital downloads, $80 million from digital subscriptions and $500 million from ringtones/mastertones.

Our updated model estimates the size of the retail digital market in 2005 at $2.9 billion and wholesale market at $1.1 billion. Thus, we decreased our assumptions on the retail size of the market, but increased our estimates of the share of revenues retained by the music companies. On average, we estimate music companies received about 40% of the retail digital revenues in 2005. Wholesale revenue splits, as percent of retail revenues, range from 65-70% for digital downloads (57-62% for the labels and 8-9% for the publishers) to 8-9% for ringtones. Over time, we expect wholesale revenue splits to increase to 55-60% of retail revenue by 2010. The increase in wholesale revenue splits will be driven by the migration in the mobile market from mono and polyphonic ringtones (on which music companies earn only a publishing rights fee and no licensing fee) to master tones (on which music companies earn both publishing rights fee and licensing fees).

We employ two methods to estimate the size of the digital market in 2005: 1) using the digital revenues data reported by the music companies, and 2) building a detailed bottom-up analysis of each revenue stream by taking into account the number of transactions and their retail and wholesale prices. We use the latter model to forecast the digital market growth through 2010.

2005 market sizing based on the digital revenue data reported by the music companies.
For this exercise, we separate Music Publishing from Recorded Music. At the wholesale level, we estimate the digital publishing market at $170-180 million in 2005, and the digital recorded music market at about $1.0 billion in 2005. Music Publishing earns publishing rights fees of 8-9% on three revenue streams: 1) monophonic and polyphonic ringtones (MIDI files), 2) master tones and ringbacks, and 3) online downloads. The use of monophonic and polyphonic ringtones typically involves publishing rights fees, but does not require licensing from record labels. Master tones are recorded music that is clipped from a studio performance by a specific artist, and thus requires a licensing from record labels in addition to publishers. Thus, Music Publishing receives the 8-9% royalty fee on both ringtones and master tones, but Recorded Music companies participate only in master tones revenue. Recorded Music receives licensing fees on three types of revenues: 1) about $0.40 for each dollar of master tones revenue, 2) about $0.40 for each dollar of subscription revenue, and 3) about $0.65 for each dollar of downloads revenue. See Exhibit 9.

WMG, EMI and UMG each report digital music revenues, separately for Music Publishing and for Recorded Music. Since each company is on a different fiscal year end, we normalized their most recently reported data to arrive to the 2005 estimates. We then apply the market share data from ifpi to gross up these reported revenues and to arrive at the total size of the wholesale digital market. Knowing the typical splits of the digital revenue between wholesale and retail allows us to gross up the wholesale market to the size of the retail market.

Each company also provides a different level of disclosure on the split of their digital revenues by source. EMI gives the most detail. EMI's 2005 publishing digital revenues are split as follows: 77% ringtones, 14% master tones and ringbacks, and 9% downloads. None of the other companies provide the split of their publishing digital data, but it is fair to assume that they are roughly in line with EMI's. EMI's 2005 recorded music digital revenues are split as follows: 52% downloads, 8% subscriptions and 40% master tones and ringbacks. UMG's reported split for recorded music is similar: 55% downloads, 5% subscriptions and 40% master tones and ringbacks. We assumed that WMG's recorded music revenue split is similar to that of the other two companies.

There is a time lag in revenue recognition by Music Publishing compared to Recorded Music. Recorded Music recognizes revenue when the sale is being made, and Music Publishing

recognizes revenue when the payment is received, i.e., in arrears. This is the general rule for all products, both physical and digital. The time delay is about 90 days in the US and UK for the established physical products and longer for the new digital products. In France, Italy and other territories, the time lag is even longer, roughly 6 months. As a result, digital revenues reported by the Publishing divisions of the music companies lag digital revenues reported by the Recorded Music divisions. Using wholesale revenue as the foundation for an analysis of retail digital music expenditures is in some sense the triangulation of a mosaic of company and seasonal data points. A combination of recorded music data points and of publishing data points needs to be used to arrive at the estimates of the different components of the global digital music market.

In 2005, we estimate that downloads accounted for 35-40% of the wholesale digital revenue and ringtones and master tones accounted for another 45-50%. By 2010, we expect mobile revenues to be the main source of digital revenues for the music companies, which will be driven primarily by the migration from ringtones to the higher margin master tones.

2005-2010 market sizing based on the roll-up of individual digital revenue streams.
Our estimates for the size of the individual components of the digital music market in 2004-2010 are summarized in Exhibits 12 and 13. Exhibits in the Appendix 1 show the detailed build-up of each of the digital revenue stream.

We estimate the 2005 ***online downloads*** market at $650 million in retail revenue and $420 million in wholesale revenue (65% wholesale margins). We estimate that US accounted for 75-80% of the online download market in 2005. Our definition of online downloads includes 1) single track downloads, 2) digital album downloads and 3) ancillary revenues such as music video downloads, downloads of accompanying stories and photographs, audiobooks, etc. Nielsen Media's Soundscan provides data on the number of digital downloads in the US, Ifpi is the source of data on digital downloads in the major international markets. Soundscan's digital download data, which is most often quoted by various industry articles, includes only single track downloads. Digital album downloads are included by Soundscan into its total album purchases data (which represents primarily purchases of physical albums).

In 2005, 353 million single tracks and 16.25 million digital albums were downloaded in the US. We use the assumption that each digital album is equivalent to 10 single track downloads. This implies that in 2005, 51.5 million digital album equivalents were downloaded in the US. Album downloads represented roughly 25% of the total US digital downloads market.

MP3 player penetration and the number of downloads per MP3 player are likely to be the key drivers of the digital download market in the near future. Morgan Stanley's PC and Enterprise Hardware team estimates that the installed base of i-Pods at the end of 2005 was 30.9 million units in the US and 5.6 million units outside the US. On average, households that own an i-Pod, own 1.5 different i-Pod units, i.e., a combination of i-Pod mini, i-Pod nano, and i-Pod shuffle. Thus, the installed i-Pod household base was probably about 20-21 million in the US and 3-4 million outside the US by the end of 2005. The household penetration is more important for our analysis than the unit penetration, since the members of the same household can share downloaded songs and thus the whole household in effect represents a single purchaser of the online music. About 85% of all i-Pod shipments so far were in the US, and only 15% were sold internationally.

Other MP3 players currently have higher penetration outside the US than i-Pods. We estimate that the installed unit base of other MP3 players was 46.1 million in the US and 31.3 million outside the US by the end of 2005. On average, the owners of other MP3 players own 2.2 different MP3 player units (excluding i-Pods). Thus, the installed household base for other MP3 players was roughly 21 million in the US and 14-15 million outside the US by the end of 2005. Based on the consumer survey conducted by the Morgan Stanley's PC and Enterprise Hardware team in December 2005, we estimate that the overlap between households that own an i-Pod and those that own an other MP3 player was about 8%, or 4.7 million households at the end of 2005. Thus, the total number of households that owned a device capable of downloading digital music was 38.1 million in the US and 16.6 million outside the US. To forecast the installed base of i-Pods and other MP3 players in 2006-2010, we use the Morgan Stanley's PC and Enterprise Hardware team estimates for i-Pod shipments and IDC forecasts for the other MP3 players shipments. We also assume that the average life of an i-Pod and of other MP3 players is roughly two years, after which these units are retired from the installed base. This assumption is in line with the historical trends.

The 38.1 million households that owned an MP3 player in the US by the end of 2005 represent 35% of the US total households and probably cover the majority of the households with teenagers. We forecast that by 2010, 90-91 million of all US households, or 80% of the total households, own an MP3

player. For comparison, DVD player penetration was just under 40% in 2002, has reached roughly 75% by the end of 2005, and is likely to exceed 80% in 2006.

The 51.5 million digital album equivalents downloaded in the US in 2005 imply that on average, each MP3 player household (including both I-Pod and other MP3 player households) downloaded 19.3 single tracks in the US and 7.2 million single tracks outside the US. We expect the number of downloads per MP3 player household in the US to decline to 12 by 2010 as the incremental MP3 player purchasers are likely to buy less online music than the early adopters. Outside the US, the number of downloads is likely to grow until it reaches 14-15 downloads per MP3 player household and will also likely decline slightly thereafter.

In 2005, music physical unit sales declined 9.2% in the US and 2.7% in the UK. We assume that the physical unit sales continue to decline globally at an average rate of 1% annually, starting with 2006. Our assumptions on the growth of the digital download market imply that the number of digital album equivalents sold in the US grows from the 7.9% of the total unit purchases in 2005 to 15-16% by 2010. Internationally, we think the share of digital purchases lags the US by two years in the major European markets (UK, France and Germany), and lags US by four years in Japan. In other territories, the share of digital in total album purchases is likely to remain very low, probably below 1%. In these markets, we expect the MP3 player penetration to remain very low, primarily because the wide penetration of the 3G cell phones will likely continue to cannibalize purchases of the MP3 player units.

Online music subscriptions are still a small source of digital revenue for music companies. We estimate retail online subscription market in 2005 at roughly $160-170 million and wholesale at $100 million (60-65% margins). The size of the online music subscription market can be estimated in two ways: 1) by rolling up the number of subscribers to each individual major service provider (Rhapsody, Napster, YahooMusic and other, mostly international, providers) and 2) by rolling up the number of subscribers in the major markets (US, Europe and rest of the world). Both methods arrive at the same number of subscribers and the similar size of the online music subscription market. We use estimated weighted average subscription prices (weighted for prices of the basic and the premium services) and apply a discount to account for promotional offers.

The mobile market is the most controversial piece of the puzzle. It is important to differentiate between ringtones and master tones, since music companies have very different economics on these two products. Music companies earn only publishing rights fee and no licensing fee on mono and polyphonic ringtones. On master tones, they earn both publishing rights fee and licensing fees.

At the retail level, mobile is by far the largest piece of the digital revenues ($2.0 billion of the estimated $2.9 billion total digital market). Since music companies currently receive only about 9% of the ringtones revenues, ringtones currently account for less than 10% of the wholesale digital revenues. Ringtones are being gradually substituted by master tones. The adoption of master tones is driven by the penetration of 2.5 G and 3.0G cell phones which are capable of downloading master tones. Currently, the biggest market for ringtones is Asia, we estimate it accounts for about 35% of the global retail ringtone revenue. When the penetration of 2.5G and 3.0G cell phones increased in Asia in 2005, growth in master tones almost entirely cannibalized the market for ringtones. Thus, the total mobile market in Asia increased only slightly in 2005 from 2004. In Europe, the development of master tones was also accretive to the total mobile market. In the US, ringtones had rather low penetration by 2005, and the introduction of 2.5 G and 3.0G cell phones led to a rapid growth in mobile digital revenues.

Over the next five years, on the global basis, we assume that the total mobile digital market roughly doubles at the retail level; ringtones sales almost entirely disappear by 2010 and master tones account for all of the growth in 2005-2010.

For licensing revenues from ***satellite radio*** we use estimates for XM Radio and Sirius Radio provided by our cable and satellite analyst Benjamin Swinburne. These two companies account for the entire US satellite radio market and we do not expect a significant growth in satellite radio outside the US.

Exhibit 9

Digital Music Market, 2005

	EMI					Wholesale Market			Retail Market	
Digital Revenue	4/1/05-9/30/05 % of total	4/1/05-9/30/05 $ mm	1/1/05-12/31/05 % of total	1/1/05-12/31/05 $ mm	Market Share	1/1/05-12/31/05 % of total	1/1/05-12/31/05 $ mm	As % of Retail	1/1/05-12/31/05 % of total	1/1/05-12/31/05 $ mm
Music Publishing										
Ringtones	77.0%	12.2	77.0%	27.0		77.0%	136.8	9.0%	77.0%	1,520.0
Mastertones and RingBacks	14.0%	2.2	14.0%	4.9		14.0%	24.9	9.0%	14.0%	276.4
Downloads	9.0%	1.4	9.0%	3.2		9.0%	16.0	9.0%	9.0%	177.7
Total Publishing, $mm	100.0%	15.8	100.0%	35.0	19.7%	100.0%	177.7	9.0%	100.0%	1,974.1
Recorded Music										
Downloads	52.0%	34.0	52.0%	67.6		52.0%	563.3	65.0%	40.0%	866.7
Subscription	8.0%	5.2	8.0%	10.4		8.0%	86.7	40.0%	10.0%	216.7
Mastertones and RingBacks	40.0%	26.1	40.0%	52.0		40.0%	433.3	40.0%	50.0%	1,083.3
Total Recorded Music, $mm	100.0%	65.3	100.0%	130.0	12.0%	100.0%	1,083.3	50.0%	100.0%	2,166.7
Total Digital Music										
Online Downloads	43.6%	35.4	42.9%	70.8		45.9%	579.3			
Subscriptions	6.4%	5.2	6.3%	10.4		6.9%	86.7			
Ringtones	15.0%	12.2	16.3%	27.0		10.8%	136.8			
Mastertones and RingBacks	34.9%	28.4	34.5%	56.9		36.3%	458.2			
Total Digital Music, $mm	100.0%	81.2	100.0%	165.0	13.1%	100.0%	1,261.0			

	UMG					Wholesale Market			Retail Market	
Digital Revenue	1/1/05-6/30/05 % of total	1/1/05-6/30/05 $ mm	1/1/05-12/31/05 % of total	1/1/05-12/31/05 $ mm	Market Share	1/1/05-12/31/05 % of total	1/1/05-12/31/05 $ mm	As % of Retail	1/1/05-12/31/05 % of total	1/1/05-12/31/05 $ mm
Ringtones	77.0%	6.9	77.0%	15.4		77.0%	123.1	9.0%	77.0%	1,367.7
Mastertones and RingBacks	14.0%	1.3	14.0%	2.8		14.0%	22.4	9.0%	14.0%	248.7
Downloads	9.0%	0.8	9.0%	1.8		9.0%	14.4	9.0%	9.0%	159.9
Total Publishing, $mm	100.0%	9.0	100.0%	20.0	12.5%	100.0%	159.9	9.0%	100.0%	1,776.2
Online Downloads	55.0%	68.5	55.0%	152.3		55.0%	543.9	65.0%	42.9%	836.8
Subscriptions	5.0%	6.2	5.0%	13.8		5.0%	49.4	40.0%	6.3%	123.6
Mastertones and RingBacks	40.0%	49.8	40.0%	110.8		40.0%	395.6	40.0%	50.7%	988.9
Total Recorded Music, $mm	100.0%	124.5	100.0%	276.9	28.0%	100.0%	988.9	50.7%	100.0%	1,949.3
Total Digital Music										
Online Downloads	51.9%	69.3	61.9%	154.1		48.6%	558.3			
Subscriptions	4.7%	6.2	4.7%	13.0		4.3%	49.4			
Ringtones	5.2%	6.9	5.2%	15.4		10.7%	123.1			
Mastertones and RingBacks	38.3%	51.1	38.3%	113.8		36.4%	418.0			
Total Digital Music, $mm	100.0%	133.6	100.0%	296.3	25.0%	100.0%	1,148.8			

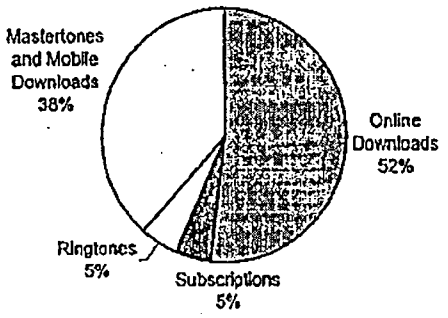
	WMG					Wholesale Market			Retail Market	
Digital Revenue	10/1/04-9/30/05 % of total	10/1/04-9/30/05 $ mm	1/1/05-12/31/05 % of total	1/1/05-12/31/05 $ mm	Market Share	1/1/05-12/31/05 % of total	1/1/05-12/31/05 $ mm	As % of Retail	1/1/05-12/31/05 % of total	1/1/05-12/31/05 $ mm
Ringtones	77.0%	15.4	77.0%	21.6		77.0%	139.1	9.0%	77.0%	1,545.5
Mastertones and RingBacks	14.0%	2.8	14.0%	3.9		14.0%	25.3	9.0%	14.0%	281.0
Downloads	9.0%	1.8	9.0%	2.5		9.0%	16.3	9.0%	9.0%	180.6
Total Publishing, $mm	100.0%	20.0	100.0%	28.0	15.5%	100.0%	180.6	9.0%	100.0%	2,007.2
Online Downloads	53.5%	73.3	53.5%	80.7		53.5%	504.1	65.0%	41.5%	775.5
Subscriptions	6.5%	8.9	6.5%	9.8		6.5%	61.2	40.0%	8.2%	153.1
Mastertones and RingBacks	40.0%	54.8	40.0%	60.3		40.0%	376.9	40.0%	50.4%	942.2
Total Recorded Music, $mm	100.0%	137.0	100.0%	150.8	16.0%	100.0%	942.2	50.4%	100.0%	1,870.8
Total Digital Music										
Online Downloads	47.6%	75.1	46.5%	83.2		46.3%	520.3			
Subscriptions	5.7%	8.9	5.5%	9.8		5.5%	61.2			
Ringtones	9.8%	15.4	12.1%	21.6		12.4%	139.1			
Mastertones and RingBacks	36.7%	57.6	35.9%	64.2		35.8%	402.2			
Total Digital Music, $mm	100.0%	157.0	100.0%	178.8	15.0%	100.0%	1,122.8			

Source: Company data, Nielsen Soundscan, ifpi, Billboard, Morgan Stanley Research

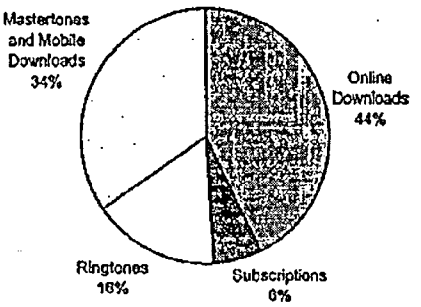
Exhibit 10

Wholesale Digital Revenue Breakdown, 2005

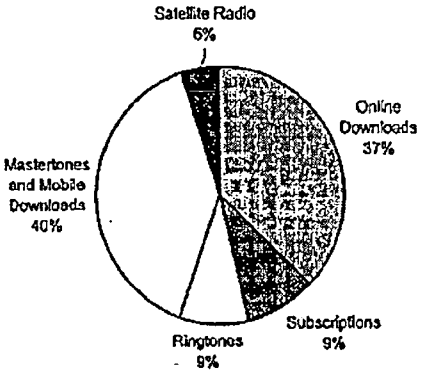
UMG: Digital Revenue Breakdown



EMI: Digital Revenue Breakdown



Total Market: Digital Revenue Breakdown

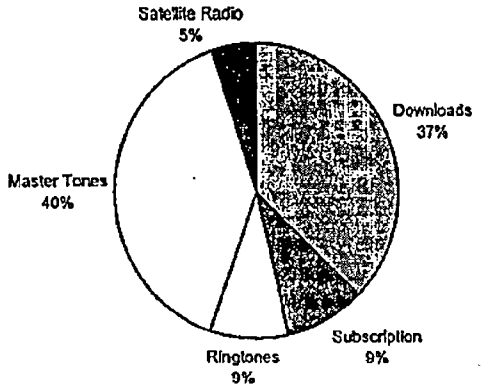


Source: Company data, Nielsen Soundscan, ifpi, Billboard, Morgan Stanley Research

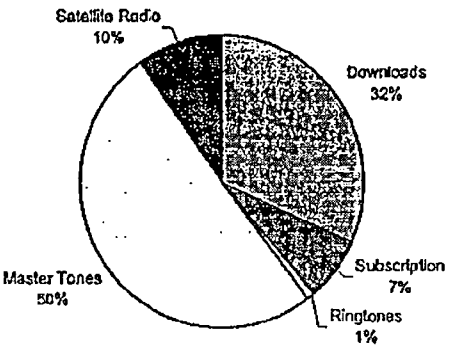
Exhibit 11

Wholesale Digital Revenue Breakdown, 2005 versus 2010

Total Market: Digital Revenue Breakdown, 2005



Total Market: Digital Revenue Breakdown, 2010



Source: Company data, Nielsen Soundscan, ifpi, Billboard, Morgan Stanley Research

Exhibit 12
Global Retail Digital Music Market

	2004	1H:05	2H:05	2005	2006E	2007E	2008E	2009E	2010E	05-10 CAGR
Retail Digital Revenue, $mm										
Digital Downloads	233.2	277.2	369.0	646.6	1,120.6	1,424.9	1,619.5	1,755.4	1,834.5	23.2%
Subscriptions	68.1	70.9	91.4	162.3	231.3	282.7	333.1	380.7	423.8	21.2%
Satellite Radio	21.8	22.6	32.7	55.3	105.0	165.4	226.9	292.9	362.9	45.7%
Ringtones	1,200.0	650.0	450.0	1,100.0	733.7	525.0	406.7	344.8	311.1	-22.3%
Mastertones and Ringbacks	100.0	315.0	585.0	900.0	1,647.4	2,251.9	2,843.2	3,374.6	3,821.5	33.5%
Total Retail Digital Revenue, $mm	1,723.1	1,335.7	1,528.1	2,864.3	3,838.1	4,650.0	5,431.5	6,148.3	6,753.8	18.7%
% Change										
Digital Downloads				177.3%	73.3%	27.2%	13.7%	8.4%	4.5%	
Subscriptions				138.2%	42.5%	22.2%	17.8%	14.3%	11.3%	
Satellite Radio				153.9%	89.8%	57.5%	37.2%	29.1%	23.9%	
Ringtones				-15.4%	-33.3%	-28.4%	-22.2%	-15.6%	-9.8%	
Mastertones and Ringbacks				800.0%	83.0%	36.7%	26.3%	18.7%	13.2%	
Total Retail Digital Revenue, % Change				68.2%	34.0%	21.2%	16.8%	13.2%	9.8%	

Source: Nielsen Soundscan, ifpi, Billboard, Company Reports, Morgan Stanley Research

Exhibit 13
Global Wholesale Digital Music Market

	2004	1H:05	2H:05	2005	2006E	2007E	2008E	2009E	2010E	05-10 CAGR
Wholesale Digital Revenue, $mm										
Digital Downloads	151.6	180.2	239.9	420.3	728.4	926.2	1,052.7	1,141.0	1,192.4	23.2%
Subscriptions	44.4	44.4	60.0	104.4	151.2	184.8	217.7	248.8	277.0	21.5%
Satellite Radio	21.8	22.6	32.7	55.3	105.0	165.4	226.9	292.9	362.9	45.7%
Ringtones	117.0	58.5	40.5	99.0	66.0	47.3	36.6	31.0	28.0	-22.3%
Master Tones and Ringbacks	50.0	157.5	292.5	450.0	823.7	1,126.0	1,421.6	1,687.3	1,910.7	33.5%
Total Wholesale Digital Revenue, $mm	384.7	463.2	665.6	1,129.0	1,874.3	2,449.6	2,955.7	3,401.0	3,771.0	27.3%
Wholesale Revenue, as % of Retail Revenue										
Digital Downloads	65.0%	65.0%	65.0%	65.0%	65.0%	65.0%	65.0%	65.0%	65.0%	
Subscriptions	65.2%	62.7%	65.6%	64.3%	65.4%	65.4%	65.4%	65.4%	65.4%	
Satellite Radio	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	
Ringtones	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	
Master Tones and Ringbacks	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	
Wholesale Revenue, as % of Retail Revenue	22.3%	34.7%	43.6%	39.4%	48.8%	52.7%	54.4%	55.3%	55.8%	
% Change										
Digital Downloads				177.3%	73.3%	27.2%	13.7%	8.4%	4.5%	
Subscriptions				135.1%	44.8%	22.2%	17.8%	14.3%	11.3%	
Satellite Radio				153.9%	89.8%	57.5%	37.2%	29.1%	23.9%	
Ringtones				-15.4%	-33.3%	-28.4%	-22.2%	-15.5%	-9.8%	
Master Tones and Ringbacks				800.0%	83.0%	36.7%	26.3%	18.7%	13.2%	
Wholesale Digital Revenue, % Change				193.5%	66.0%	30.7%	20.7%	15.1%	10.9%	
% of Total Wholesale Digital Revenue										
Digital Downloads	39.4%	38.9%	36.0%	37.2%	38.9%	37.8%	35.6%	33.5%	31.6%	
Subscriptions	11.5%	9.6%	9.0%	9.2%	8.1%	7.5%	7.4%	7.3%	7.3%	
Satellite Radio	5.7%	4.9%	4.9%	4.9%	5.6%	6.8%	7.7%	8.6%	9.6%	
Ringtones	30.4%	12.6%	6.1%	8.8%	3.5%	1.9%	1.2%	0.9%	0.7%	
Master Tones and Ringbacks	13.0%	34.0%	43.9%	39.9%	43.9%	46.0%	48.1%	49.6%	50.7%	
Total Wholesale Digital Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	

Source: Nielsen Soundscan, ifpi, Billboard, Company Reports, Morgan Stanley Research

EMI and WMG: Leverage Capacity and Comparative Cost Analysis

Published stories in the financial media suggest continued market conjecture regarding a potential merger of WMG and EMI, especially given WMG's current premium valuation: a price-to-F2006 EPS multiple of 23–24 times versus EMI's 16–17 times 2006 EPS, on Morgan Stanley's estimates. On EV/2006 EBITDA multiple, WMG is also more expensive: 12-13 times compared to 10-11 times for EMI (see Exhibit 3). Our P/E multiples calculations are based on the adjusted prices (i.e., market price less the estimated value of unconsolidated assets) and adjusted EPS that exclude amortization of intangibles on an after-tax basis. Although we cannot be certain whether such a merger will occur, we analyze several possible scenarios, reflecting different levels of leverage and different potential cost savings.

A merger has already been tried three times by EMI and Warner Music:

1) In 1997, prior to EMI spin out from Thorn EMI

2) Formally proposed but turned down by the regulators in 2000-2001, and

3) Non-exclusive discussions in September 2003 at the time of the Time Warner disposal of WMG.

EMI management was reluctant to get involved in discussion of the possibility of a deal with Warner at the time of its interims. EMI management did stress, however, that (i) given the management difficulties faced by the Sony-BMG joint venture in Recorded Music, EMI would not countenance a merger with Warner. EMI management's view is that one or other party would need to be in charge, (ii) EMI is of the view that a deal, if one were to come about, would be more easily constructed as an EMI approach to Warner rather than vice versa. In turn, WMG refused, on the publication of its F4Q05 earnings on December 1, 2005 to comment on any such corporate activity.

Although we cannot be certain whether such a merger will occur, we have analyzed several possible scenarios for a hypothetical WMG-EMI combination. One set of scenarios includes different assumptions on the level of debt at the combined entity. The other set of scenarios is based on the different cost savings assumptions.

There appears to be limited debt financing capacity to fund a merger of WMG and EMI. The high level of debt at both companies is likely to prohibit an all cash acquisition of either EMI or WMG by the alternate party.

WMG had $2.0 billion in net debt at the end of F2005 (September 2005), and EMI had net debt of £1.1 billion or $1.9 billion at the end of its F1H:06 (September 2005). If these companies were to merge, their 2006 debt/EBITDA would be 4.1 times, before the assumption of any new debt. In the failed merger of EMI and Warner Music in 2000, the EU informed the companies that one of their publishing operations would have to be sold as their combined market shares would exceed 35% on a global basis. If the combined enterprise sold WMG's publishing unit for $1.9 billion (13.0 times F2006 EBITDA), their 2006 debt/EBITDA would be 2.6 times, before the assumption of any new debt. We believe that the tax basis assigned under Section 338 of the Tax code in the original buyout of WMG would shield most of the proceeds from taxes.

Exhibit 14
Incremental Debt Capacity, if EMI and WMG Were to Merge

(In $ Millions)			
WMG's Net Debt, September 2005	1,958		
EMI's Net Debt, September 2005	1,884		
Total Net Debt	3,842		
WMG's EBITDA, F2006	434		
EMI's EBITDA, F2006	508		
Total EBITDA	942		
Debt/EBITDA Before Sale of WMG Publishing	4.1 x		
WMG's Publishing EBITDA, F2006	145		
Total EBITDA, excl. WMG Publishing	796		
Publishing Acquisition Multiple	13.0 x		
Cash Raised in Sale of WMG Publishing	1,891		
Tax Basis	1,500		
Proceeds from Sale of Publishing, at 40% Tax	1,735		
Debt After Sale of WMG Publishing	2,107		
Debt/EBITDA After Sale of WMG Publishing	2.6 x		
Debt/EBITDA	4.0 x	3.5 x	3.0 x
Incremental Debt Capacity	1,878	679	281

Source: Company data, Morgan Stanley Research

To maintain a single-B debt rating or better, we believe that the New Co would have to keep its debt-to-F2006E EBITDA

ratio at 4.0 times or lower. This implies only $1.1 billion in the incremental debt capacity which could be borrowed for an acquisition. Under 3.5x and 3.0x debt/F2006 EBITDA scenarios, the incremental debt capacity would only be $700 million and $300 million, respectively (see Exhibit 14). Thus, under these assumptions, neither WMG nor EMI could finance an all cash bid for the other company without completing a large public or private placement of new equity

If either company were to propose a stock-financed acquisition, it could lead to a 'vicious cycle". If the market agreed with our skeptical opinion of the benefits from scale, the transaction would be viewed as highly dilutive to the acquiring party's adjusted EPS and free cash flow per share. A rapid decline in the buyer's shares would lead to compression in the merger price. In the worst case, if the deal had collar mechanisms that adjusted the exchange ratio if the acquirer's share price declined, then this could keep repeating until the low end of the collar was reached.

Music companies' cost and capital structures do not justify further consolidation, in our view. While the market continues to discuss a potential for WMG and EMI to merge (especially given WMG's current premium valuation), we see little benefit from further consolidation. The cost structures of WMG, EMI and UMG are rather similar, regardless of the differences in their size. With 70-80% of costs being variable, we see no benefits from cost reduction if WMG and EMI were to merge.

UMG is nearly twice the size of either EMI or WMG. On an adjusted basis (i.e., after eliminating the differences in the accounting standards, the methodology is described below), we estimate UMG's recorded music EBITA margin is roughly 130-140 bps above total EBITA margin at EMI and WMG. Assuming that New Co can optimize its margins to the level of UMG (the most realistic scenario, in our opinion), this would translate into the $80-90 million of cost synergies, see Exhibit 16. These economies of scale would be fully offset if the premium embedded in the transaction price (the offer price less the normalized value at public market multiples) exceeds $800-900 million.

If New Co's margins lag UMG's by 50 bps, the economies of scale would be equal to $50-55 million (the low-end scenario).

Exhibit 15
Summary Cost Comparisons

In $ Millions	EMI 10/1/04-9/30/05 12Months	WMG 10/01/04 9/30/05 F2005	UMG 7/1/04-6/30/05 12Months
Recorded Music			
Net Revenue	3,043	2,924	5,961
Reported EBITA	251	399	767
Reported EBITA Margin	8.3%	13.6%	12.9%
Adjustments for Joint Ventures	2.0%	0.0%	0.0%
Corporate Overhead Allocation	0.0%	-3.1%	-1.0%
Allocation of Division Overhead to Publishing	0.0%	0.0%	0.2%
Stock Option Expenses	0.0%	0.0%	-0.3%
Adjusted EBITA Margin	10.3%	10.5%	11.8%
Music Publishing			
Net Revenue	768	544	421
Reported EBITA	185	137	132
Reported EBITA Margin	24.0%	25.2%	31.4%
Corporate Overhead Allocation	0.0%	-3.1%	-1.0%
Allocation of Division Overhead to Publishing	0.0%	0.0%	-3.2%
Stock Option Expenses	0.0%	0.0%	-0.3%
Adjusted EBITA Margin	24.0%	22.1%	27.0%
Total Group			
Net Revenue	3,811	3,468	6,382
Reported EBITA	436	427	899
Reported EBITA Margin	11.4%	12.3%	14.1%
Adjusted EBITA Margin	13.0%	12.3%	12.8%

Note: WMG reports EBITDA excluding FAS 123R expense and EBIT including FAS 123R expense
Source: Company data, Morgan Stanley Research

The market appears to believe that New Co would be able to extract cost savings above the $80-90 million that we estimate in our most realistic scenario. Morgan Stanley European Media team estimates the potential cost savings in a theoretical EMI/WMG merger at £100 million ($180 million), see December 2, 2005 report *"EMI: Cautiously Optimistic"*. This is equivalent to 300 bps improvement in EBITA margin. This could be plausible if New Co merged some of its labels (e.g., merged EMI's and WMG's classical music labels) and conducted another round of cuts in A&R, marketing or overhead expenses. While this would result in a near-term margin improvement, we doubt that the additional cost cuts are sustainable. We had cited the sustainability of cost cuts as one of the major risks to our valuation of Warner Music since our initiation on the company in June 2005. In fact, WMG's reported F2005 marketing expenses turned out to be $12 million, or 2%, above the amount that we had anticipated prior to WMG's reporting F4Q05 results on December 1, 2005. Reported F2005 A&R expenses were $35 million, or 25%, higher than our pre F4Q05 results forecast. However, a part of this

difference related to the difference in the classification of costs by WMG compared to our previous understanding of its cost classification.

Exhibit 16
Cost Savings Scenarios

Recorded Music Adjusted EBITA Margin:	
EMI/WMG	10.40%
UMG	11.79%
Margin Differential	1.39%
Realistic Scenario	
Additional Cost Savings	0.00%
Total Cost Savings	1.39%
Total Cost Savings, $mm	83.0
Low-End Scenario	
Additional Cost Savings	-0.50%
Total Cost Savings	0.89%
Total Cost Savings, $mm	53.1
High-End Scenario	
Additional Cost Savings	1.63%
Total Cost Savings, High-End Scenario	3.02%
Total Cost Savings, $mm	180.0

Source: Company data, Morgan Stanley Research

Normalizing cost comparisons

The real difficulty in comparing music companies' cost structures is to ensure that the operating margins are presented as an apples-to-apples comparison. For the latest 12-month period, it is possible to compare the companies' EBITA margins, rather than EBITDA margins. All music companies by now have outsourced all or nearly all of their manufacturing and depreciation expense structurally is comparable among the companies. For earlier periods, WMG's normalized EBITDA margins would appear higher than for EMI and UMG, because WMG outsourced its manufacturing earlier than EMI and UMG. When the plants are sold, depreciation and labor costs (which can be included in overhead or allocated to manufacturing) are reduced and variable distribution costs are increased.

Beyond the issue of outsourcing versus owing manufacturing capacity, there are four key issues that require normalization are as follows:

1.) WMG, EMI and UMG use different accounting principles related to the recognition of stock option expense. WMG uses US GAAP. EMI and UMG used UK and French GAAP, respectively, until the end of their last fiscal years and switched to IFRS from the beginning of their current fiscal years. Under IFRS, reported EBITA includes stock compensation expense, thus WMG's EBITA also needs to be after FAS 123 stock options expense.

2.) Additionally, IFRS and US GAAP differ in the recognition of revenues from unconsolidated joint-ventures. Under US GAAP, revenues are reported net of revenues from unconsolidated affiliates, and profits from affiliates are reported below the operating segment EBIT. Under IFRS, music companies' reported revenues include revenues from unconsolidated affiliates where the parent controls the subsidiary's distribution. Thus, the higher relative revenue base makes margins look lower than if the results were reported under US GAAP. This issue affects EMI more than UMG due to the higher share of such JV revenues.

3.) Music companies differ in their practices of allocating central overhead costs among the segments (music versus publishing). WMG does not allocate centralized overhead and reports a separate corporate overhead category. EMI allocates overhead between recorded music and publishing based on the relative size of their revenue contributions. UMG allocates music segment overhead to recorded music (which increases the publishing margins), but some costs are reported as part of corporate overhead for the entire Vivendi Universal entity. To make the segment margins comparable, we have reallocated a portion of UMG divisional overhead from recorded music to publishing (which brings its publishing margins into line with EMI and WMG). We have also allocated the corporate overhead of the holding company by charging the recorded music and publishing businesses 1% of their revenues. Finally, for WMG we have allocated the corporate overhead based on revenues.

4.) Music companies differ in the level of disclosure and in their definitions of the reported cost items. This impacts the comparability of the cost breakdowns within the recorded music segments. For example, WMG allocates overhead costs to marketing but not to product costs. EMI and UMG take the opposite approach. However, in all three cases the combined costs are all similarly captured into the recorded music total operating cost line. In Exhibits 17-18, we showed the cost buckets as reported by the companies, but we describe below which allocations would need to be made to make the cost breakdowns more comparable.

UMG's adjusted EBITA margins are 11-12% at Recorded Music and 26-27% at Publishing. Three types of adjustments that need to be made to normalize UMG's EBITA margins:

- Allocate roughly $11 million of the divisional overhead from Recorded Music to Publishing. This has a high negative impact on the Publishing margins due to this segment's small revenue base (about 340 bps of the negative impact,) and a much smaller positive impact on the Recorded Music margins, due to large revenue base (about 20 bps).

- Allocate the central corporate overhead from Vivendi to UMG. We estimate that this would have a negative impact of roughly 100 bps on margins in both segmonts.

- Include the full impact of stock options expensing. For each company, we look at margins over the most recently reported 12 months period. For UMG, this includes the second half of 2004 and the first half of 2005, ending June 30, 2005. 1H:05 is reported based on IFRS. UMG provides IFRS-restated results for 1H04, but 2004 full year results are still only available under French GAAP. The main difference between French GAAP and IFRS in the case of UMG is the expensing of stock options, which are expensed under IFRS and are not expensed under French GAAP. .UMG started to expense its employee stock options in 2005. We have estimated the pro forma stock option expense for 2H04 and reduced recorded music margins by 30 bps.

The other adjustments relate to the classification of cost buckets and do not affect the overall segment margins. First, UMG's reported marketing expenses include marketing and selling overhead, while EMI and WMG include marketing and selling overhead into administrative expenses. Thus, UMG's marketing and promotion expenses as percent of revenue are higher than at EMI and WMG. Secondly, UMG includes A&R staff overhead into A&R and royalty expenses, whereas at WMG and EMI, A&R expenses represent only payments to the artists.

EMI's adjusted EBITA margins are 10-11% at Recorded Music and 24% at Publishing. For EMI, the main issue is the treatment of revenues from joint-ventures. Under the US GAAP, revenues are reported net of revenues from unconsolidated affiliates. Under IFRS, reported revenues include revenues from unconsolidated affiliates where music companies control the distribution. Thus, the higher relative revenue base makes margins look lower than if the results were reported under US GAAP. EMI started to report under IFRS in F2006 and restated its F2005 results. Its most recent 12-months results include F2H:05 and F1H:06 ending September 30, 2005, both reported under IFRS. EMI has greater exposure to joint ventures than UMG, and the issue of JV's revenues consolidation has a greater negative impact on its reported margins. We estimate that EMI's reported margins need to be grossed up by about 200 bps in Recorded Music to make them comparable to UMG's and WMG's. No JV adjustment is necessary for the Publishing segment. Since EMI restated its F2005 results under IFRS, the reported numbers already include stock options expensing for both F2005 and F1H:06.

WMG's adjusted EBITA margins are 10-11% at Recorded Music and 24% at Publishing. Two adjustments need to be made to normalize WMG's reported segment margins. First, we include the $17 million of FAS 123 expense at Recorded Music and $3 million of FAS 123 expense at Music Publishing, since EMI's and UMG's margins also include the stock options expense. Second, we allocate WMG's corporate overhead costs of $109 million in F2005 (including the $6 million in FAS 123 expense) between Recorded Music and Publishing based on their respective revenue contributions.

The other adjustments relate to the classification of cost buckets and do not affect the overall segment margins. First, WMG's reported marketing expenses include marketing and selling overhead. For our analysis, we allocated marketing and selling overhead into administrative costs, similarly to the practice used by EMI. Second, WMG's reported manufacturing costs are higher than other companies', as they include the manufacturing overhead. The latter is included into the administrative expenses by EMI and UMG.

Exhibit 17

EMI: Cost Structure and Profitability

	EMI (in £ millions)							
	UK GAAP			IFRS				
	4/1/04-9/30/04 F1H:05	10/1/04-3/31/05 F2H:05	4/1/04-3/31/05 F2005	4/1/04-9/30/04 F1H:05	10/1/04-3/31/05 F2H:05	4/1/04-3/31/05 F2005	4/1/05-9/30/05 F1H:06	10/1/04-9/30/05 12Months
Recorded Music								
Revenues before Eliminations								
Corporate Eliminations								
Net Revenues	660.0	882.1	1,542.1	683.0	917.5	1,600.5	720.7	1,638.2
EBITDA after allocation of central costs	40.1	111.7	151.8	38.1	107.5	145.6	48.6	156.1
Depreciation Expense	9.2	9.9	19.1	9.7	10.4	20.1	10.3	20.7
EBITA	30.9	101.8	132.7	28.4	97.1	125.5	38.3	135.4
A&R and Royalties	207.9	277.9	485.8	215.1	289.0	504.2	227.0	516.0
Admin Costs	196.8	202.5	399.3	207.2	219.4	426.7	219.3	429.8
Marketing and Promotion	108.9	145.5	254.4	112.7	151.4	264.1	118.9	270.3
Manufacturing, Distribution & Associated Costs	106.3	144.4	250.7	109.8	150.2	260.0	115.8	266.0
As % of Divisional Sales:								
A&R and Royalties	31.5%	31.5%	31.5%	31.5%	31.5%	31.5%	31.5%	31.5%
Admin Costs	29.8%	23.0%	25.9%	30.3%	23.9%	26.7%	29.2%	26.2%
Marketing and Promotion	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%
Manufacturing, Distribution & Associated Costs	16.1%	16.4%	16.3%	16.1%	16.4%	16.2%	16.1%	16.2%
EBITDA Margin (after allocation of central costs)	6.1%	12.7%	9.8%	5.6%	11.7%	9.1%	6.7%	9.5%
Depreciation	1.4%	1.1%	1.2%	1.4%	1.1%	1.3%	1.4%	1.3%
EBITA Margin (after allocation of central costs)	4.7%	11.5%	8.6%	4.2%	10.6%	7.8%	5.3%	8.3%
Music Publishing								
Revenues before Eliminations	202.0	223.7	425.7	202.0	224.7	426.7	215.9	440.6
Corporate Eliminations	(11.0)	(14.0)	(25.0)	(11.0)	(15.0)	(26.0)	(12.0)	(27.0)
Net Revenues	191.0	209.7	400.7	191.0	209.7	400.7	203.9	413.6
EBITDA after allocation of central costs	51.2	53.8	105.0	51.0	53.6	104.6	51.0	104.6
Depreciation Expense	2.3	2.5	4.8	2.4	2.6	5.0	2.6	5.2
EBITA	48.9	51.3	100.2	48.6	51.0	99.6	48.4	99.4
A&R and Royalties	105.1	115.3	220.4	105.1	115.3	220.4	112.1	227.5
Admin Costs	34.8	40.6	75.3	34.9	40.8	75.7	40.8	81.5
As % of Divisional Sales:								
Royalties	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%	55.0%
Admin Costs	19.4%	20.5%	20.0%	19.6%	20.7%	20.1%	21.3%	19.7%
EBITDA Margin (after allocation of central costs)	26.8%	25.6%	26.2%	26.7%	25.6%	26.1%	25.0%	25.3%
Depreciation	1.2%	1.2%	1.2%	1.3%	1.2%	1.3%	1.3%	1.3%
EBITA Margin (on net revenue after eliminations)	25.6%	24.5%	25.0%	25.4%	24.3%	24.9%	23.7%	24.0%
EBITA Margin (on revenue before eliminations)	24.2%	22.9%	23.5%	24.1%	22.7%	23.3%	22.4%	22.6%
Group Total								
Net Revenues, £m	851.0	1,091.8	1,942.8	874.0	1,127.2	2,001.2	924.6	2,051.8
EBITDA after allocation of central costs	91.3	165.5	256.8	89.1	161.1	250.2	99.6	260.7
Depreciation Expense	11.5	12.4	23.9	12.1	13.0	25.1	12.9	25.9
Reported EBITA	79.8	153.1	232.9	77.0	148.1	225.1	86.7	234.8
EBITDA Margin	10.7%	15.2%	13.2%	10.2%	14.3%	12.5%	10.8%	12.7%
EBITA Margin	9.4%	14.0%	12.0%	8.8%	13.1%	11.2%	9.4%	11.4%
A&R and Royalties	313.0	393.2	706.1	320.2	404.3	724.5	339.2	743.5
Admin Costs	231.6	243.1	474.7	242.2	260.2	502.4	251.1	511.3
Marketing and Promotion	108.9	145.5	254.4	112.7	151.4	264.1	118.9	270.3
Manufacturing, Distribution & Associated Costs	106.3	144.4	250.7	109.8	150.2	260.0	115.8	266.0
As % of Divisional Sales:								
A&R and Royalties	36.8%	36.0%	36.3%	36.6%	35.9%	36.2%	36.7%	36.2%
Admin Costs	27.2%	22.3%	24.4%	27.7%	23.1%	25.1%	27.2%	24.9%
Marketing and Promotion	12.8%	13.3%	13.1%	12.9%	13.4%	13.2%	12.9%	13.2%
Manufacturing, Distribution & Associated Costs	12.5%	13.2%	12.9%	12.6%	13.3%	13.0%	12.5%	13.0%
EBITDA Margin (after allocation of central costs)	10.7%	15.2%	13.2%	10.2%	14.3%	12.5%	10.8%	12.7%
Depreciation	1.4%	1.1%	1.2%	1.4%	1.2%	1.3%	1.4%	1.3%
EBITA Margin (after allocation of central costs)	9.4%	14.0%	12.0%	8.8%	13.1%	11.2%	9.4%	11.4%

Source: Company data, Morgan Stanley Research

Exhibit 18

UMG and WMG: Cost Structures and Profitability

	UMG (in € millions)							WMG ($mm)
	2002	2003	1/1/04-6/30/04 F1H:04	7/1/04-12/31/04 F2H:04	1/1/04-12/31/04 2004	1/1/05-6/30/05 F1H:05	7/1/04-6/30/05 12Months	10/01/04 9/30/05 F2005
Recorded Music								
Revenues before Eliminations	5,864.0	4,603.8	1,911.0	2,748.0	4,659.0	1,940.0	4,688.0	2,924.0
Corporate Eliminations	-	-	-	-	-	-	-	-
Net Revenues	5,864.0	4,603.8	1,911.0	2,748.0	4,659.0	1,940.0	4,688.0	2,924.0
EBITDA after allocation of central costs	834.3	319.0	182.0	454.0	636.0	221.0	675.0	339.9
Depreciation Expense	82.0	82.0	41.0	41.0	82.0	31.0	72.0	32.0
EBITA	752.3	237.0	141.0	413.0	554.0	190.0	603.0	307.9
A&R and Royalties	1,984.7	1,722.9	793.6	1,112.2	1,905.7	775.1	1,887.2	857.3
Admin Costs			282.8	336.3	619.1	301.2	637.5	692.0
Marketing and Promotion	1,278.4	957.1	382.2	456.6	838.8	368.2	824.8	408.3
Manufacturing, Distribution & Associated Costs	809.0	668.0	270.5	388.9	659.4	274.6	663.5	626.6
As % of Divisional Sales:								
A&R and Royalties	33.8%	37.4%	41.5%	40.5%	40.9%	40.0%	40.3%	29.3%
Admin Costs	0.0%	0.0%	14.8%	12.2%	13.3%	15.5%	13.6%	23.7%
Marketing and Promotion	21.8%	20.8%	20.0%	16.6%	18.0%	19.0%	17.6%	14.0%
Manufacturing, Distribution & Associated Costs	13.8%	14.5%	14.2%	14.2%	14.2%	14.2%	14.2%	21.4%
EBITDA Margin (after allocation of central costs)	14.2%	6.9%	9.5%	16.5%	13.7%	11.4%	14.4%	11.6%
Depreciation	1.4%	1.8%	2.1%	1.5%	1.8%	1.6%	1.5%	1.1%
EBITA Margin (after allocation of central costs)	12.8%	5.1%	7.4%	15.0%	11.9%	9.8%	12.9%	10.5%
Music Publishing								
Revenues before Eliminations	459.0	412.2	176.0	196.0	372.0	177.0	373.0	573.0
Corporate Eliminations	(47.0)	(42.0)	(21.0)	(17.0)	(38.0)	(25.0)	(42.0)	(29.0)
Net Revenues	412.0	370.2	155.0	179.0	334.0	152.0	331.0	544.0
EBITDA after allocation of central costs	125.7	119.0	49.0	58.0	107.0	50.0	108.0	124.2
Depreciation Expense	4.0	4.0	2.0	2.0	4.0	2.0	4.0	5.0
EBITA	121.7	115.0	47.0	56.0	103.0	48.0	104.0	119.2
A&R and Royalties	241.3	199.1	83.0	99.0	182.0	81.0	180.0	382.0
Admin Costs	45.0	52.1	23.0	22.0	45.0	21.0	43.0	37.8
As % of Divisional Sales:	-							
Royalties	58.6%	53.8%	53.5%	55.3%	54.3%	53.3%	54.4%	70.2%
Admin Costs	10.9%	14.1%	14.8%	12.3%	13.5%	13.8%	13.0%	7.0%
EBITDA Margin (after allocation of central costs)	30.5%	32.1%	31.6%	32.4%	32.0%	32.9%	32.6%	22.8%
Depreciation	1.0%	1.1%	1.3%	1.1%	1.2%	1.3%	1.2%	0.9%
EBITA Margin (on net revenue after eliminations)	29.5%	31.1%	30.3%	31.3%	30.8%	31.6%	31.4%	21.9%
EBITA Margin (on revenue before eliminations)	26.5%	27.9%	26.7%	28.6%	27.7%	27.1%	27.9%	20.8%
Group Total								
Net Revenues, fm	6,276.0	4,974.0	2,066.0	2,927.0	4,993.0	2,092.0	5,019.0	3,468.0
EBITDA after allocation of central costs	960.0	438.0	231.0	512.0	743.0	271.0	783.0	464.1
Depreciation Expense	86.0	86.0	43.0	43.0	86.0	33.0	76.0	37.0
Reported EBITA	874.0	352.0	188.0	469.0	657.0	238.0	707.0	427.1
EBITDA Margin	15.3%	8.8%	11.2%	17.5%	14.9%	13.0%	15.6%	13.4%
EBITA Margin	13.9%	7.1%	9.1%	16.0%	13.2%	11.4%	14.1%	12.3%
A&R and Royalties	2,226.0	1,922.0	876.6	1,211.2	2,087.7	856.1	2,067.2	1,239.3
Admin Costs	1,002.6	988.9	305.8	358.3	664.1	322.2	680.5	729.8
Marketing and Promotion	1,278.4	957.1	382.2	456.6	838.8	368.2	824.8	408.3
Manufacturing, Distribution & Associated Costs	809.0	668.0	270.5	388.9	659.4	274.6	663.5	626.6
As % of Divisional Sales:								
A&R and Royalties	35.5%	38.6%	42.4%	41.4%	41.8%	40.9%	41.2%	35.7%
Admin Costs	16.0%	19.9%	14.8%	12.2%	13.3%	15.4%	13.6%	21.0%
Marketing and Promotion	20.4%	19.2%	18.5%	15.6%	16.8%	17.6%	16.4%	11.8%
Manufacturing, Distribution & Associated Costs	12.9%	13.4%	13.1%	13.3%	13.2%	13.1%	13.2%	18.1%
EBITDA Margin (after allocation of central costs)	15.3%	8.8%	11.2%	17.5%	14.9%	13.0%	15.6%	13.4%
Depreciation	1.4%	1.7%	2.1%	1.5%	1.7%	1.6%	1.5%	1.1%
EBITA Margin (after allocation of central costs)	13.9%	7.1%	9.1%	16.0%	13.2%	11.4%	14.1%	12.3%

Source: Company data, Morgan Stanley Research

Appendix 1: Global Digital Music Market Drivers

Exhibit 19

Global Digital Downloads Market

	2004	1H:05	2H:05	2005	2006E	2007E	2008E	2009E	2010E
Single Track Downloads									
UK	5.7	10.0	16.4	26.4	66.6	96.4	115.8	126.5	131.7
France	1.5	4.0	4.0	8.0	26.0	37.6	45.2	49.4	51.4
Germany	6.2	8.5	12.5	21.0	56.7	82.1	98.6	107.8	112.2
US	142.6	159.0	193.7	352.7	510.6	612.7	669.5	696.7	713.7
Japan	0.0	4.0	8.0	12.0	28.9	45.9	63.1	91.4	109.7
Rest of the World	0.0	0.5	1.0	1.5	6.4	6.3	6.2	6.2	6.1
Global Tracks Downloaded, *Million*	156.0	186.0	235.6	421.6	695.1	881.1	998.4	1,078.0	1,124.8
UK		900.0%	248.9%	363.2%	152.2%	44.8%	20.1%	9.3%	4.1%
France		300.0%	700.0%	433.3%	224.8%	44.8%	20.1%	9.3%	4.1%
Germany		750.0%	140.4%	236.7%	170.1%	44.8%	20.1%	9.3%	4.1%
US		189.1%	121.1%	147.3%	44.8%	20.0%	9.3%	4.1%	2.4%
Japan		NM	NM	NM	140.7%	58.9%	37.5%	44.8%	20.1%
Rest of the World		NM	NM	NM	323.6%	-1.0%	-1.0%	-1.0%	-1.0%
Global Tracks Downloaded, % Growth		215.3%	142.9%	170.3%	64.9%	26.8%	13.3%	8.0%	4.3%
Digital Album Downloads									
UK	0.5	0.4	0.6	1.0	2.5	3.7	4.4	4.8	5.0
France	0.5	0.4	0.6	1.0	3.2	4.7	5.6	6.2	6.4
Germany	0.5	0.4	0.6	1.0	2.7	3.9	4.7	5.1	5.3
US	5.0	6.6	9.7	16.3	23.5	28.2	30.8	32.1	32.9
Japan	0.5	0.4	0.6	1.0	2.4	3.8	5.3	7.8	9.1
Other	0.5	0.4	0.6	1.0	4.2	4.2	4.2	4.1	4.1
Global Albums Downloaded, *Million*	7.5	8.6	12.7	21.3	38.6	48.5	55.0	59.9	62.9
% Change									
UK				100.0%	152.2%	44.8%	20.1%	9.3%	4.1%
France				100.0%	224.8%	44.8%	20.1%	9.3%	4.1%
Germany				100.0%	170.1%	44.8%	20.1%	9.3%	4.1%
US				225.0%	44.8%	20.0%	9.3%	4.1%	2.4%
Japan				100.0%	140.7%	58.9%	37.5%	44.8%	20.1%
Other				100.0%	323.6%	-1.0%	-1.0%	-1.0%	-1.0%
Global				183.3%	81.8%	25.6%	13.3%	9.0%	4.9%
Digital Album Equivalents									
Equivalent Tracks per Digital Album	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
UK	1.1	1.4	2.2	3.6	9.2	13.3	16.0	17.4	18.2
France	0.7	0.8	1.0	1.8	5.8	8.5	10.2	11.1	11.6
Germany	1.1	1.3	1.9	3.1	8.4	12.1	14.6	15.9	16.6
US	19.3	22.5	29.1	51.5	74.6	89.5	97.8	101.8	104.2
Japan	0.5	0.8	1.4	2.2	6.3	8.4	11.6	16.8	20.1
Other	0.5	0.5	0.7	1.2	4.8	4.8	4.8	4.7	4.7
Global Digital Albums Equivalents, *Million*	23.1	27.2	38.3	63.4	108.1	136.6	154.8	167.7	175.3
Digital Album Equivalents									
UK				240.2%	152.2%	44.8%	20.1%	9.3%	4.1%
France				178.9%	224.8%	44.8%	20.1%	9.3%	4.1%
Germany				176.0%	170.1%	44.8%	20.1%	9.3%	4.1%
US				167.5%	44.8%	20.0%	9.3%	4.1%	2.4%
Japan				340.0%	140.7%	58.9%	37.5%	44.8%	20.1%
Other				130.0%	323.6%	-1.0%	-1.0%	-1.0%	-1.0%
Global Digital Albums Equivalents, % Change				174.5%	298.3%	276.8%	144.2%	55.1%	28.3%
Digital Downloads, % of Total Unit Sales									
% of US penetration in the previous year					70.0%	70.0%	70.0%	70.0%	70.0%
UK	0.7%			2.3%	5.5%	7.9%	9.4%	10.3%	10.7%
France	0.6%			1.8%	5.5%	7.9%	9.4%	10.3%	10.7%
Germany	0.7%			2.1%	5.5%	7.9%	9.4%	10.3%	10.7%
US	2.8%			7.9%	11.2%	13.4%	14.7%	15.3%	15.8%
Japan	0.2%			1.1%	2.6%	4.0%	5.5%	7.9%	9.4%
Rest of the World	0.0%			0.1%	0.5%	0.5%	0.5%	0.5%	0.5%
Digital Downloads, % of Total Unit Sales	1.0%			2.8%	4.7%	5.9%	6.7%	7.3%	7.7%

Source: Nielsen Soundscan, Ifpi, Billboard, Company Reports, Morgan Stanley Research

Exhibit 20

Global Digital Downloads Market (Continued)

	2004	1H:05	2H:05	2005	2006E	2007E	2008E	2009E	2010E
Exchange Rates									
$ per €	1.24	1.28	1.21	1.25	1.25	1.25	1.25	1.25	1.25
$ per £	1.83	1.87	1.77	1.82	1.82	1.82	1.82	1.82	1.82
Average Price per Track, in USD									
UK	$1.45	$1.48	$1.40	$1.44	$1.44	$1.44	$1.44	$1.44	$1.44
France	$1.23	$1.27	$1.19	$1.23	$1.23	$1.23	$1.23	$1.23	$1.23
Germany	$1.23	$1.27	$1.19	$1.23	$1.23	$1.23	$1.23	$1.23	$1.23
US	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99
Japan	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99
Rest of the World	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99	$0.99
Retail Single Track Download Revenue, *$ million*									
UK	8.3	14.8	22.9	38.0	95.8	138.7	166.5	182.0	189.4
France	1.6	5.1	4.8	9.9	32.0	46.4	55.7	60.9	63.4
Germany	7.6	10.8	14.9	25.9	69.9	101.3	121.6	132.9	138.3
US	141.2	157.4	191.8	349.2	505.5	606.6	662.8	689.8	706.5
Japan	0.0	4.0	7.9	11.9	28.6	45.4	62.5	90.5	108.6
Rest of the World	0.0	0.6	1.0	1.5	8.3	6.2	6.2	6.1	6.0
Global Retail Single Track Download Revenue	158.9	192.6	243.3	436.3	738.1	944.6	1,076.2	1,162.1	1,212.3
Average Price per Album, *US$*									
Worldwide	$9.90	$9.90	$9.90	$9.90	$9.90	$9.90	$9.90	$9.90	$9.90
Retail Digital Album Download Revenue, $mm									
UK	5.0	4.0	5.9	9.9	25.0	36.2	43.4	47.5	49.4
France	5.0	4.0	5.9	9.9	32.2	46.6	55.9	61.1	63.6
Germany	6.0	4.0	5.9	9.9	28.7	38.7	46.5	50.8	52.9
US	49.5	64.8	96.0	160.9	232.9	279.5	305.4	317.8	325.5
Japan	5.0	4.0	5.9	9.9	23.8	37.9	52.1	75.4	90.5
Rest of the World	5.0	4.0	5.9	9.9	41.9	41.5	41.1	40.7	40.3
Retail Album Download Revenue, $mm	74.3	84.6	125.7	210.4	382.5	480.3	544.3	593.3	622.2
Total Retail Download Revenue									
UK	13.2	18.8	28.9	47.9	120.7	174.9	209.9	229.5	238.8
France	6.8	9.0	10.7	19.8	64.2	93.0	111.6	122.0	127.0
Germany	12.6	14.8	20.9	35.8	98.6	140.0	168.1	183.7	191.2
US	190.7	222.3	287.8	510.0	738.3	886.0	968.1	1,007.6	1,032.1
Japan	5.0	7.9	13.9	21.8	52.4	83.3	114.5	165.9	199.2
Rest of the World	5.0	4.5	6.9	11.4	48.2	47.7	47.3	46.8	46.3
Total Retail Download Revenue	233.2	277.2	369.0	646.6	1,120.6	1,424.9	1,619.5	1,755.4	1,834.5
Labels' Share of Retail Revenues	65%	65%	65%	65%	65%	65%	65%	65%	65%
Wholesale Download Revenue, *$ million*									
UK	8.6	12.2	18.8	31.1	78.5	113.7	136.5	149.1	155.2
France	4.4	5.9	7.0	12.8	41.7	60.4	72.5	79.3	82.5
Germany	8.2	9.6	13.6	23.3	62.8	91.0	109.2	119.4	124.3
US	123.9	144.5	187.1	331.5	479.9	575.9	629.3	654.9	670.8
Japan	3.2	5.1	9.0	14.2	34.1	54.1	74.4	107.8	129.4
Rest of the World	3.2	2.9	4.5	7.4	31.3	31.0	30.7	30.4	30.1
Global Wholesale Single Track Download Revenue	151.6	180.2	239.9	420.3	728.4	926.2	1,052.7	1,141.0	1,192.4
Total Digital Download Market									
Total Retail Download Revenue	233.2	277.2	369.0	646.6	1,120.6	1,424.9	1,619.5	1,755.4	1,834.5
Total Wholesale Download Revenue	151.6	180.2	239.9	420.3	728.4	926.2	1,052.7	1,141.0	1,192.4
Wholesale as % of Retail	65.0%	65.0%	65.0%	65.0%	65.0%	65.0%	65.0%	65.0%	65.0%

Source: Nielsen Soundscan, IFPI, Billboard, Company Reports, Morgan Stanley Research

Exhibit 21

I-Pod and Other MP3 Players Installed Base

I-Pods	2004	1H:05	2H:05	2005	2006E	2007E	2008E	2009E	2010E
US I-Pod Unit Shipments	3.7	9.7	17.4	27.1	34.3	41.1	45.2	49.8	54.7
Rest of the World I-Pod Unit Shipments	0.8	1.7	3.1	4.8	11.4	21.8	26.4	28.5	29.8
Global I-Pod Unit Shipments, *Millions*	4.5	11.5	20.5	31.9	45.7	62.9	71.7	78.3	84.6
US I-Pod Unit Shipments, % of Total	81.8%	85.0%	85.0%	85.0%	75.0%	65.4%	63.1%	63.6%	64.8%
Rest of the World I-Pod Unit Shipments, % of Total	18.2%	15.0%	15.0%	15.0%	25.0%	34.6%	36.9%	36.4%	35.2%
Global I-Pod Unit Shipments	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
US I-Pod Unit Shipments		587.8%	655.5%	629.7%	26.3%	20.0%	10.0%	10.0%	10.0%
Rest of the World I-Pod Unit Shipments		587.8%	433.3%	480.1%	138.7%	90.6%	21.3%	7.9%	4.6%
Global I-Pod Unit Shipments, % Change		587.8%	611.1%	602.6%	43.2%	37.7%	13.9%	9.2%	8.0%
US I-Pod Retirements	0.0	-0.5	-0.4	-0.9	-3.7	-27.1	-34.3	-41.1	-45.2
Rest of the World I-Pod Retirements	0.0	0.0	0.0	0.0	-0.8	-4.8	-11.4	-21.8	-26.4
Global I-Pod Retirements, *Millions*	0.0	-0.5	-0.4	-0.9	-4.5	-31.9	-45.7	-62.9	-71.7
US I-Pod Installed Unit Base	4.7	14.0	30.9	30.9	61.5	75.5	88.5	95.1	104.6
Rest of the World I-Pod Installed Unit Base	0.8	2.5	5.6	5.6	16.2	33.2	48.2	54.9	58.3
Global I-Pod Installed Unit Base, End of Period, MM	5.5	16.5	36.5	36.5	77.7	108.7	134.7	150.0	162.9
US I-Pod Units per Household	1.3	1.3	1.5	1.5	1.7	1.7	1.7	1.7	1.7
Rest of the World I-Pod Units per Household	1.3	1.3	1.5	1.5	1.7	1.7	1.7	1.7	1.7
US I-Pod Households	3.6	10.7	20.3	20.3	36.2	44.4	50.9	55.9	61.5
Rest of the World I-Pod Households	0.8	2.0	3.7	3.7	9.5	19.5	28.4	32.3	34.3
Global I-Pod Households, End of Period, MM	4.3	12.7	24.0	24.0	45.7	63.9	79.2	88.3	95.8
Other MP3 Players									
US Other MP3 Player Unit Shipments	20.6	9.5	16.9	26.4	35.9	39.0	43.2	47.2	51.0
Rest of the World Other MP3 Player Unit Shipments	13.7	6.3	11.3	17.6	23.9	25.3	28.8	31.5	34.0
Global Other MP3 Player Unit Shipments, *Millions*	34.3	15.8	28.2	44.0	59.8	63.3	72.1	78.7	85.0
US Other MP3 Player Unit Shipments, % of Total	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%
Rest of the World Other MP3 Player Unit Shipments, % of Total	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%
Global Other MP3 Player Unit Shipments	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
US Other MP3 Player Unit Shipments		25.4%	29.7%	28.1%	36.1%	5.7%	13.9%	9.2%	8.0%
Rest of the World Other MP3 Player Unit Shipments		25.4%	29.7%	28.1%	36.1%	5.7%	13.9%	9.2%	8.0%
Global Other MP3 Player Unit Shipments, % Change		25.4%	29.7%	28.1%	35.1%	5.7%	13.9%	9.2%	8.0%
US Other MP3 Player Retirements	0.0	-2.0	-3.9	-5.9	-20.6	-26.4	-36.7	-40.1	-44.8
Rest of the World Other MP3 Player Retirements	0.0	-4.0	-6.0	-10.0	-13.7	-17.6	-23.9	-25.3	-28.8
Global Other MP3 Player Retirements, Millions	0.0	-6.0	-9.9	-15.9	-34.3	-44.0	-60.7	-65.4	-73.7
US Other MP3 Player Installed Unit Base	25.6	33.1	46.1	46.1	61.4	73.0	79.5	86.6	92.8
Rest of the World Other MP3 Player Installed Unit Base	23.7	26.1	31.3	31.3	41.5	49.2	54.1	60.3	65.5
Global Other MP3 Player Installed Unit Base, End of Period, MM	49.3	59.1	77.4	77.4	102.9	122.2	133.6	147.0	158.3
US Other MP3 Player Units per Household	2.0	2.0	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Rest of the World Other MP3 Player Units per Household	2.0	2.0	2.2	2.2	2.2	2.2	2.2	2.2	2.2
US Other MP3 Player Households	12.6	16.5	21.0	21.0	28.0	33.3	36.3	39.6	42.4
Rest of the World Other MP3 Player Households	11.8	13.0	14.3	14.3	19.0	22.5	24.7	27.5	29.9
Global Other MP3 Player Households, End of Period, MM	24.7	29.6	35.4	35.4	47.0	55.8	61.0	67.1	72.3

Source: Nielsen Soundscan, Ipi, Billboard, Company Reports, Morgan Stanley Research

Exhibit 22

Total MP3 Players Installed Base

Total MP3 Players	2004	1H:05	2H:05	2005	2006E	2007E	2008E	2009E	2010E
US Total MP3 Player Unit Shipments	13.4	19.2	34.3	53.5	70.2	79.1	88.5	97.0	105.8
Rest of the World Total MP3 Player Unit Shipments	14.8	8.0	14.3	22.4	35.4	47.1	55.3	60.0	63.8
Total Global MP3 Player Unit Shipments, *Millions*	28.9	27.3	48.6	75.9	105.6	126.2	143.7	157.0	168.9
Total Global MP3 Player Unit Shipments, % Change									
US Total MP3 Player Unit Shipments, % of Total	34.4%	70.5%	70.5%	70.5%	66.5%	62.7%	61.6%	61.8%	62.6%
Rest of the World Total MP3 Player Unit Shipments, % of Total	37.4%	29.5%	29.5%	29.5%	33.5%	37.3%	38.4%	38.2%	37.8%
Global Total MP3 Player Unit Shipments	71.8%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.4%
US Total MP3 Player Unit Shipments		114.2%	123.6%	300.6%	31.2%	12.7%	11.9%	9.6%	9.0%
Rest of the World Total MP3 Player Unit Shipments		62.0%	54.7%	53.8%	58.0%	33.1%	17.4%	8.6%	6.3%
Global Total MP3 Player Unit Shipments, % Change		91.2%	97.6%	95.3%	39.1%	19.5%	13.9%	9.2%	7.6%
US Total MP3 Player Retirements	0.0	-2.5	-4.3	-6.8	-24.3	-53.5	-71.0	-81.2	-90.1
Rest of the World Total MP3 Player Retirements	0.0	-4.0	-6.0	-10.0	-14.8	-22.4	-35.4	-47.1	-55.3
Global Total MP3 Player Retirements, Millions	0.0	-6.5	-10.3	-16.8	-38.9	-75.9	-106.4	-128.3	-145.3
US I-Pods/MP3 Players Overlap, % of Gross Unit Base	-6.4%	-7.1%	-7.9%	-7.9%	-8.7%	-9.5%	-10.5%	-11.5%	-12.7%
ROW I-Pods/MP3 Players Overlap, % of Gross Unit Base	-6.4%	-7.1%	-7.9%	-7.9%	-8.7%	-9.5%	-10.5%	-11.5%	-12.7%
Global I-Pods/MP3 Players Overlap, % of Gross Unit Base	-6.4%	-7.1%	-7.9%	-7.9%	-8.7%	-9.5%	-10.5%	-11.5%	-12.7%
US I-Pods/MP3 Players Overlap, Units MM	-1.9	-3.3	-6.1	-6.1	-10.7	-14.2	-17.4	-21.0	-25.1
ROW I-Pods/MP3 Players Overlap, Units MM	-1.6	-2.0	-2.9	-2.9	-5.0	-7.9	-10.7	-13.3	-15.7
Global I-Pods/MP3 Players Overlap, Units MM	-3.5	-5.4	-9.0	-9.0	-15.7	-22.0	-28.1	-34.3	-40.8
US Total MP3 Player Installed Unit Base	28.4	43.7	70.9	70.9	112.2	134.3	148.5	160.8	172.4
Rest of the World Total MP3 Player Installed Unit Base	23.0	26.6	34.0	34.0	52.7	74.5	91.6	102.0	108.1
Global Total MP3 Player Installed Unit Base, End of Period, MM	51.4	70.3	105.0	105.0	165.0	208.9	240.1	262.7	280.5
US I-Pods/MP3 Players Overlap	-1.0	-1.9	-3.3	-3.3	-5.6	-7.4	-9.1	-11.0	-13.2
ROW I-Pods/MP3 Players Overlap	-0.8	-1.1	-1.4	-1.4	-2.5	-4.0	-5.6	-6.9	-8.2
Global I-Pods/MP3 Players Overlap, MM	-1.8	-3.0	-4.7	-4.7	-8.0	-11.4	-14.7	-17.9	-21.3
US Total MP3 Player Households	15.4	25.3	38.1	38.1	58.7	70.3	78.0	84.5	90.7
Rest of the World Total MP3 Player Households	11.7	13.9	16.6	16.6	26.0	38.0	47.5	53.0	56.1
Global Total MP3 Player Households, End of Period, MM	27.1	39.3	54.6	54.6	84.7	108.3	125.5	137.5	146.8
US		228.4%	145.9%	147.6%	54.0%	19.9%	10.9%	8.3%	7.4%
Rest of the World		90.4%	40.6%	41.6%	57.1%	46.0%	25.0%	11.5%	5.9%
Global MP3 Players Installed Base, % Change		161.2%	100.4%	101.8%	65.0%	27.9%	15.9%	9.5%	6.8%
US Households	108.9	109.5	110.0	110.0	111.1	112.2	113.3	114.5	115.6
US Total MP3 Player Penetration of Households	14.1%	23.2%	34.6%	34.6%	52.8%	62.7%	68.8%	73.8%	78.5%
US Total MP3 Player Units per Household	1.8	1.7	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Rest of the World Total MP3 Player Units per Household	2.0	1.9	2.1	2.1	2.0	2.0	1.9	1.9	1.9
US	25.0	11.0	9.2	19.3	15.4	13.9	13.2	12.5	11.9
Rest of the World	6.6	3.7	4.7	7.2	15.8	14.7	13.3	13.1	13.0
Tracks downloaded per MP3 Player Household	17.1	8.2	7.7	15.5	15.5	14.2	13.2	12.8	12.3

Source: Nielsen Soundscan, ifpi, Billboard, Company Reports, Morgan Stanley Research

Exhibit 23

Global Digital Subscriptions Market (Based on Geographical Roll-Up)

	2004	1H:05	2H:05	2005	2006E	2007E	2008E	2009E	2010E
Subscription Revenue									
Period-End Subscribers, *millions*									
Europe	0.2	0.2	0.3	0.3	0.4	0.4	0.5	0.5	0.6
US	1.4	2.0	2.5	2.5	3.2	3.8	4.4	4.9	5.4
Rest of the World	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Global Subscriptions	1.5	2.2	2.8	2.8	3.5	4.2	4.9	5.5	6.0
Period-End Subscribers, *% Growth*									
Europe				66.7%	25.0%	20.0%	16.0%	12.8%	10.0%
US				66.7%	25.0%	20.0%	16.0%	12.8%	10.0%
Rest of the World				NA	NA	NA	NA	NA	NA
Total Global Subscriptions				66.7%	25.0%	20.0%	16.0%	12.8%	10.0%
Average Subscribers, *Million*									
Europe	0.1	0.2	0.3	0.2	0.3	0.4	0.5	0.5	0.6
US	0.9	1.7	2.3	1.9	2.8	3.5	4.1	4.7	5.2
Rest of the World	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Global Subscriptions	1.2	1.9	2.5	2.2	3.2	3.9	4.5	5.2	5.8
Average Monthly Subscription Price									
Discount from Stated Price Due to Promotions, Etc.	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%
Europe	€5.40	€5.40	€5.40	€5.40	€5.40	€5.40	€5.40	€5.40	€5.40
US	$5.98	$6.18	$5.91	$6.05	$5.91	$5.91	$5.91	$5.91	$5.91
Rest of the World	$5.98	$6.18	$5.91	$6.05	$5.91	$5.91	$5.91	$5.91	$5.91
Retail Subscription Revenue, *$ million*									
Europe	7.2	9.1	11.6	20.7	30.1	38.8	43.4	49.6	55.2
US	61.0	61.8	79.8	141.6	201.2	245.9	289.8	331.1	368.6
Rest of the World	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Retail Subscription Revenue	68.1	70.9	91.4	162.3	231.3	282.7	333.1	380.7	423.8
Labels' Monthly Retail Revenue per Subscriber	$4.00	$4.00	$4.00	$4.00	$4.00	$4.00	$4.00	$4.00	$4.00
Wholesale Revenue, *$ million*									
Europe	3.6	4.4	6.0	10.4	15.1	18.5	21.8	24.9	27.7
US	40.8	40.0	54.0	94.0	136.1	166.3	196.0	223.9	249.3
Rest of the World	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Wholesale Subscription Revenue	44.4	44.4	60.0	104.4	151.2	184.8	217.7	248.8	277.0
Total Digital Subscription Market									
Total Retail Subscription Revenue	68.1	70.9	91.4	162.3	231.3	282.7	333.1	380.7	423.8
Total Wholesale Subscription Revenue	44.4	44.4	60.0	104.4	151.2	184.8	217.7	248.8	277.0
Wholesale as % of Retail	65.2%	62.7%	65.6%	64.3%	65.4%	65.4%	65.4%	65.4%	65.4%

Source: Nielsen Soundscan, ifpi, Billboard, Company Reports, Morgan Stanley Research

Exhibit 24

Global Digital Subscriptions Market (Based on Service Providers)

	1H:05	2H:05	2005	2006E	2007E	2008E	2009E	2010E
Period-End Subscribers, *millions*								
Napster	0.4	0.5	0.5	0.7	0.8	0.9	1.0	1.1
Rhapsody	1.2	1.4	1.4	1.8	2.1	2.4	2.7	3.0
YahooMusic	0.6	0.7	0.7	0.9	1.0	1.2	1.4	1.5
Other (Primarily Outside US)	0.0	0.2	0.2	0.2	0.3	0.3	0.4	0.4
Total	2.2	2.8	2.8	3.5	4.2	4.9	5.5	6.0
Period-End Subscribers, % Change								
Napster				25.0%	20.0%	16.0%	12.8%	10.0%
Rhapsody				25.0%	20.0%	16.0%	12.8%	10.0%
YahooMusic				25.0%	20.0%	16.0%	12.8%	10.0%
Total				25.0%	20.0%	16.0%	12.8%	10.0%

Source: Nielsen Soundscan, ifpi, Billboard, Company Reports, Morgan Stanley Research

Exhibit 26

Global Ringtone Market (Includes mono and polyphonic ring tones)

	2004	1H:05	2H:05	2005	2006E	2007E	2008E	2009E	2010E
Ringtones Sold, Millions									
US				201.7	141.2	98.8	69.2	48.4	33.9
Europe				247.5	148.5	89.1	53.5	32.1	19.2
Asia				320.8	160.4	80.2	40.1	20.1	10.0
Latin America				146.7	161.3	169.4	177.9	186.8	196.1
Total Ringtones				918.7	611.4	437.5	340.8	287.3	259.3
Ringtones Sold, % Change									
US					-30.0%	-30.0%	-30.0%	-30.0%	-30.0%
Europe					-40.0%	-40.0%	-40.0%	-40.0%	-40.0%
Asia					-50.0%	-50.0%	-50.0%	-50.0%	-50.0%
Latin America					10.0%	5.0%	5.0%	5.0%	5.0%
Total Ringtones					-33.3%	-28.4%	-22.2%	-15.6%	-9.8%
Price per Ringtones									
US				$1.20	$1.20	$1.20	$1.20	$1.20	$1.20
Europe				$1.20	$1.20	$1.20	$1.20	$1.20	$1.20
Asia				$1.20	$1.20	$1.20	$1.20	$1.20	$1.20
Latin America				$1.20	$1.20	$1.20	$1.20	$1.20	$1.20
Total				$1.20	$1.20	$1.20	$1.20	$1.20	$1.20
Retail Ringtone Revenues									
US	250.0			242.0	169.4	118.6	83.0	58.1	40.7
Europe	300.0			297.0	178.2	106.9	64.2	38.5	23.1
Asia	600.0			385.0	192.5	96.3	48.1	24.1	12.0
Latin America	150.0			176.0	193.6	203.3	213.4	224.1	235.3
Total	1,300.0	650.0	450.0	1,100.0	733.7	525.0	408.7	344.8	311.1
Retail Ringtone Revenue - Geographic Breakdown									
US				22.0%	23.1%	22.6%	20.3%	16.9%	13.1%
Europe				27.0%	24.3%	20.4%	15.7%	11.2%	7.4%
Asia				35.0%	26.2%	18.3%	11.8%	7.0%	3.9%
Latin America				16.0%	26.4%	38.7%	52.2%	65.0%	75.6%
Total				100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Retail Ringtone Revenues, % Change									
US					-30.0%	-30.0%	-30.0%	-30.0%	-30.0%
Europe					-40.0%	-40.0%	-40.0%	-40.0%	-40.0%
Asia					-50.0%	-50.0%	-50.0%	-50.0%	-50.0%
Latin America					10.0%	5.0%	5.0%	5.0%	5.0%
Total, % Change					-33.3%	-28.4%	-22.2%	-15.6%	-9.8%
Retail Revenues, Based on Companies' Data									
Publishing				1,477.7					
Recorded Music				0.0					
Eliminations				0.0					
Total Retail Revenues				1,477.7					
Publishers' Share of Revenues	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
Wholesale Revenues									
Publishing	117.0	58.5	40.5	99.0	66.0	47.3	36.8	31.0	28.0
Recorded Music	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Wholesale Revenues	117.0	58.5	40.5	99.0	66.0	47.3	36.8	31.0	28.0
Total Ringtone Market									
Total Retail Ringtone Revenue	1,300.0	650.0	450.0	1,100.0	733.7	525.0	408.7	344.8	311.1
Total Wholesale Ringtone Revenue	117.0	58.5	40.5	99.0	66.0	47.3	36.8	31.0	28.0
Wholesale as % of Retail	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%

Source: Nielsen Soundscan, Ipi, Billboard, Company Reports, Morgan Stanley Research

Exhibit 26

Global Mastertone Download Market

Mastertones Sold, *Millions*	2004	1H:05	2H:05	2005	2006E	2007E	2008E	2009E	2010E
US				121.2	212.1	286.4	356.5	417.7	467.8
Europe				77.6	155.2	232.7	314.2	391.2	458.2
Asia				150.0	262.5	328.1	385.5	432.8	469.9
Total Mastertones				348.8	629.8	847.2	1,056.3	1,241.6	1,395.9
Price per Mastertones									
US				$2.25	$2.25	$2.25	$2.25	$2.25	$2.25
Europe				$3.74	$3.74	$3.74	$3.74	$3.74	$3.74
Asia				$2.25	$2.25	$2.25	$2.25	$2.25	$2.25
Total				$2.58	$2.62	$2.66	$2.69	$2.72	$2.74
Retail Mastertone Revenues, % Change									
US					75.0%	35.0%	24.5%	17.2%	12.0%
Europe					100.0%	50.0%	35.0%	24.5%	17.2%
Asia					75.0%	25.0%	17.5%	12.3%	8.6%
Total, % *Change*					83.0%	36.7%	26.3%	18.7%	13.2%
Retail Mastertone Revenues									
US	0.0			272.7	477.3	644.3	802.2	939.7	1,052.6
Europe	50.0			289.8	579.5	869.3	1,173.6	1,461.1	1,711.7
Asia	50.0			337.5	590.6	738.3	867.5	973.7	1,057.2
Total, $ *Million*	100.0	315.0	585.0	900.0	1,647.4	2,251.9	2,843.2	3,374.6	3,821.5
Retail Mastertone Revenue - Geographic Breakdown									
US	0.0%			30.3%	29.0%	28.6%	28.2%	27.8%	27.5%
Europe	50.0%			32.2%	35.2%	38.6%	41.3%	43.3%	44.8%
Asia	50.0%			37.5%	35.8%	32.8%	30.5%	28.9%	27.7%
Total	100.0%			100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Combined Retail Mastertone & Ringtone Revenue									
US	250.0			514.7	646.7	762.9	885.2	997.9	1,093.2
Europe	350.0			586.8	757.7	976.2	1,237.7	1,499.6	1,734.8
Asia	650.0			722.5	783.1	834.5	915.8	997.8	1,069.3
Latin America	150.0			176.0	193.6	203.3	213.4	224.1	235.3
Total	1,400.0			2,000.0	2,381.1	2,776.9	3,252.0	3,719.4	4,132.6
Combined Retail Mastertone & Ringtone Revenue - % Chg.									
US					25.6%	18.0%	16.0%	12.7%	9.6%
Europe					29.1%	28.8%	26.8%	21.2%	15.7%
Asia					8.4%	6.6%	9.7%	9.0%	7.2%
Latin America					10.0%	5.0%	5.0%	5.0%	5.0%
Total					19.1%	16.6%	17.1%	14.4%	11.1%
Publishers' Share of Revenues	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
Labels' Share of Revenues	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%
Wholesale Revenues:									
Publishing	9.0	28.4	52.7	81.0	148.3	202.7	255.9	303.7	343.9
Recorded Music	50.0	157.5	292.5	450.0	823.7	1,126.0	1,421.6	1,687.3	1,910.7
Eliminations	(9.0)	(28.4)	(52.7)	(81.0)	(148.3)	(202.7)	(255.9)	(303.7)	(343.9)
Total Wholesale Revenues	50.0	157.5	292.5	450.0	823.7	1,126.0	1,421.6	1,687.3	1,910.7
Total Mastertone Market									
Total Retail Mastertone Revenue	100.0	315.0	585.0	900.0	1,647.4	2,251.9	2,843.2	3,374.6	3,821.5
Total Wholesale Mastertone Revenue	50.0	157.5	292.5	450.0	823.7	1,126.0	1,421.6	1,687.3	1,910.7
Wholesale as % of Retail	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%	50.0%

Source: Nielsen Soundscan, ifpi, Billboard, Company Reports, Morgan Stanley Research

Appendix 2: Warner Music Group Financial Model

Exhibit 27

WMG: Sum-of-the-Parts Fair Market Value Analysis

US$ Millions *Fiscal Year End - September*	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Recorded Music	3,113	3,142	3,197	3,269	3,357	3,452
Music Publishing	2,115	2,191	2,268	2,347	2,428	2,509
Corporate Overhead and Eliminations	(1,017)	(1,043)	(1,070)	(1,097)	(1,124)	(1,153)
FAS 123 Stock Option Expense	(160)	(155)	(151)	(146)	(140)	(135)
IRS Code Section 338 Tax Shield	288	303	316	329	343	352
Total	4,339	4,437	4,560	4,702	4,863	5,026
Cash	288	369	406	417	418	436
Total Debt	(2,246)	(2,251)	(2,257)	(2,266)	(2,276)	(2,282)
Equity Value	2,381	2,555	2,708	2,853	3,004	3,180
Common Shares Outstanding	152.2	156.2	160.2	164.1	167.9	171.7
Value per Share	$15.64	$16.35	$16.91	$17.39	$17.89	$18.53
Enterprise Value	4,339	4,437	4,560	4,702	4,863	5,026
Enterprise Value / Concurrent EBITDA	8.9x	9.6x	10.7x	11.4x	12.1x	12.2x
Enterprise Value / Forward EBITDA	9.4x	10.4x	11.1x	11.7x	11.8x	11.7x
Enterprise Value	4,339	4,437	4,560	4,702	4,863	5,026
Present Value of Tax Shield	(288)	(303)	(316)	(329)	(343)	(352)
Adjusted Enterprise Value	4,051	4,134	4,244	4,373	4,520	4,674
Enterprise Value / Concurrent EBITDA	8.3x	9.0x	9.9x	10.6x	11.2x	11.3x
Enterprise Value / Forward EBITDA	8.8x	9.7x	10.3x	10.9x	10.9x	10.9x

E = Morgan Stanley Research Estimates
Source: Company Reports, Morgan Stanley Analysis

Exhibit 28

FCF/Share Multiple Valuation

US$ Millions						
Fiscal Year End - September	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
EBITDA	490	462	427	413	402	413
Capital Expenditures	(30)	(40)	(40)	(40)	(40)	(41)
Total Interest Expense, Net	(147)	(136)	(135)	(135)	(136)	(138)
Cash Taxes	(55)	(62)	(68)	(81)	(79)	(68)
FAS 123 Stock Option Expense	(25)	(28)	(28)	(28)	(28)	(28)
Increase in Working Capital	19	4	2	7	10	13
Minority Interests & Preferred Dividends	(5)	0	0	0	0	0
Free Cash Flow	247	200	159	136	128	151
Add: Cash Taxes	55	62	68	81	79	68
Subtract: Total Tax Provision	(73)	(77)	(79)	(76)	(75)	(85)
Adjusted Free Cash Flow	229	184	148	141	133	134
FCF/Share	$1.87	$1.28	$1.00	$0.84	$0.77	$0.89
Adjusted FCF/Share	$1.74	$1.19	$0.93	$0.87	$0.80	$0.79
Recurring Dividends/Share	$0.00	$0.53	$0.53	$0.53	$0.53	$0.53
Target Multiple of Forward FCF/Share	8.9x	12.4x	14.6x	17.4x	19.3x	20.0x
Intrinsic Value before Tax Shield & Dividends	$10.55	$11.56	$12.67	$13.89	$15.22	$16.68
Present Value of Tax Shield	1.89	1.94	1.97	2.01	2.04	2.05
Present Value of Dividends through F2010	2.02	1.69	1.32	0.92	0.48	0.00
Intrinsic Value per Share	$14.46	$15.19	$15.97	$16.81	$17.74	$18.73
Target Return on Equity	9.6%					

E = Morgan Stanley Research Estimates
Source: Company Reports, Morgan Stanley Analysis

Exhibit 29

Annual Income Statement

Income Statement US$ Millions	Pro Forma F2004	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
	Year Ended Sept. 30						
Gross Sales Net of Returns	2,692	2,639	2,578	2,475	2,401	2,351	2,329
Digital Sales	32	157	263	352	440	510	580
Other Sales/Allowances	513	524	525	531	532	532	531
Total Revenue ex. Licensing	3,237	3,320	3,367	3,358	3,373	3,422	3,492
% Change		2.6%	1.4%	-0.3%	0.7%	1.2%	2.0%
Licensing Revenue	141	148	159	153	148	145	144
Divested Operations and Merger Accounting Adj.	58	34	0	0	0	0	0
Total Revenue	3,436	3,502	3,526	3,511	3,533	3,568	3,636
% Change		1.9%	0.7%	-0.4%	0.6%	1.0%	1.9%
Product Costs	527	553	567	546	532	522	518
Royalties	972	1,036	1,071	1,087	1,111	1,136	1,173
A&R	227	174	189	212	227	243	248
Licensing Costs/Other Recurring Expenses	79	64	96	92	89	87	87
Divested Operations and Merger Accounting Adj.	39	20	0	0	0	0	0
Total COGS	1,843	1,850	1,923	1,937	1,959	1,989	2,026
Gross Profit	1,593	1,652	1,603	1,574	1,572	1,579	1,610
Gross Margin	46.4%	47.2%	45.5%	44.8%	44.5%	44.2%	44.3%
Distribution	95	72	68	65	63	62	61
Variable Marketing	420	411	412	406	404	406	409
Selling Overhead	89	77	79	81	83	85	87
Marketing Overhead	165	120	127	129	132	134	137
G&A Overhead	469	425	479	488	500	511	524
Additional OIBDA Cost Reserve	0	0	0	0	0	0	0
Other Recurring Expenses	(46)	(31)	(23)	(23)	(22)	(22)	(22)
Divested Operations and Merger Accounting Adj.	22	14	0	0	0	0	0
Total Selling, Gen. & Admin. Exp. (excl. Mgmt. F	1,214	1,162	1,141	1,147	1,160	1,176	1,197
EBITDA before FAS 123 Stock Compensation	379	490	462	427	413	402	413
EBITDA Margin, %	11.0%	14.0%	13.1%	12.2%	11.7%	11.3%	11.4%
Management Fees	(10)	(5)	0	0	0	0	0
FAS 123 Stock Compensation	0	(25)	(28)	(28)	(28)	(28)	(28)
EBITDA after FAS 123 Stock Compensation	369	459	434	399	385	374	385
EBITDA Margin, %	10.7%	13.1%	12.3%	11.4%	10.9%	10.5%	10.6%
Depreciation	67	51	52	50	47	43	39
Amortization of Intangible Assets	178	187	188	186	186	186	186
EBIT before Nonrecurring Expenses	124	221	194	164	152	145	160
Nonrecurring Expenses	0	(137)	0	0	0	0	0
EBIT after Nonrecurring Expenses	124	84	194	164	152	145	160
Interest Expense, net	(150)	(181)	(170)	(161)	(169)	(169)	(172)
Minority Interest	0	(5)	0	0	0	0	0
Equity in the Losses of Equity-Method Affiliates	(14)	(1)	(3)	(3)	(3)	(3)	(3)
Other Income/(Expense)	(1,136)	(11)	0	0	0	0	0
Pre-Tax Income	(1,176)	(114)	21	(8)	(19)	(27)	(15)
Cash Tax (Expense) / Benefit	NA	(53)	(67)	(63)	(81)	(79)	(68)
Deferred Tax (Expense) / Benefit	NA	0	(8)	0	17	17	0
Total Tax Provision (Expense) / Benefit	275	(55)	(67)	(68)	(64)	(62)	(68)
Effective Tax Rate	23%	-48%	318%	-867%	-330%	-230%	-444%
Net Income	(901)	(169)	(49)	(76)	(83)	(90)	(83)
Minority Interest	0	0	0	0	0	0	0
Preferred Dividends to Investors	0	0	0	0	0	0	0
Net Income Available to Common	(901)	(169)	(49)	(76)	(83)	(90)	(83)
Average Basic Shares Outstanding	140.1	120.9	136.5	138.6	138.6	138.6	138.6
Net Income per Avg. Basic Share	($6.43)	($1.40)	($0.36)	($0.54)	($0.60)	($0.65)	($0.60)
Average Diluted Shares Outstanding	140.1	126.8	136.5	138.6	138.6	138.6	138.6
Net Income per Avg. Diluted Share	($6.43)	($1.33)	($0.36)	($0.54)	($0.60)	($0.65)	($0.60)
Reported Net Income Available to Common	(901)	(169)	(49)	(76)	(83)	(90)	(83)
Add: Amortization of Intangible Assets	178	187	188	186	186	186	186
Add: Nonrecurring Losses per Share	1,157	182	34	34	34	34	34
Subtract: Nonrecurring Gains per Share	(1)	0	0	0	0	0	0
Tax Prov./(Benefit) Related to Non-recurring Item	(467)	(36)	(34)	(34)	(34)	(34)	(34)
Adjusted Net Income	(34)	114	139	110	102	96	103
Adjustment for Additional Com. Share Equivalen	0.0	12.0	16.8	20.0	23.9	27.8	31.5
Adjusted Average Diluted Shares Outstanding	140.1	138.7	153.3	158.7	162.6	166.4	170.2
Adj. Net Income per Adj. Avg. Diluted Share	($0.24)	$0.82	$0.91	$0.69	$0.63	$0.58	$0.61

E = Morgan Stanley Research estimates Source: Morgan Stanley Research

Exhibit 30

Quarterly Income Statement

US$ Millions	2005				2006			
	1Q	2Q	3Q	4Q	1QE	2QE	3QE	4QE
Gross Sales Net of Returns	886	557	510	686	810	542	504	652
Digital Sales	25	35	44	53	47	58	71	87
Other Sales/Allowances	129	131	140	126	129	131	141	131
Total Revenue ex. Licensing	1,040	723	694	863	1,056	731	716	863
% Change	-7.8%	6.1%	2.5%	15.0%	1.5%	1.2%	3.2%	0.0%
Licensing Revenue	33	33	40	42	27	38	46	48
Divested Operations and Merger Accounting Adj.	15	11	8	0	0	0	0	0
Total Revenue	1,088	767	742	905	1,083	769	762	912
% Change	-7.6%	4.4%	2.2%	13.6%	-0.5%	0.3%	2.7%	0.7%
Product Costs	166	123	112	153	189	121	112	146
Royalties	342	202	223	269	347	223	246	251
A&R	39	41	39	53	38	41	40	50
Licensing Costs/Other Recurring Expenses	24	27	17	(4)	17	23	27	28
Divested Operations and Merger Accounting Adj.	8	7	5	0	0	0	0	0
Total COGS	581	400	396	473	611	407	426	479
Gross Profit	507	367	346	432	472	362	337	432
Gross Margin	46.6%	47.8%	46.6%	47.7%	43.6%	47.1%	44.2%	47.4%
Distribution	26	15	13	18	24	14	13	17
Variable Marketing	120	83	96	111	128	82	95	108
Selling Overhead	21	16	16	24	20	17	17	25
Marketing Overhead	32	29	27	37	33	31	28	35
G&A Overhead	128	124	108	135	108	125	113	133
Additional OIBDA Cost Reserve	0	0	0	0	0	0	0	0
Other Recurring Expenses	(19)	(3)	2	(11)	(9)	(2)	(5)	(6)
Divested Operations and Merger Accounting Adj.	4	5	4	0	0	(0)	(0)	0
Total Selling, Gen. & Admin Exp. (excl. Mgmt. F	313	270	267	318	303	266	261	311
EBITDA before FAS 123 Stock Compensation	195	98	79	119	168	96	75	122
EBITDA Margin, %	17.9%	12.7%	10.6%	13.1%	15.6%	12.5%	9.9%	13.4%
Management Fees	(1)	(7)	(1)	0	0	0	0	0
FAS 123 Stock Compensation	(2)	(7)	(9)	(7)	(7)	(7)	(7)	(7)
EBITDA after FAS 123 Stock Compensation	190	88	69	112	161	89	68	115
EBITDA Margin, %	17.5%	11.5%	9.3%	12.4%	14.9%	11.6%	8.9%	12.6%
Depreciation	14	14	12	11	13	13	13	13
Amortization of Intangible Assets	46	47	47	47	47	47	47	47
EBIT before Nonrecurring Expenses	130	27	10	54	101	29	8	55
Nonrecurring Expenses	0	0	(102)	(35)	0	0	0	0
EBIT after Nonrecurring Expenses	130	27	(92)	19	101	29	8	55
Interest Expense, net	(38)	(32)	(49)	(42)	(42)	(42)	(42)	(42)
Minority Interest	(5)	0	0	0	0	0	0	0
Equity in the Losses of Equity-Method Affiliates	(1)	0	0	0	(1)	0	(1)	(1)
Other Income (Expense)	(18)	19	(34)	2	0	0	0	0
Pre-Tax Income	68	14	(175)	(21)	58	(13)	(35)	11
Cash Tax (Expense) / Benefit	(35)	(5)	(8)	(7)	(19)	(14)	(15)	(12)
Deferred Tax (Expense) / Benefit	3	(5)	4	(2)	(2)	(2)	(2)	(2)
Total Tax Provision (Expense) / Benefit	(32)	(10)	(4)	(9)	(21)	(16)	(17)	(13)
Effective Tax Rate	47%	71%	-2%	-43%	37%	-119%	-49%	124%
Net Income	36	4	(179)	(30)	37	(29)	(52)	(4)
Minority Interest	0	0	0	0	0	0	0	0
Preferred Dividends to Investors	0	0	0	0	0	0	0	0
Net Income Available to Common	36	4	(179)	(30)	37	(29)	(52)	(4)
Average Basic Shares Outstanding	107.5	107.7	127.0	141.2	134.3	134.3	138.6	138.6
Net Income per Avg. Basic Share	$0.33	$0.04	($1.41)	($0.21)	$0.27	($0.22)	($0.38)	($0.03)
Average Diluted Shares Outstanding	115.3	123.5	127.0	141.2	134.3	134.3	138.6	138.6
Net Income per Avg. Diluted Share	$0.31	$0.03	($1.41)	($0.21)	$0.27	($0.22)	($0.38)	($0.03)
Reported Net Income Available to Common	36	4	(179)	(30)	37	(29)	(52)	(4)
Add: Amortization of Intangible Assets	46	47	47	47	47	47	47	47
Add: Nonrecurring Losses per Share	21	(36)	37	1	3	3	3	3
Subtract: Nonrecurring Gains per Share	0	0	1	2	0	0	1	1
Tax Prov./(Benefit) Related to Non-recurring Item	(23)	(4)	(30)	(17)	(17)	(17)	(18)	(18)
Adjusted Net Income	80	11	(124)	2	69	3	(19)	29
Adjustment for Additional Com. Share Equivalen	0	0	1	2	0	0	1	1
Adjusted Average Diluted Shares Outstanding	115.3	123.5	128.0	143.2	134.3	134.3	139.6	139.6
Adj. Net Income per Adj. Avg. Diluted Share	$0.69	$0.09	($0.97)	$0.02	$0.52	$0.02	($0.14)	$0.21

E = Morgan Stanley Research estimates Source: Morgan Stanley Research

Exhibit 31

Annual Balance Sheet

US$ Millions	Pro Forma						
Fiscal Year End - September	F2004	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Current Assets:							
Cash & Marketable Securities	555	288	369	406	417	418	436
Accounts Receivable	571	637	641	639	642	649	661
Inventories	65	52	54	54	55	56	57
Royalty Advances Expected to be Recouped With	223	190	191	190	192	194	197
Deferred Tax Assets	38	36	35	36	36	36	37
Other Current Assets	86	39	39	39	39	40	40
Current Assets	1,538	1,242	1,330	1,364	1,381	1,393	1,429
Royalty Advances Expected to be Recouped After	223	190	191	190	192	194	197
Investments	8	21	38	55	72	89	106
Gross PP&E	225	241	255	266	272	273	275
Accumulated Depreciation	(36)	(84)	(110)	(131)	(143)	(147)	(147)
Net Prop., Plant, & Equip.	189	157	145	135	129	126	128
Goodwill	978	869	869	869	869	869	869
Intangible Assets Subject to Amortization, Net	1,937	1,815	1,627	1,441	1,255	1,069	883
Intangible Assets Not Subject to Amortization	100	100	100	100	100	100	100
Other Assets	117	104	105	104	105	106	108
Total Assets	5,090	4,498	4,405	4,259	4,102	3,946	3,821
Liabilities:							
Accounts Payable	226	247	257	259	262	266	270
Accrued Royalties	1,003	1,057	1,064	1,060	1,066	1,077	1,097
Taxes and Other Withholdings	10	23	23	23	23	23	24
Current Portion of Long-term Debt & Short-term	12	17	17	17	17	17	0
Note Payable to Shareholders	342	0	0	0	0	0	0
Accrued Liabilities	283	306	301	302	305	310	315
Fair Value of Warrants	155	0	0	0	0	0	0
Other Current Liabilities	149	98	99	98	99	100	102
Current Liabilities (excl. ST Debt & Prog. Liab.)	2,180	1,748	1,760	1,758	1,771	1,792	1,809
Long Term Debt	1,828	2,229	2,234	2,240	2,249	2,259	2,282
Deferred Taxes	265	201	209	209	192	175	175
Other Liabilities	333	231	233	232	233	235	240
Minority Interests	204	0	0	0	0	0	0
Common Stock	0	0	0	0	0	0	0
Additional Paid-In Capital	512	548	558	564	567	567	567
Retained Earnings	(238)	(480)	(609)	(765)	(931)	(1,104)	(1,273)
Accumulated Other Comprehensive Income (Loss	6	21	21	21	21	21	21
Total Equity	280	89	(30)	(180)	(343)	(516)	(685)
Total Liabilities & Equity	5,090	4,498	4,405	4,259	4,102	3,946	3,821

E = Morgan Stanley Research estimates Source: Morgan Stanley Research

Exhibit 32

Annual Sources and Uses of Cash

US$ Millions *Fiscal Year End - September*	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Net Income (Loss)	(169)	(49)	(76)	(83)	(90)	(83)
Depreciation	51	52	50	47	43	39
Amortization	187	188	186	186	186	186
Deferred Taxes	0	8	0	(17)	(17)	0
Equity in Profits (Losses) of Affiliated Companie	1	3	3	3	3	3
Minority Interests	5	0	0	0	0	0
Unrealized Loss on Warrants	(17)	0	0	0	0	0
Noncash Interest Expense	68	17	19	20	22	6
Noncash Compensation Expense	25	10	6	3	0	0
Other Losses/(Gains)	35	0	0	0	0	0
Cash From Operations Before Changes in Oper. A	186	229	188	159	148	151
Changes In Operating Assets and Liabilities:						
Accounts Receivable	(58)	(4)	3	(4)	(7)	(12)
Inventories	(3)	(2)	(0)	(1)	(1)	(1)
Royalty Advances	0	(3)	2	(2)	(4)	(7)
Accounts Payable and Accrued Liabilities	10	17	(3)	9	15	25
Other	70	(4)	1	4	6	9
Total	19	4	2	7	10	13
Net Cash From Operations	205	233	189	166	158	165
Capital Expenditures	(30)	(40)	(40)	(40)	(40)	(41)
Acquisitions	(78)	0	0	0	0	0
Investments	54	(20)	(20)	(20)	(20)	(20)
Net Cash From Investing	(54)	(60)	(60)	(60)	(60)	(61)
Change in Short-term Debt	5	0	0	0	0	(17)
Change in Long-term Debt	333	(12)	(12)	(12)	(12)	17
Sale of Stock (Repurchase)	6	0	0	0	0	0
Proceeds from IPO	517	0	0	0	0	0
Dividends (cash only)	(584)	(80)	(81)	(82)	(84)	(86)
Repayment of Note Payable to Shareholders	(342)	0	0	0	0	0
Repurchase Subsidiary Preferred Stock	(200)	0	0	0	0	0
Repayment of Warrants	(138)	0	0	0	0	0
Other, Net	(13)	0	0	0	0	0
Net Cash From Financing	(416)	(92)	(93)	(94)	(96)	(86)
Beginning Cash Balance	555	288	369	406	417	418
Exchange Movement on Opening Cash Balance	(2)	0	0	0	0	0
Net Increase/(Decrease) in Cash	(265)	81	37	11	1	18
Ending Cash Balance	288	369	406	417	418	436

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 33

WMG Debt Analysis

US$ Millions	Pro Forma						
Fiscal Year End - September	F2004	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Revolver, Libor +200bps, 37.5bps commitment fe	-	-	-	-	-	-	-
Term Loan (USD), Libor +250bps	1,194.0	1,430.0	1,418.0	1,406.0	1,394.0	1,382.0	1,382.0
Senior Subordinated Debt, 7.375%	465.0	465.0	465.0	465.0	465.0	465.0	465.0
Senior Subordinated Debt (GBP), 8.125%	181.0	177.0	177.0	177.0	177.0	177.0	177.0
HoldCo Notes (Cash Pay), Libor +438bps	-	-	-	-	-	-	-
HoldCo Discount Notes (5-yr Accretion), 9.5%	-	174.0	190.9	209.5	229.9	252.2	257.9
HoldCo Notes (10-yr PIK), Libor +700bps	-	-	-	-	-	-	-
Total Debt	1,840.0	2,246.0	2,250.9	2,257.5	2,265.9	2,276.2	2,281.9
Current Portion of Long Term Debt	12.0	17.0	17.0	17.0	17.0	17.0	-
Long-term Debt	1,828.0	2,229.0	2,233.9	2,240.5	2,248.9	2,259.2	2,281.9
Cash Interest							
Revolver, Libor +200bps, 37.5bps commitment fe	0.8	0.8	0.9	0.9	0.9	0.9	0.9
Term Loan (USD), Libor +250bps	36.4	72.2	78.3	77.7	77.0	76.3	76.0
Senior Subordinated Debt, 7.375%	20.3	34.3	34.3	34.3	34.3	34.3	34.3
Senior Subordinated Debt (GBP), 8.125%	7.0	14.5	14.4	14.4	14.4	14.4	14.4
HoldCo Notes (Cash Pay), Libor +438bps	-	9.2	-	-	-	-	-
HoldCo Discount Notes (5-yr Accretion), 9.5%	-	-	-	-	-	-	19.4
HoldCo Notes (10-yr PIK), Libor +700bps	-	-	-	-	-	-	-
Total Cash Interest Expense	64.5	131.1	127.9	127.3	126.6	125.9	145.0
Noncash Interest							
Revolver, Libor +200bps, 37.5bps commitment fee							
Term Loan (USD), Libor +250bps							
Senior Subordinated Debt, 7.375%							
Senior Subordinated Debt (GBP), 8.125%							
HoldCo Notes (Cash Pay), Libor +438bps							
HoldCo Discount Notes (5-yr Accretion), 9.5%		15.7	16.9	18.6	20.4	22.4	5.7
HoldCo Notes (10-yr PIK), Libor +700bps		10.5	-	-	-	-	-
Total Noncash Interest Expense		26.2	16.9	18.6	20.4	22.4	5.7
Interest							
Libor		3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Revolver, Libor +200bps		5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Term Loan (USD), Libor +250bps		5.50%	5.50%	5.50%	5.50%	5.50%	5.50%
Senior Subordinated Debt, 7.375%		7.38%	7.38%	7.38%	7.38%	7.38%	7.38%
Senior Subordinated Debt (GBP), 8.125%		8.13%	8.13%	8.13%	8.13%	8.13%	8.13%
HoldCo Notes (Cash Pay), Libor +438bps		7.38%	7.38%	7.38%	7.38%	7.38%	7.38%
HoldCo Discount Notes (5-yr Accretion), 9.5%		9.50%	9.50%	9.50%	9.50%	9.50%	9.50%
HoldCo Notes (10-yr PIK), Libor +700bps		10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Total Interest Expense		7.7%	6.44%	6.5%	6.5%	6.5%	6.6%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 34

Annual Segment Operating Forecast

Fiscal Year End - September	Pro Forma F2004	F2005	F2006E	F2007E	F2008E	F2009E	F2010E
Music	2,850	2,924	2,953	2,905	2,893	2,901	2,925
Publishing	552	573	602	635	667	696	740
Divested Publishing Operations	56	34	0	0	0	0	0
Other Divestitures and Adjustments	2	0	0	0	0	0	0
Corporate Eliminations	(24)	(29)	(29)	(29)	(29)	(29)	(29)
Total Revenue	3,436	3,502	3,526	3,511	3,531	3,568	3,636
% Change		1.9%	0.7%	-0.4%	0.6%	1.0%	1.9%
Music	1,479	1,477	1,550	1,541	1,540	1,551	1,557
Publishing	350	382	403	425	448	467	498
Divested Publishing Operations	35	20	0	0	0	0	0
Other Divestitures and Adjustments	4	0	0	0	0	0	0
Corporate Eliminations	(24)	(29)	(29)	(29)	(29)	(29)	(29)
Total Cost of Revenues	1,843	1,850	1,923	1,937	1,959	1,989	2,026
% of Revenue	53.6%	52.8%	54.5%	55.2%	55.5%	55.8%	55.7%
Music	1,371	1,447	1,403	1,364	1,353	1,350	1,368
Publishing	202	191	200	209	219	229	242
Divested Publishing Operations	21	14	0	0	0	0	0
Other Divestitures and Adjustments	(2)	0	0	0	0	0	0
Corporate Eliminations	0	0	0	0	0	0	0
Total Gross Profit	1,593	1,652	1,603	1,574	1,572	1,579	1,610
% Change		3.7%	-3.0%	-1.8%	-0.1%	0.4%	2.0%
% Margin	46.4%	47.2%	45.5%	44.8%	44.5%	44.2%	44.3%
Music	1,071	999	997	998	1,006	1,018	1,033
Publishing	53	46	51	53	56	58	61
Divested Publishing Operations	18	14	0	0	0	0	0
Other Divestitures and Adjustments	4	0	0	0	0	0	0
Corporate Eliminations	68	103	93	95	98	100	103
Total Selling, General, and Admin. Expenses	1,214	1,162	1,141	1,147	1,160	1,176	1,197
Depreciation Expense	67	51	52	50	47	43	39
Management Fees	10	6	0	0	0	0	0
FAS 123 Stock Compensation	0	25	28	28	28	28	28
Reported Total Selling, General, and Admin. Exp.	1,291	1,244	1,221	1,224	1,234	1,247	1,264
% Change		-3.6%	-1.8%	0.2%	0.8%	1.0%	1.4%
% of Revenue	37.6%	35.5%	34.6%	34.9%	35.0%	35.0%	34.8%
Music	300	448	406	366	347	332	334
Publishing	149	145	149	156	164	171	181
Divested Publishing Operations	3	0	0	0	0	0	0
Other Divestitures and Adjustments	(5)	0	0	0	0	0	0
Corporate Eliminations	(68)	(103)	(93)	(95)	(98)	(100)	(103)
Total EBITDA before Mgmt. Fees & Stk. Comp	379	490	462	427	413	402	413
% Change		29.3%	-5.8%	-7.4%	-3.4%	-2.5%	2.7%
% Margin	11.0%	14.0%	13.1%	12.2%	11.7%	11.3%	11.4%
Music	-	(17)	(19)	(19)	(19)	(19)	(19)
Publishing	-	(3)	(3)	(3)	(3)	(3)	(3)
Corporate	-	(5)	(6)	(6)	(6)	(6)	(6)
FAS 123 Expense	-	(25)	(28)	(28)	(28)	(28)	(28)
Music	300	431	387	347	328	313	315
Publishing	149	142	145	153	160	167	178
Divested Publishing Operations	3	0	0	0	0	0	0
Other Divestitures and Adjustments	(5)	0	0	0	0	0	0
Corporate Eliminations	(68)	(103)	(99)	(101)	(103)	(106)	(108)
Total EBITDA after Mgmt. Fees, after Stk. Comp	379	465	434	399	385	374	385
% Change		22.7%	-6.8%	-7.9%	-3.7%	-2.7%	2.9%
% Margin	11.0%	13.3%	12.3%	11.4%	10.9%	10.5%	10.6%

E = Morgan Stanley Research estimates Source: Morgan Stanley Research

Exhibit 35

Quarterly Segment Operating Forecast

	Actual 2004					2005					2006E			
Fiscal Year End - September	1Q	2Q	3Q	4Q		1Q	2Q	3Q	4Q		1QE	2QE	3QE	4QE
Music	1,019	553	577	632	-	940	621	588	775	-	942	628	610	771
Publishing	142	175	145	132	-	130	143	155	137	-	148	169	150	146
Divested Publishing Operations	15	14	10	16	-	15	11	8	6	-	0	0	0	0
Other Divestitures and Adjustments	0	0	0	2	-	0	0	0	0	-	0	0	0	0
Corporate Eliminations	(2)	(1)	(4)	(2)	-	(2)	(1)	(2)	(2)	-	(2)	(1)	(2)	(2)
Total Revenue	1,178	739	726	787	-	1,048	767	742	905	-	1,033	769	762	812
% Change						-7.6%	4.4%	2.2%	13.6%		-0.5%	0.3%	2.7%	0.7%
Music	536	308	259	345	-	475	318	287	396	-	567	327	313	401
Publishing	103	78	100	69	-	104	83	111	84	-	111	85	117	66
Divested Publishing Operations	10	9	6	10	-	9	7	5	3	-	0	0	0	0
Other Divestitures and Adjustments	0	(1)	2	2	-	0	0	0	0	-	0	0	0	0
Corporate Eliminations	(2)	(6)	(4)	(5)	-	(2)	(3)	(2)	(2)	-	(7)	(8)	(7)	(7)
Total Cost of Revenue	648	388	393	421	-	581	408	398	473	-	611	407	426	479
% of Revenue	55.0%	52.5%	54.1%	53.5%		55.4%	53.2%	53.6%	52.3%		56.4%	52.9%	55.8%	52.6%
Music	495	269	318	307	-	465	303	301	379	-	415	301	294	372
Publishing	39	57	43	63	-	36	60	42	53	-	37	60	42	60
Divested Publishing Operations	6	5	4	6	-	6	4	3	0	-	0	0	0	0
Other Divestitures and Adjustments	(1)	1	(2)	0	-	0	0	0	0	-	0	0	0	0
Corporate Eliminations	0	0	0	0	-	0	0	0	0	-	0	0	0	0
Total Gross Profit	539	347	333	376	-	507	367	346	432	-	422	362	337	432
% Change						-4.3%	5.8%	3.9%	14.9%		-7.0%	-1.5%	-2.7%	0.1%
% Margin	45.7%	47.2%	45.9%	47.2%		48.4%	47.8%	46.6%	47.7%		40.8%	47.1%	44.2%	47.4%
Music	334	261	221	255	-	268	226	229	276	-	267	218	221	274
Publishing	13	14	12	14	-	14	11	11	10	-	12	13	13	13
Divested Publishing Operations	5	4	7	5	-	4	5	4	0	-	0	0	0	0
Other Divestitures and Adjustments	5	1	(1)	(3)	(3)	0	0	0	0	-	0	0	0	0
Corporate Eliminations	13	18	20	14	-	26	27	23	27	-	24	23	24	24
Total Selling, General and Admin. Expenses	371	298	260	286	-	313	270	267	313	-	303	264	261	311
Depreciation Expense	20	17	14	16	-	14	14	12	11	-	13	13	13	13
Management Fees	0	1	3	3	-	3	3	1	0	-	0	0	0	0
FAS 123 Stock Compensation	0	0	0	0	-	1	7	9	7	-	7	7	7	7
Reported Total Selling, General and Admin. Exp.	391	316	276	304	-	331	293	289	331	-	323	286	281	331
% Change						-15.3%	-7.3%	4.7%	8.9%		-2.3%	-2.4%	-2.6%	-0.1%
% of Revenue						30.4%	31.2%	38.9%	36.6%		28.0%	34.6%	34.3%	34.1%
Music	139	23	67	52	-	197	77	72	103	-	161	73	66	98
Publishing	26	44	31	49	-	22	49	31	43	-	25	45	29	48
Divested Publishing Operations	1	1	(3)	1	-	2	(1)	(1)	0	-	0	0	0	0
Other Divestitures and Adjustments	(14)	(1)	(3)	3	-	0	0	0	0	-	0	0	0	0
Corporate Eliminations	(13)	(18)	(20)	(14)	-	(26)	(27)	(23)	(27)	-	(24)	(23)	(24)	(24)
Total EBITDA before Mgmt. Fees & Stk. Comp	159	49	74	91	-	195	98	79	119	-	168	96	75	122
% Change						22.3%	99.0%	7.3%	31.5%		-13.4%	-1.5%	-4.8%	2.4%
% Margin	13.5%	6.7%	10.1%	11.4%		17.9%	12.7%	10.6%	13.1%		15.0%	12.3%	9.9%	13.4%
Music	-	-	-	-		(1)	(5)	(6)	(5)	-	(5)	(5)	(5)	(4)
Publishing	-	-	-	-		(1)	(1)	(1)	(1)	-	(1)	(1)	(1)	(1)
Corporate	-	-	-	-		(1)	(1)	(1)	(1)	-	(1)	(1)	(1)	(1)
FAS 123 Expense	-	-	-	-		(3)	(7)	(9)	(7)	-	(7)	(7)	(7)	(7)
Music	139	23	67	52		194	72	66	98	-	163	68	61	94
Publishing	26	44	31	49		22	49	30	42	-	24	47	28	47
Divested Publishing Operations	1	1	(3)	1		2	(1)	(1)	0	-	0	0	0	0
Other Divestitures and Adjustments	(14)	(1)	(3)	3		0	0	0	0	-	0	0	0	0
Corporate Eliminations	(13)	(18)	(20)	(14)		(25)	(28)	(25)	(28)	-	(25)	(25)	(25)	(25)
Total EBITDA after Mgmt. Fees, after Stk. Comp	159	49	74	91		193	91	70	112	-	161	89	68	115
% Change														
% Margin	13.5%	6.7%	10.1%	11.4%		17.7%	11.8%	9.4%	12.4%		14.9%	11.6%	8.9%	12.6%

E = Morgan Stanley Research estimates Source: Morgan Stanley Research

Exhibit 38

Annual Recorded Music Operating Forecast

	Fiscal Years Ending September 30th						
Fiscal Year End - September	2004	2005	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	2,692	2,639	2,578	2,475	2,401	2,353	2,329
Digital Sales	32	137	215	277	344	403	452
Other Sales/Allowances	(15)	-	-	-	-	-	-
Total Revenue ex. Licensing	2,709	2,776	2,793	2,752	2,744	2,755	2,781
% Change		2.5%	0.6%	-1.5%	-0.3%	0.4%	0.9%
Licensing Revenue	141	148	159	153	148	145	144
Total Revenue	2,850	2,924	2,953	2,905	2,893	2,901	2,925
% Change		2.6%	1.0%	-1.6%	-0.4%	0.3%	0.8%
Product Costs	528	555	567	546	532	522	518
Royalties	672	706	728	722	725	733	742
A&R	201	151	159	181	194	208	210
Other	78	64	96	92	89	87	87
Total COGS	1,479	1,477	1,550	1,541	1,540	1,551	1,557
Gross Profit	1,371	1,447	1,403	1,364	1,353	1,350	1,368
% Change		5.5%	-3.1%	-2.8%	-0.8%	-0.2%	1.3%
Gross Margin	48.1%	49.5%	47.5%	47.0%	46.8%	46.5%	46.8%
Distribution	95	72	68	65	63	62	61
Variable Marketing	418	408	411	404	403	404	408
Selling Overhead	89	77	79	81	83	85	87
Marketing Overhead	161	123	124	126	129	131	134
G&A Overhead	352	351	340	344	351	358	365
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	(44)	(31)	(23)	(23)	(22)	(22)	(22)
Total Operating Expenses	1,071	999	997	998	1,006	1,018	1,033
% Change		-6.7%	-0.2%	0.1%	0.8%	1.2%	1.5%
EBITDA	300	448	406	366	347	332	334
% Change		49.1%	-9.4%	-9.7%	-5.4%	-4.3%	0.8%
EBITDA Margin, %	10.5%	15.3%	13.7%	12.6%	12.0%	11.4%	11.4%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 37

Quarterly Recorded Music Operating Forecast

	2005					2006E			
Fiscal Year End - September	1Q	2Q	3Q	4Q		1QE	2QE	3QE	4QE
Gross Sales Net of Returns	886	557	510	686	-	880	542	504	652
Digital Sales	21	31	38	47	-	35	48	59	73
Other Sales/Allowances	-	-	-	-	-	-	-	-	-
Total Revenue ex. Licensing	907	588	548	733	-	915	590	564	724
% Change	-8.8%	6.4%	1.9%	17.6%		0.9%	0.4%	2.9%	-1.2%
Licensing Revenue	33	33	40	42	-	27	38	46	48
Total Revenue	940	621	588	775	-	942	628	610	773
% Change	-8.6%	4.9%	1.9%	18.9%		0.2%	1.2%	3.7%	-0.3%
				9					
Product Costs	166	123	112	153	-	189	121	112	146
Royalties	250	133	125	199	-	249	150	144	184
A&R	35	35	33	48	-	52	33	32	42
Other	24	27	17	(4)	-	17	23	27	28
Total COGS	475	318	287	396	-	507	327	315	401
Gross Profit	465	303	301	379	-	435	302	294	372
% Change	-5.8%	6.7%	4.7%	23.5%		-6.4%	-0.3%	-2.2%	-1.8%
Gross Margin	49.5%	48.7%	51.2%	48.9%		46.2%	48.0%	48.3%	48.2%
Distribution	26	15	13	18	-	24	14	13	17
Variable Marketing	120	83	96	110	-	127	82	95	107
Selling Overhead	21	16	16	24	-	20	17	17	25
Marketing Overhead	32	29	26	35	-	32	30	27	35
G&A Overhead	88	86	76	101	-	73	88	81	97
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-	-	-
Other	(19)	(3)	2	(11)	-	(9)	(3)	(5)	(6)
Total Operating Expenses	268	226	229	276	-	267	228	228	274
% Change									
EBITDA	197	77	72	103	-	168	73	66	98
% Change	23.3%	238.5%	7.9%	99.2%		-14.5%	-4.1%	-7.9%	-4.7%
EBITDA Margin, %	20.9%	12.3%	12.2%	13.3%		17.8%	11.7%	10.9%	12.7%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 38

Annual U.S. Recorded Music Operating Forecast

Fiscal Year End - September	2004	2005E	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	1,266	1,266	1,243	1,194	1,158	1,135	1,123
Digital Sales	26	105	165	214	268	314	353
Other Sales/Allowances	(1)	-	-	-	-	-	-
Total Revenue ex. Licensing	1,291	1,371	1,408	1,408	1,425	1,449	1,476
% Change		6.2%	2.7%	0.0%	1.3%	1.7%	1.9%
Licensing Revenue	45	50	61	58	57	55	55
Total Revenue	1,336	1,421	1,469	1,466	1,482	1,504	1,531
% Change		6.4%	3.3%	-0.2%	1.1%	1.5%	1.8%
Product Costs	307	328	339	327	318	313	310
Royalties	229	289	281	289	300	312	322
A&R	120	80	74	91	100	109	111
Other	36	16	46	44	42	42	41
Total COGS	692	712	739	750	760	775	784
Gross Profit	644	709	729	715	722	730	747
% Change		10.0%	2.9%	-1.9%	0.9%	1.1%	2.4%
Gross Margin	48.2%	49.9%	49.7%	48.8%	48.7%	48.5%	48.8%
Distribution	41	27	25	24	23	23	22
Variable Marketing	170	183	196	196	198	202	205
Selling Overhead	42	39	40	40	41	42	43
Marketing Overhead	91	64	65	66	67	69	70
G&A Overhead	203	216	225	228	232	237	242
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	(19)	(6)	-	-	-	-	-
Total Operating Expenses	528	532	551	554	562	572	582
EBITDA	116	177	178	162	159	158	164
% Change		51.8%	0.7%	-9.2%	-1.4%	-1.0%	4.2%
EBITDA Margin, %	8.7%	12.4%	12.1%	11.0%	10.7%	10.5%	10.7%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 39

Annual International Recorded Music Operating Forecast

Fiscal Year End - September	2004	2005	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	1,426	1,373	1,335	1,281	1,243	1,218	1,206
Digital Sales	6	32	51	63	76	88	99
Other Sales/Allowances	(14)	-	-	-	-	-	-
Total Revenue ex. Licensing	1,418	1,405	1,386	1,345	1,319	1,306	1,305
% Change		-0.9%	-1.4%	-2.9%	-1.9%	-1.0%	-0.1%
Licensing Revenue	96	98	99	95	92	90	89
Total Revenue	1,514	1,503	1,484	1,439	1,411	1,396	1,394
% Change		-0.7%	-1.2%	-3.0%	-2.0%	-1.0%	-0.2%
% Change excluding FX Impact		-4.8%	5.2%	-3.0%	-2.0%	-1.0%	-0.2%
Product Costs	221	227	228	220	214	210	208
Royalties	443	418	447	433	425	421	420
A&R	81	70	85	89	94	100	99
Other	42	49	50	48	47	46	45
Total COGS	787	764	810	790	779	776	773
Gross Profit	727	739	674	649	631	620	621
% Change		1.6%	-8.8%	-3.7%	-2.7%	-1.8%	0.1%
Gross Margin	48.0%	49.2%	45.4%	45.1%	44.8%	44.4%	44.5%
Distribution	54	44	43	41	40	39	39
Variable Marketing	248	225	215	208	204	202	202
Selling Overhead	47	38	39	40	42	43	44
Marketing Overhead	70	59	58	60	61	63	64
G&A Overhead	145	123	114	116	119	121	123
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	(25)	(25)	(23)	(23)	(22)	(22)	(22)
Total Operating Expenses	539	465	446	444	444	446	451
EBITDA	188	273	228	205	187	174	170
% Change		45.4%	-16.7%	-10.0%	-8.5%	-7.2%	-2.3%
EBITDA Margin, %	12.4%	18.2%	15.3%	14.2%	13.3%	12.5%	12.2%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 40

Annual Publishing Operating Forecast

Fiscal Year End - September	2004	2005E	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	-	-	-	-	-	-	-
Digital Sales	-	20	48	75	96	108	128
Other Sales/Allowances	552	553	554	560	571	588	612
Total Revenue ex. Licensing	552	573	602	635	667	696	740
% Change		3.8%	5.1%	5.4%	5.1%	4.3%	6.3%
Licensing Revenue	-	-	-	-	-	-	-
Total Revenue	552	573	602	635	667	696	740
% Change		3.8%	5.1%	5.4%	5.1%	4.3%	6.3%
Product Costs	(1)	-	-	-	-	-	-
Royalties	322	358	373	394	414	432	460
A&R	29	24	30	32	34	35	37
Other	-	-	-	-	-	-	-
Total COGS	350	382	403	425	448	467	498
Gross Profit	202	191	200	209	219	229	242
% Change		-5.6%	4.5%	4.9%	4.8%	4.2%	6.0%
Gross Margin	36.6%	33.3%	33.1%	33.0%	32.9%	32.8%	32.8%
Distribution	-	-	-	-	-	-	-
Variable Marketing	1	1	0	0	0	0	0
Selling Overhead	-	-	-	-	-	-	-
Marketing Overhead	-	-	-	-	-	-	-
G&A Overhead	53	45	50	53	55	58	61
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	(1)	-	-	-	-	-	-
Total Operating Expenses	53	46	51	53	56	58	61
EBITDA	149	145	149	156	164	171	181
% Change		-2.6%	2.7%	4.9%	4.8%	4.2%	6.1%
EBITDA Margin, %	27.0%	25.3%	24.7%	24.6%	24.5%	24.5%	24.5%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 41

Quarterly Publishing Operating Forecast

	2005				2006E			
Fiscal Year End - September	1Q	2Q	3Q	4Q	1QE	2QE	3QE	4QE
Gross Sales Net of Returns	-	-	-	-	-	-	-	-
Digital Sales	4	4	6	6	12	10	12	14
Other Sales/Allowances	136	139	147	131	136	139	148	132
Total Revenue ex. Licensing	140	143	153	137	148	149	160	146
% Change	-1.4%	5.9%	7.0%	3.8%	5.7%	4.2%	4.3%	6.5%
Licensing Revenue	-	-	-	-	-	-	-	-
Total Revenue	140	143	153	137	148	149	160	146
% Change	-1.4%	5.9%	7.0%	3.8%	5.7%	4.2%	4.3%	6.5%
Product Costs	-	-	-	-	-	-	-	-
Royalties	100	77	105	77	105	81	109	78
A&R	4	6	7	7	7	8	8	8
Other	-	-	-	-	-	-	-	-
Total COGS	104	83	111	84	111	89	117	86
Gross Profit	36	60	42	53	37	60	42	60
% Change	-7.3%	5.1%	-3.9%	-15.3%	1.5%	0.5%	1.5%	13.6%
Gross Margin	25.8%	42.0%	27.2%	38.8%	24.8%	40.5%	26.5%	41.4%
Distribution	-	-	-	-	-	-	-	-
Variable Marketing	0	0	0	0	0	-	-	-
Selling Overhead	-	-	-	-	-	-	-	-
Marketing Overhead	-	-	-	-	-	-	-	-
G&A Overhead	14	11	10	10	12	13	13	13
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-	-
Total Operating Expenses	14	11	11	10	12	13	13	13
EBITDA	22	49	31	43	25	48	29	48
% Change	-15.2%	13.6%	-0.7%	-11.4%	11.7%	-2.6%	-6.9%	10.9%
EBITDA Margin, %	15.7%	34.3%	20.3%	31.4%	16.6%	32.0%	18.1%	32.7%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 42

Annual U.S. Publishing Operating Forecast

Fiscal Year End - September	2004	2005	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	-	-	-	-	-	-	-
Digital Sales	-	8	26	43	58	64	80
Other Sales/Allowances	220	215	217	219	223	230	239
Total Revenue ex. Licensing	220	223	243	262	281	294	319
% Change		1.5%	8.7%	7.9%	7.4%	4.4%	8.6%
Licensing Revenue	-	-	-	-	-	-	-
Total Revenue	220	223	243	262	281	294	319
% Change		1.5%	8.7%	7.9%	7.4%	4.4%	8.6%
Product Costs	-	-	-	-	-	-	-
Royalties	102	115	123	135	147	154	169
A&R	13	11	16	17	18	19	21
Other	-	-	-	-	-	-	-
Total COGS	115	126	139	152	165	173	189
Gross Profit	105	97	104	110	116	121	129
% Change		-7.2%	7.2%	5.6%	5.7%	4.0%	7.2%
Gross Margin	47.6%	43.5%	42.9%	42.0%	41.3%	41.1%	40.6%
Distribution	-	-	-	-	-	-	-
Variable Marketing	-	0	-	-	-	-	-
Selling Overhead	-	-	-	-	-	-	-
Marketing Overhead	-	-	-	-	-	-	-
G&A Overhead	17	12	18	19	21	22	23
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-
Total Operating Expenses	17	12	18	19	21	22	23
OIBDA	88	85	86	91	96	99	106
% Change		-2.8%	1.3%	5.1%	5.3%	3.9%	6.9%
OIBDA Margin, %	39.8%	38.2%	35.6%	34.7%	34.0%	33.8%	33.3%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Exhibit 43

Annual International Publishing Operating Forecast

Fiscal Year End - September	2004	2005	2006E	2007E	2008E	2009E	2010E
Gross Sales Net of Returns	-	-	-	-	-	-	-
Digital Sales	-	12	22	32	38	44	48
Other Sales/Allowances	331	338	338	341	348	358	373
Total Revenue ex. Licensing	331	350	360	373	386	402	421
% Change		5.6%	2.9%	3.7%	3.5%	4.2%	4.7%
Licensing Revenue	-	-	-	-	-	-	-
Total Revenue	331	350	360	373	386	402	421
% Change		5.6%	2.9%	3.7%	3.5%	4.2%	4.7%
% Change excluding FX Impact		1.5%	9.3%	3.7%	3.5%	4.2%	4.7%
Product Costs	-	-	-	-	-	-	-
Royalties	218	243	250	259	267	278	291
A&R	15	13	14	15	15	16	17
Other	-	-	-	-	-	-	-
Total COGS	233	256	264	273	283	295	308
Gross Profit	98	94	96	99	103	108	113
% Change		-3.9%	1.8%	4.1%	3.8%	4.4%	4.8%
Gross Margin	29.5%	26.8%	26.6%	26.7%	26.7%	26.8%	26.8%
Distribution	-	-	-	-	-	-	-
Variable Marketing	1	1	0	0	0	0	0
Selling Overhead	-	-	-	-	-	-	-
Marketing Overhead	-	-	-	-	-	-	-
G&A Overhead	29	28	29	30	31	32	34
Additional OIBDA Cost Reserve	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-
Total Operating Expenses	30	29	29	30	31	32	34
OIBDA	67	65	66	69	72	75	79
% Change		-3.6%	2.7%	4.3%	3.9%	4.5%	4.8%
OIBDA Margin, %	20.3%	18.5%	18.5%	18.6%	18.7%	18.7%	18.7%

E = Morgan Stanley Research estimates
Source: Morgan Stanley Research

Morgan Stanley
ModelWare℠

ModelWare is Morgan Stanley's new system for helping investors and analysts to uncover value, free from the distortions and ambiguities created by accounting data. Morgan Stanley has dissected and fundamentally redefined the components of corporate valuation, giving clients more consistent definitions, more comparable data, and more flexible analytic tools. ModelWare makes investment insights easier by making value more visible.

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(as of December 31, 2005)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	753	36%	272	40%	36%
Equal-weight/Hold	943	45%	320	47%	34%
Underweight/Sell	382	18%	88	13%	23%
Total	2,078		680		

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Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

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Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months.

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Industry Coverage: Entertainment

Company (Ticker)	Rating (as of)	Price (01/26/2006)
Richard A. Gliotti		
CBS Corporation (CBS.N)	O-V (01/17/2006)	$26.81
Discovery Holding Company (DISCA.O)	U-V (08/30/2005)	$15.40
Dreamworks Animation (DWA.N)	E-V (09/13/2005)	$27.00
Liberty Media (L.N)	E (07/09/2003)	$8.24
News Corp. (NWSa.N)	O (04/13/2005)	$15.89
Pixar Inc. (PIXR.O)	U (03/18/2002)	$57.06
Time Warner Inc. (TWX.N)	E-V (04/28/2005)	$17.11
Viacom (VIA.N)	O-V (01/17/2006)	$43.09
Walt Disney (DIS.N)	E (05/16/2004)	$25.08
Warner Music Group (WMG.N)	Underweight-V (01/27/2006)	$20.94

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EXHIBIT CO 0968

PALI RESEARCH

March 2, 2006

Warner Music Group

Reversing Industry View – Initiate with BUY rating & $25 Price Tgt

Richard Greenfield
(212) 259-5176
rgreenfield@palicapital.com

WMG: BUY
Price $21.00
Target Price: $25.00

52 Week Range: WMG	$14.70-$21.32
Market Cap (mm)	$3,192
Avg. Daily Volume (100 day)	365,000
3 Yr. Est. EBITDA Grwt Rate	45%

Fiscal Syr	2005A	2006E	2007E
Q1	$0.31A	$0.40E	N/A
Q2	$0.04A	$0.16E	N/A
Q3	($0.34)A	($0.27)E	N/A
Q4	$0.04A	$0.02E	N/A
FY	$0.00A	$0.06E	$0.28E
P/E	NM	N/M	75X
Consensus	NM	$0.05E	$0.13E
Revenues	$3,602	$3,448	$3,475
EBITDA	$468	$478	$505
EV/EBITDA	NM	10.5X	10.0X

Source: Pali Research, Company Documents
Note: EBITDA and EPS are based on calendar years

Please Read: Important disclosures and analyst's certification appear in Appendix.

PALI CAPITAL, INC.

While we were very cautious on the music industry leading up to and following WMG's IPO on May 11, 2005, our view has changed dramatically over the past 8-12 weeks. In turn, we are initiating coverage of WMG with a BUY rating, and a $25.00 price target (19% implied upside from current levels).

- Our $25 price target equates to 17.6x estimated '07 Free Cash Flow per share (11.0x '07E EV/EBITDA). With WMG selling at 16.2x '06E FCF/share and 10.5x '06E EV/EBITDA, our target price assumes modest multiple expansion over the coming year (our DCF yields $25.09 based on a 10% WACC, 3% perpetual growth rate and a 14.3x terminal multiple).

Why are we more positive on the music industry?

- Dramatic acceleration in average Q4 '05 and Q1 '06 weekly digital downloads (including digital album tracks) compared to relatively stagnant first three quarters of 2005.

- Despite the more rapid than expected digital growth, physical declines have actually slowed, with physical albums now down 5.5% in Q1 '06, the slowest decline since Q3 2004.

- Total albums (converting all digital tracks 10:1 into albums) are up for the first time since Q3 2004, with 6 of the first 7 weeks of 2006 showing year-over-year improvements.

Beyond the Industry, What Else Drives Our WMG BUY rating?

- Market share gains likely to continue (increased US total album market share 1% in 2005, albeit bolstered by lower margin ADA distribution) as Sony BMG continues to struggle.

- Potential Merger with EMI. While we have no visibility on a transaction, we continue to believe there is logic in a combination, with some level of cost savings available and the strategic benefits of removing an industry competitor.

Our View of the Music Industry is Significantly More Positive than Mid-Late 2005

1. We were very concerned that digital downloads were not growing as fast as we would have expected, given the tremendous growth in MP3 players. In fact, during the first three quarters of 2005, average weekly downloads increased very modestly (see Exhibit A).

   However, the last few weeks of 2005 and the first 7 weeks of 2006, illustrate a marked change in digital download trends. Exhibit A shows that strength in the month of December resulted in a 27% increase in the Q4 '05 weekly average download rate, with Q1 '06 up another 36% sequentially (with the week ended February 19, 2006 at 11.6 million – above the quarterly Q1 average, implying this is not simply a holiday gift card effect anymore).

   - We have also been concerned that Apple's growing dominance (with their DRM/pricing control) was limiting digital download growth. While that may still be the case, it does not appear to be preventing the industry from achieving growth.

Exhibit A: Quarterly Average US Digital Single Song Downloads (figures in thousands)

	as of 12/4/2005	Seq. % Chg	as of 3/11/2006	Seq. % Chg
Q1 '05A	5,858		5,858	
Q2 '05A	6,355	8%	6,355	8%
Q3 '05A	6,573	3%	6,573	3%
Q4 '05A	7,088	8%	8,341	27%
Q1 '06-to-date	N/A		11,369	36%
Q4 '05 Y-o-Y	21%		42%	
Q1 '06 Y-o-Y			79%	

Source: Pali Research and Soundscan data via Billboard magazine.com

Total digital track performance (converting digital albums into singles at a 1:10 rate) is also encouraging relative to Q3 '05. We were concerned that the growth trajectory of digital track downloads was simply not fast enough to overcome the inherent pressure on physical albums as the industry transitioned from physical to digital distribution.

- The two graphs in Exhibit B highlight the significant improvement in the rate of growth in the average quarterly digital tracks downloaded relative to the growth in MP3 players (flattening in top graph, with growth reignited in lower graph).

- While part of the improvement can be explained by the first time inclusion of eMusic downloads in early 2006, we believe sequential growth in Q1 '06 is still at least 20%-25%. Furthermore, we believe there will be an ongoing positive bias to the digital download as new formats are included for the first time in Soundscan figures:

  - Over the air downloads – Sprint exceeded 1.0 million downloads recently in 107 days. No mobile OTA figures are included in Soundscan today.

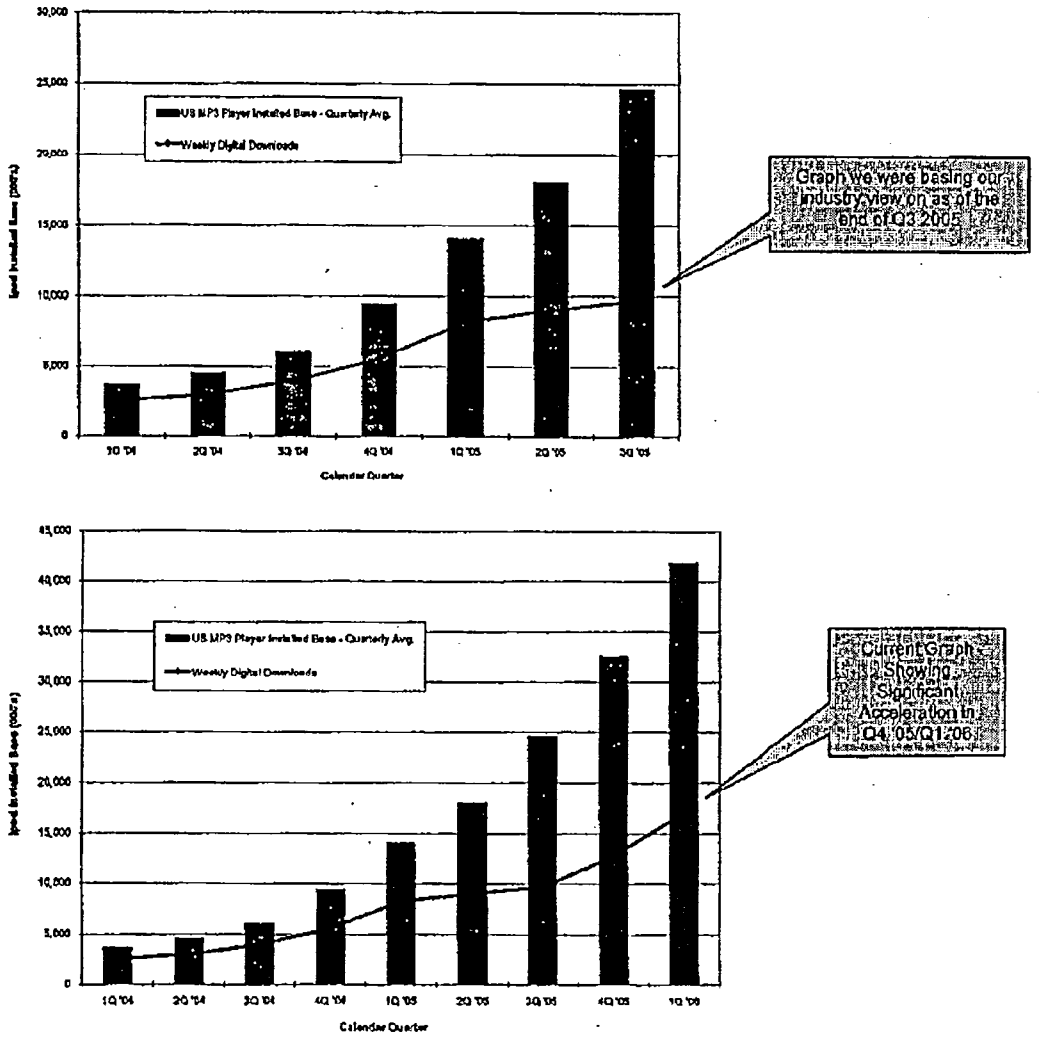
  - Music Videos – we believe Soundscan is currently discussing whether or not to include digitally downloaded videos in the digital track units.

We also find it quite interesting that **digital tracks downloaded as part of a digital albums have become a larger component of total digital tracks downloaded**, which is the opposite of what would have expected given the rise of unbundling (no longer necessary to buy an entire album to get the songs you want). The album-based infrastructure of the music industry is simply not being completely replaced by the downloading of individual tracks.

- In Q1 '05 digital tracks downloaded via a digital album were about 28%
- In Q1 '06 digital tracks downloaded via a digital album were about 33%

Exhibit B: Significant Acceleration in Digital Track Downloads

(Singles plus Digital Albums Converted to Digital Singles at 1:10 rate)



Source: Pali Research estimates and company documents

2. **Physical Album Declines Moderating Unexpectedly.** Our concern over digital download growth slowing was exacerbated by high-single digit, low-teen declines in physical album sales throughout 2005. With 95% of 2005 recorded music revenues driven by physical album sales, steep declines in physical albums sales are far more concerning than excitement over rapid digital growth. With digital likely representing about 9% of industry unit sales in 2006, the biggest swing factor in industry performance over the next couple of years will be the performance of physical unit sales (with over 90% market share in 2006).

    - Physical albums sales (excluding digital albums), as shown in Exhibit C, are down 5.5% Q1 '06-to-date, compared to the 8%-10% declines experienced over the past year. While we believe it is likely that Q1 and full-year 2006 end up worse than down 5.5%, our concerns of double-digit declines are diminishing.

    - We remain concerned that big box retailers such as Circuit City, Best Buy, Target and Amazon will dramatically reduce music floor space and/or pressure CD wholesale pricing; however, the negative impact appears to be more gradual in nature than originally expected. ***We view this as the most significant risk to our more positive industry view.***

3. **Overall Music Industry Unit Sales Increasing Again.** After five straight quarters of total music units declining in the US (converting tracks to albums at 10:1 ratio), total music units are up 2.9% in Q1 '06 (as shown in Exhibit C).

    - Given our view that physical unit declines will increase, we would not expect this figure to remain up almost 3% throughout the remainder of the year, but it is clearly a positive sign, particularly as **only one week has been negative during the first seven weeks of 2006**.

    - Given that the average MP3 owner is only purchasing about 22 digital songs annually ($22 of spending at $0.99 per song), the average consumer is clearly buying both physical and digital music, otherwise digital would drag down the overall industry performance. Exhibit D illustrates downloads per MP3 player.

        - The average US consumer of music spent about $45.85 in 2004 (RIAA reported retail sales of $11.4 billion divided by 249.1 mm Americans between the ages of 10-84 according to US census statistics – our assumption of the music buying public).

        - Also note that the trend in downloads per MP3 player appear to have stabilized after 18 months of decline, with Q1 '06 actually increasing over Q4 '05, albeit the level of variability in our estimates implies a stabilization is the most relevant conclusion.

Exhibit C: Quarterly US Digital and Physical Music Performance '04 – '06 (Q1 '06-to-date)

Figures are units sold in thousands

Digital Tracks Sold Including 10 songs per Digital Album	YTD 2006	YTD 2005	% Chg 06/05	2004	% Chg 05/04	Full-Year 2005	Full-Year 2004	% Chg 05/04
1Q	119,412	54,053	121%	17,389	210.6%	106,456	33,750	215%
2Q			NM			117,205	38,661	203%
3Q			NM			126,026	51,465	145%
4Q			NM			165,474	72,213	129%
FY/YTD	119,412	54,053	121%	17,389		515,163	196,089	163%

Physical Album Sales Excluding Digital Albums	YTD 2006	YTD 2005	% Chg 06/05		% Chg 05/04	Full-Year 2005	Full-Year 2004	% Chg 05/04	Full-Year 2003	% Chg 04/03
1Q	71,681	75,862	-5.5%	84,063	-9.8%	142,181	155,059	-8.3%	144,699	7.2%
2Q			NM			133,936	146,223	-8.4%	141,185	3.6%
3Q			NM			128,117	143,654	-10.9%	139,914	2.8%
4Q			NM			198,454	216,144	-8.2%	230,501	-6.2%
FY/YTD	71,681	75,862	-5.5%	118,841	-36.2%	602,690	661,280	-8.9%	656,299	0.8%

Total Physical & Digital (Converting Digital Tracks to Albums 10:1)	YTD 2006	YTD 2005	% Chg 06/05		% Chg 05/04	Full-Year 2005	Full-Year 2004	% Chg 05/04	Full-Year	% Chg 04/03
1Q	83,622	81,267	2.9%	85,802	-5.3%	152,827	158,434	[illegible]	144,699	9.5%
2Q			NM		NM	145,659	150,069	[illegible]	141,185	6.3%
3Q			NM		NM	140,720	149,001	-5.6%	139,914	6.5%
4Q			NM		NM	215,001	223,365	-3.7%	230,501	[illegible]
FY/YTD	83,622	81,267	2.9%	85,802	-5.3%	654,206	680,889	-3.9%	656,299	3.7%

Source: Soundscan data via Billboard magazine.com (week 1 omitted in 2004 to compensate for 53 week 2004)

Exhibit D: Quarterly Downloads Per US iPod/MP3 Player (figures in thousands, ex. Annual per Ipod/MP3 player stats)

(Note Digital Tracks includes downloads as part of Digital Albums converted at a 1:10 conversion rate)

Calendar Q	Avg. Global Ipod Installed Base	Avg. US Ipod Installed Base	Avg Weekly Dig Singles	Avg Weekly Digital Tracks	Implied Annual US Downloads / Ipod
1Q '04	2,455	2,209	1,977	2,598	61
2Q '04	3,288	2,644	2,259	2,974	54
3Q '04	4,726	3,923	2,858	3,959	52
4Q '04	8,024	6,379	3,770	5,555	45
1Q '05	12,970	9,857	5,858	8,189	43
2Q '05	18,703	13,559	6,355	9,016	35
3Q '05	25,006	17,254	6,573	9,694	29
4Q '05	35,231	21,843	8,341	12,729	30
1Q '06	46,231	26,814	11,369	17,059	33
Q1 Year-over-Year		172%	94%	108%	-23%

Calendar Q	Ipod Mkt Share	Average US MP3 Players	Avg Weekly Dig Singles	Avg Weekly Digital Tracks	Implied Annual Downloads / MP3 Player
1Q '04	60.0%	3,682	1,977	2,598	37
2Q '04	62.5%	4,551	2,259	2,974	34
3Q '04	65.0%	6,035	2,858	3,959	34
4Q '04	67.5%	9,450	3,770	5,555	31
1Q '05	70.0%	14,081	5,858	8,189	30
2Q '05	75.0%	18,079	6,355	9,016	26
3Q '05	71.0%	24,301	6,573	9,694	21
4Q '05	66.0%	32,122	8,341	12,729	21
1Q '06	66.0%	40,627	11,369	17,059	22

Source: Soundscan data via Billboard magazine.com Company reports and Pali Research estimates (week 1 omitted in 2004 to compensate for 53 week 2004)

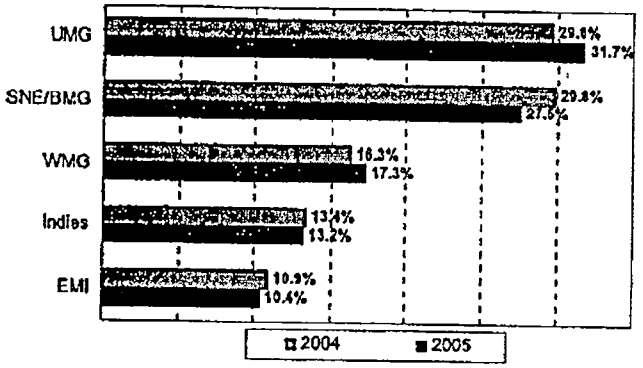
Beyond the Industry Improvement, Why Buy Warner Music Group?

1. Aggressively exploiting new distribution platforms. While we do not believe that WMG is generating significant profits from its recent flurry of digital distribution announcements (working with Skype, MTV, Myspace, AOL, etc.), their aggressiveness in mining the value of their catalog appears to be driving superior digital revenue growth.

    - We are forecasting digital revenues of $310 million in 2006, up 98% from $157 million in 2005, representing 9% of revenues in 2006 compared to 5% in 2005.

2. Capturing market share. Despite the public perception that Warner has cut its artist development (A&R) spending too far, it has been able to increase its market share. While market share can be manipulated by including distribution arrangements with artists (such as ADA), we believe Warner, Universal and EMI all stand to gain from the continued (possibly even escalating) troubles at Sony BMG.

Exhibit E: US Market Share Statistics



Source: Soundscan data via Billboard magazine.com

3. Potential merger with EMI. While we do not believe merger speculation is a reason to own Warner, we do believe a merger with EMI makes sense and should happen at some point over the next 12-24 months (albeit assessing the anti-trust regulatory issues remains difficult). We remain unclear on who buys whom and for what price, but we believe the key issue to focus on is that there is a strong strategic rationale to eliminating a competitor and leveraging each company's geographic strengths (Warner in the US and EMI outside the US, particularly in Europe).

    - Exhibit F illustrates a valuation comparison of WMG and EMI.

Exhibit F: Valuation Comparison of WMG and EMI

(in $mm, expect per share)

	Pali WMG	Street Consensus EMI Valuation
Price	$21.00	$14.[illegible]

FY Sept 2006E

		March FY converted to Sept FY
'06E EBITDA Multiple	10.5x	10.6x
'06E FCF Multiple	18.2x	23.3x
'06E Normalized FCF Multiple	18.2x	
'06E EPS Multiple	355.6x	17.3x
Valuation Metrics		
Valuation EBITDA	478	495
Val. EBITDA/Share	$3.15	$0.57
Valuation Net Debt	(1,842)	(1,451)
Net Debt/Share	($12.14)	($1.66)
Valuation Non-EBITDA	0	0
Non-EBITDA/share	$0.00	$0.00
Free Cash Flow (a)	196	163
FCF/Share	$1.29	$0.19
FCF Yield	6.2%	4.3%
Normalized FCF (a)	196	
FCF/Share	$1.29	
FCF Yield	6.2%	
Earnings	9	219
EPS	$0.06	$0.25
Shares Outstanding	152	873

FY Sept 2007E

		March FY converted to Sept FY
'07E EBITDA Multiple	9.8x	9.7x
'07E FCF Multiple	14.8x	17.9x
'07E Normalized FCF Multiple	14.8x	
'07E EPS Multiple	75.4x	14.8x
Valuation Metrics		
Valuation EBITDA	505	629
Val. EBITDA/Share	$3.28	$0.61
Valuation Net Debt	(1,703)	(1,357)
Net Debt/Share	($11.06)	($1.55)
Valuation Non-EBITDA	0	0
Non-EBITDA/share	$0.00	$0.00
Free Cash Flow (a)	218	212
FCF/Share	$1.42	$0.24
FCF Yield	1.0%	0.0%
Normalized FCF (a)	218	
FCF/Share	$1.42	
FCF Yield	6.7%	
Earnings	43	258
EPS	$0.28	$0.29
Shares Outstanding	154	873

(a) Our FCF definition includes cash investments to renew catalogs that WMG records in Investments/Acquisitions rather than cap/ex

Source: Pali Research estimates and Thomson First Call consensus estimates

How Can We Rate a Music Company With a 9.8x Estimated '07 EBITDA Multiple a BUY?

1. The industry is changing and while a 9.8x multiple of EBITDA is not cheap relative to News Corp. at 7.0x, Disney at 9.0x or Time Warner at 8.0x, we believe it is hard to compare very different businesses, particularly as the music industry is undergoing a major business model transition.

    - If digital ends up improving WMG's performance over the next 1-2 years versus hurting their results, our expectation of 1%-2% revenue growth (including the more stable music publishing business) is likely to be conservative. In turn, our 5% EBITDA growth forecast would likely prove conservative.

        - Current digital revenues streams are still in their infancy (over the air downloads, leveraging content across social networking portals, VoIP ringtones, etc.) implying that today's valuation may be an increasingly poor tool for determining whether to buy/sell WMG.

            - Modest revenues streams, such as those received from satellite radio operators, may grow substantially over the next few years as current industry agreements are renegotiated.

        - We also believe there is a high likelihood that the digital platform will facilitate the creation of successful legal, viral distribution platforms for music content.

    - Its also important to factor in that the rest of the world is trailing the US from a digital song/album download standpoint (most regions outside of the US are driving digital revenues via ringtones), so as the US begins to grow again, it bodes well for overall music revenue growth on a global basis over the next couple of years.

2. FCF yield over 6% with dividend yield of 2.5%. While near-term free cash flow growth may be pressured by investment in digital infrastructure, the ability to exploit content over a wider array of platforms using (already) digitized content should allow for acceleration in free cash flow growth.

3. Only modest multiple expansion is needed to achieve our $25.00 price target.

    - WMG currently selling at 10.5x '06E EBITDA, price target requires 11x '07E.

    - WMG currently selling at 16.2x '06E FCF/share, price target requires 17.6x '07E.

Exhibits G - I (pages 11-14) contain our abbreviated Warner Music earnings models. Detailed models are available upon request.

Key Risks to our Valuation and Price Target

1. Significant stock sale by the private equity owners of WMG. Given that the original private equity investors in WMG have already harvested more than 100% of their original investment in WMG (negative cost basis), the potential exists for a secondary stock sale at some point in the future. However, given the improving industry fundamentals and the potential of an EMI transaction, we would be surprised if the private equity firms sold WMG stock in the near-future.

2. Significant reduction in big box retailer floor space devoted to music (physical CDs) and/or a significant reduction in the wholesale price of physical music. As previously mentioned, the impact of this issue appears more gradual than initially expected, but it remains a major industry risk factor.

3. Rapid increase in piracy. Music industry piracy is certainly not under control; however, the current level of piracy does not appear to be preventing the overall music sector from growing. Furthermore, an increasing number of high quality legal distribution platforms (such as the music companies making money on music videos streamed on Myspace), should help mitigate the on-going risks poised by piracy.

4. Physical sales could decline double digits again. Given the unexpected improvement in physical album declines (at the same time that digital growth is accelerating again), we remain concerned that the trends may reverse again. A prolonged period of double digit declines in physical CD sales, without an even more dramatic increase in digital tracks downloaded could pressure our earnings estimates going forward.

5. Digital album buying declines relative to singles. While digital album purchases have increased over the past year, a notable reduction in digital albums relative to singles could jeopardize the core album model of the music industry (impacting the industry's cost structure and the label's financial relationship with their artists).

Exhibit G: Warner Music Annual Earnings Model (Fiscal September, figures in thousands)

	2005A	2006E	2007E	2008E	2009E	05-'08 CAGR	08-'09 CAGR
Revenues							
Recorded Music	2,924 ^	2,895	2,909	2,953	3,012	0%	1%
% Prior	2.3%	-1.0%	0.5%	1.5%	2.0%		
Music Publishing	607 ^	583	595	613	634	0%	1%
% Prior	1.0%	-3.9%	2.0%	3.0%	3.5%		
Total Revenues before Intersegment	3,531 ^	3,478	3,504	3,566	3,646	0%	1%
% Prior	2.1%	-1.5%	0.8%	1.8%	2.3%		
Intersegment Eliminations	(29) ^	(29)	(29)	(29)	(30)	0%	1%
% of Total Revenues	-0.7%	-0.7%	-0.7%	-0.7%	-0.7%		
% Prior	26.1%	-1.5%	0.8%	1.8%	2.3%		
Total Revenues	3,502 ^	3,449	3,475	3,538	3,616	0%	1%
% Prior	1.9%	-1.5%	0.8%	1.8%	2.3%		
EBITDA							
Recorded Music	431 ^	452	465	487	508	4%	4%
EBITDA Margin	14.7%	15.6%	16.0%	16.5%	16.8%		
% Prior	48.6%	4.8%	3.1%	4.7%	3.9%		
Music Publishing	142 ^	135	151	158	166	4%	4%
EBITDA Margin	23.4%	23.2%	25.3%	25.8%	26.2%		
% Prior	-2.1%	-4.6%	11.1%	5.0%	5.1%		
Corporate Expenses	(107) ^	(109)	(111)	(113)	(115)	2%	2%
% Prior	72.6%	1.9%	1.8%	1.8%	1.8%		
Total EBITDA- Pre-Restructuring	466 ^	478	505	532	557	5%	5%
EBITDA Margin	13.3%	13.8%	14.5%	15.1%	15.4%		
% Prior	24.9%	2.6%	5.6%	5.4%	4.7%		
Total EBITDA- Pre-Restructuring/Stock Option Ex	491 ^	506	536	564	592		
EBITDA Margin	14.0%	14.7%	15.4%	16.0%	16.4%		
% Prior	31.3%	3.1%	5.7%	5.5%	4.9%		
% of EBITDA (before Corp. Exp.)							
Recorded Music	75%	77%	76%	76%	75%		
Music Publishing	25%	23%	24%	24%	25%		
Non-Recurring Items (Restructuring Charges, IPO Charges, etc.)							
Recorded Music	(51) ^	0	0	0	0	-100%	-100%
% Prior	NM	NM	NM	NM	NM		
Music Publishing	(1) ^	0	0	0	0	-100%	-100%
% Prior	NM	NM	NM	NM	NM		
Corporate Expense	(92) ^	0	0	0	0	-100%	-100%
% Prior	NM	NM	NM	NM	NM		
Total Non-Recurring Items	(144) ^	0	0	0	0	-100%	-100%
% Prior	NM	NM	NM	NM	NM		
EBITDA Post-Non-Recurring Items							
Recorded Music	380 ^	452	465	487	508	9%	7%
EBITDA Margin	13.0%	15.6%	16.0%	16.5%	16.8%		
% Prior	NM	18.8%	3.1%	4.7%	3.9%		
Music Publishing	141 ^	135	151	158	166	4%	4%
EBITDA Margin	23.2%	23.2%	25.3%	25.8%	26.2%		
% Prior	NM	-4.0%	11.1%	5.0%	5.1%		
Corporate Expenses	(199) ^	(109)	(111)	(113)	(115)	-17%	-13%
% Prior	NM	-45.2%	1.8%	1.8%	1.8%		
Total EBITDA-Post Non-Recurring Items	322 ^	478	505	532	557	18%	15%
EBITDA Margin	9.2%	13.9%	14.5%	15.1%	15.4%		
% Prior	-3.3%	48.4%	5.6%	5.4%	4.7%		

Source: Pali Research estimates and company documents

Exhibit G: Warner Music Annual Earnings Model cont. (Fiscal September, figures in thousands)

	2005A	2006E	2007E	2008E	2009E	05-'08 CAGR	05-'09 CAGR
Depreciation/Amortization							
Depreciation	(51)	(47)	(45)	(43)	(41)	-6%	-6%
% Prior	-23.9%	-7.0%	-5.0%	-5.0%	-5.0%		
Amortization	(187)	(187)	(187)	(187)	(187)	0%	0%
% Prior	-7.0%	0.0%	0.0%	0.0%	0.0%		
Total D&A	(238) ^	(234)	(232)	(230)	(228)	-1%	-1%
% Prior	-11.2%	-1.5%	-1.0%	-1.0%	-0.9%		
GW Impairment & other Intagibles	0	0	0	0	0	NM	NM
% Prior	-100.0%	NM	NM	NM	NM		
Operating Income	84 ^	244	273	303	329	53%	41%
Op Inc Margin	2.4%	7.1%	7.9%	8.6%	9.1%		
% Prior	-108.8%	190.0%	12.0%	10.8%	8.9%		
Net Interest Expense	(182) ^	(184)	(166)	(154)	(135)	-5%	-7%
% Prior	122.0%	1.0%	-9.9%	-7.0%	-12.4%		
Net Investment Related Gains	1 ^	0	0	0	0	-100%	-100%
% Prior	-111.1%	-100.0%	0.0%	0.0%	0.0%		
Equity losses	(1) ^	0	0	0	0	-100%	-100%
% Prior	-92.3%	-100.0%	0.0%	0.0%	0.0%		
Other Costs	(11) ^	0	0	0	0	-100%	-100%
% Prior	-92.0%	-100.0%	NM	NM	NM		
Minority Interest	(5) ^	0	0	0	0	-100%	-100%
% Prior	-64.3%	-100.0%	NM	NM	NM		
Pre-Tax Income	(114) ^	60	107	148	194	NM	NM
% Prior	-91.0%	-152.3%	79.6%	38.3%	31.1%		
Income Taxes	55 ^	51	64	82	97	14%	15%
% Prior	-63.3%	-7.7%	26.8%	26.8%	18.2%		
Tax Rate	48.2%	85.0%	60.0%	55.0%	50.0%		
Net Income	(169) ^	9	43	67	97	NM	NM
% Prior	-88.1%	-105.3%	379.0%	55.6%	45.7%		
EPS-Basic	($1.40) ^	$0.06	$0.28	$0.43	$0.64	NM	NM
% Prior	NM	104.4%	371.9%	53.3%	44.2%		
Basic Shares Out	121	145	147	149	151	7%	6%
% Prior	12.5%	20.0%	1.5%	1.5%	1.0%		
EPS-Diluted	($1.40) ^	$0.06	$0.28	$0.43	$0.61	NM	NM
% Prior	NM	104.2%	371.9%	53.3%	43.5%		
EPS-Diluted (ex-Non-Recurring)	$0.06	$0.06	$0.28	$0.43	$0.61	92%	79%
% Prior	NM	1.6%	371.9%	53.3%	43.5%		
Diluted Shares Out	121	152	154	156	159	9%	7%
% Prior	12.5%	25.5%	1.5%	1.5%	1.5%		

Source: Pali Research estimates and company documents

Exhibit H: Warner Music Annual Cash Flow Model (Fiscal September, figures in thousands)

	2005A	2006E	2007E	2008E	2009E
Cash Flow					
Operating Activities					
Net Income Pre- Acct Chg	(169) ^	9	43	67	97
D&A	239 ^	234	232	230	228
Non-cash Interest	68 ^	71	75	79	83
Equity in losses of Investees	1 ^	0	0	0	0
Minority Interest	5 ^	0	0	0	0
Other (includes cash related to restructuring)	42 ^	0	0	0	0
Working capital	19 ^	(84)	(75)	(44)	(38)
NET CASH FROM OPERATIONS	205 ^	251	275	331	369
% Prior	-25.2%	22.5%	9.6%	20.3%	11.5%
Investing Activities					
CapEx	(30) ^	(35)	(37)	(35)	(30)
Other Investments/Activities/Acquisitions	(78) ^	(20)	(20)	(20)	(30)
Investment Proceeds	54 ^	0	0	0	0
NET CASH FROM INVESTING ACTIVITIES	(54) ^	(55)	(57)	(55)	(60)
% Prior	-98.0%	1.9%	3.6%	-3.5%	9.1%
Financing Activities					
Net Borrowings	338 ^	(100)	(110)	(150)	(175)
Stock Issuances Proceeds (net)	522 ^	0	0	0	0
Payment to TWX for Warrants	(138) ^	0	0	0	0
Return of Capital	(917) ^	0	0	0	0
Common Dividends	0 ^	(80)	(80)	(80)	(80)
Other	(221) ^	0	0	0	0
NET CASH FROM FINANCING ACTIVITIES	(416) ^	(180)	(190)	(230)	(255)
% Prior	-118.9%	-56.7%	5.6%	21.1%	10.9%
Net Currency Impact	(2) ^				
INCREASE (DECREASE) IN CASH	(267) ^	16	28	46	54
Cash and equivalents BEG. YEAR	555 ^	288	304	333	379
CASH & EQUIV. YEAREND	288 ^	304	333	379	433
Reported FCF	175	216	238	296	339
Catalog Renewels (in acquisitions/investments)	(24)	(20)	(20)	(20)	(30)
Valuation FCF	151 ^	196	218	276	309
% Prior	NM	30.0%	11.3%	26.5%	12.0%
Free Cash Flow/Share	$1.25 ^	$1.29	$1.42	$1.77	$1.95
% Prior	NM	3.5%	9.7%	24.6%	10.4%
Normalized Free Cash Flow	253 ^	196	218	276	309
% Prior	NM	-22.5%	11.3%	26.5%	12.0%
Free Cash Flow/Share	$2.09 ^	$1.29	$1.42	$1.77	$1.95
% Prior	NM	-38.2%	9.7%	24.6%	10.4%

Source: Pali Research estimates and company documents

Exhibit I: Warner Music Annual Balance Sheet Model (Fiscal September, figures in thousands)

	2005A	2006E
Assets		
Cash and cash equivalents	288	304
Accounts receivable	637	690
Allowances	218	236
Inventories	52	52
Royalty advances (expected to be recouped within one year)	190	186
Deferred tax assets	36	36
Other current assets	39	39
Total Current Assets	1,242	1,308
Royalty advances (greater than 1 yr)	190	186
Investments	21	41
Property and equipment, net	157	145
Capex	30	35
Depreciation	(51)	(47)
Goodwill	869	869
Intangible Assets (amortizable)	1,815	1,815
Intangible Assets (not amortizable)	100	100
Other Assets	104	104
TOTAL ASSETS	4,498	4,567
Liabilities & Shareholders' Equity		
Accounts Payable	247	271
Accrued royalties	1,057	1,018
Taxes and other withholdings	23	23
Current portion of LT debt	17	17
Other current liabilities	404	404
Total Current Liabilities	1,748	1,733
Long-term debt	2,229	2,112
Deferred tax liabilities	201	201
Other non-current liabilities	226	226
Minority interest in pfd stock of subsidiary	5	5
TOTAL LIABILITIES	4,409	4,277
SHAREHOLDERS' EQUITY	89	290
TOTAL CAPITALIZATION	4,498	4,567

Source: Pali Research estimates and company documents

APPENDIX

IMPORTANT DISCLOSURES AND ANALYSTS' CERTIFICATIONS

Analyst Certification

I, Richard S. Greenfield, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject companies and their securities. I also certify that I have not been, and will not be, receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report.

Analyst Stock Ratings

Pali Research's ratings are defined as follows:

BUY – A stock that is expected at initiation to produce a positive total return of 15% or greater over the 12 months following the initial recommendation. The BUY rating may be maintained following initiation as long as it is deemed appropriate, notwithstanding price fluctuations that would cause the target to fall outside of the 15% return.

SELL – A stock that is expected at initiation to produce a negative total return of 15% or greater over the next 12 months following the initial recommendation. The SELL rating may be maintained following initiation as long as it is deemed appropriate, notwithstanding price fluctuations that would cause the target to fall outside of the 15% return.

NEUTRAL – A stock that is not expected to appreciate or depreciate meaningfully over the next 12 months.

Disclosure of Distribution of Ratings

Pali Research, the research arm of Pali Capital, Inc. must disclose in each research report the percentage of all securities rated by the member to which the member would assign a "buy", "neutral" or "sell" rating. Below is the distribution of Pali Capital's research recommendations:

As of the end of the last quarter, Pali Capital, Inc. had not yet assigned any ratings.

Unless otherwise noted, all prices are as of the close on March 1, 2006.

Valuation Methodology

- Our $25 price target equates to 17.6x estimated '07 Free Cash Flow per share (11.0x '07E EV/EBITDA), yielding 19% upside over the next 12 months.

  With WMG selling at 18.2x '06E FCF/share and 10.5x '06E EV/EBITDA, our target price assumes only slight multiple expansion over the coming year (our DCF yields $25.09 based on a 10% WACC, 3% perpetual growth rate and a 14.3x terminal multiple).

Risks to our valuation and price target

- Significant stock sale by the private equity owners of WMG. Given that the original private equity investors in WMG have already harvested more than 100% of their original investment in WMG (negative cost basis), the potential exists for a secondary stock sale at some point in the future. However, given the improving industry fundamentals and the potential of an EMI transaction, we would be surprised if the private equity firms sold WMG stock in the near-future.

- Significant reduction in big box retailer floor space devoted to music (physical CDs) and/or a significant reduction in the wholesale price of physical music. As previously mentioned, the impact of this issue appears more gradual than initially expected, but it remains a major industry risk factor.

- Rapid increase in piracy. Music industry piracy is certainly not under control; however, the current level of piracy does not appear to be preventing the overall music sector from growing. Furthermore, an increasing number of high quality legal distribution platforms (such as the music companies making money on music videos streamed on Myspace), should help mitigate the on-going risks poised by piracy.

- Physical sales could decline double digits again. Given the unexpected improvement in physical album declines (at the same time that digital growth is accelerating again), we remain concerned that the trends may reverse again. A prolonged period of double digit declines in physical CD sales, without an even more dramatic increase in digital tracks downloaded could pressure our earnings estimates going forward.

- Digital Album Buying Declines Relative to Singles. While digital album purchases have increased over the past year, a notable reduction in digital albums relative to singles could jeopardize the core album model of the music industry (impacting the industry's cost structure and the label's financial relationship with their artists).

General Risks of Equity Investing

Investors need to be aware that investments in equity securities may pose significant risks due to the inherent uncertainty associated with relying on forecasts of various factors that can affect the earnings, cash flow and overall valuation of a company. Any investment in equity securities should be facilitated only within the context of diversification by asset class, industry, company, as well as investment objectives and time horizon.

For additional information, please contact your Pali sales and trading representative at (212) 259-2000.

OTHER DISCLOSURES

Other Companies Mentioned:

Apple (AAPL, $69.10, NASDAQ, Not Rated)

EMI Group (EMI, LSE, £2.48, Not Rated)

Disney (DIS, NYSE, $28.09, NEUTRAL)

News Corp. (NWSA/NWS, NYSE/NYSE, $17.37/$16.37, BUY/BUY)

Time Warner (TWX, NYSE, $17.41, NEUTRAL)

Viacom (VIA'B, NYSE, $40.93, BUY)

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EXHIBIT CO 0969

SOLEIL

MEDIA METRICS

Equity Research
Earnings Preview

September 29, 2006

Warner Music Group Corporation
WMG, $25.85, HOLD
4Q Earnings Preview + Updated Models & Valuations

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Ticker	WMG
Price (9/28/06)	$25.85
52-Wk. Range	$15-$31
Rating	HOLD
Price Target	$–
Shares Out (M)	150
Market Cap (B)	$3.8
Div/Yield	$0.52/2.0%
Trading Vol(M)	0.6
Market	NYSE

Sector Opinion:
We believe piracy has stabilized and strong online digital sales should reinvigorate earnings growth. In addition, music libraries are becoming more valuable because consumers can order up to 1 million titles via online digital downloading. These factors should lead to revaluation upwards of music companies.

WMG will soon release 4Q06 and fiscal 2006 earnings. In this research report we publish our 4Q, fiscal 2006 and fiscal 2007 estimates and update our valuation models for WMG. We maintain estimates for 4Q, fiscal 2006 and fiscal 2007.

4Q06 Highlights

- **Revenue.** We project consolidated revenue of $892 million, down 1% from 4Q05 with Recorded Music revenue of $761 million, down 2% from 4Q05, and Music Publishing revenue of $137 million, flat with 4Q05. 4Q06 performance was driven by releases from Tom Petty, Danity Kane, Cassie, Young Dro and Mana.
- **EBITDA.** We project consolidated EBITDA (after corp) of $122 million, up 58% from 4Q05. Recorded Music EBITDA should reach $99 million, up 48% yr/yr, and Music Publishing EBITDA should be $49 million, up 18% over 4Q05. We believe that margin strength and digital revenue growth contributed to the strong growth in Recorded Music. The weakness in Publishing should continue for at least 1 more quarter as the turnaround continues.
- **EPS.** We project Operating EPS of $0.02, versus Operating EPS of $0.08 in 4Q05.

FYE September 30:	4Q06E	2006E	2007E
Rev Current ($mm)	$892	$3,554	$3,717
Previous ($mm)	$892	$3,554	$3,717
EBITDA ($mm)	$122	$513	$541
GAAP EPS Current	$0.02	$0.33	$0.49
Previous	$0.02	$0.33	$0.49
P/E	NMF	0.01	0.02

4Q06 Earnings Details

Table 1 includes income statement data for 4Q05A compared with our current estimates for 4Q06.

Table 1 summarizes 4Q05A vs our 4Q06 estimates.

Table 1
Warner Music Group: 4Q05R vs. 4Q06E
$ and shares in millions; except per share data

Revenue	4Q05R	New 4Q06E	Yr/Yr Growth
Recorded Music	$775	$761	-2%
Music Publishing	$137	$137	0%
Eliminations	($7)	($6)	14%
Total Revenue	**$905**	**$892**	**-1%**
Segment EBITDA (excluding charges)			
Recorded Music	$67	$99	48%
Music Publishing	$42	$49	18%
Segment EBITDA	$109	$148	36%
Corporate Exp & Elims	($32)	($27)	16%
EBITDA (after corp)	**$77**	**$122**	**58%**
Segment D & A			
Recorded Music	($40)	($45)	13%
Music Publishing	($15)	($18)	20%
Corporate Expense	($3)	($2)	-33%
Total D&A	($58)	($65)	-12%
EBIT (Op Income)	**$19**	**$57**	**198%**
Interest Expense, net	($42)	($45)	-7%
Income Before Tax	($21)	$12	155%
Income Taxes	($9)	($9)	0%
Net Income-Reported	($30)	$3	-109%
EPS Reported	**($0.20)**	**$0.02**	**NMF**
Net Income-Operating	**$12**	**$3**	**79%**
EPS Operating	**$0.08**	**$0.02**	**-79%**
Avg Diluted Shs Out	150	150	0%

Sources: Company Reports, Media Metrics estimates.

WMG Investment Positives

WMG Investment Positives

1. **Piracy is Stable.** The IFPI estimates that illegal peer-to-peer (P2P) downloads fell from 1 billion in April 2003 to 760 million in April 2005, a 24% decrease. The music market has reported less negative growth for each of the past 3 years, reporting 1.4% sales growth worldwide and 3% growth in the 10 largest markets in 2004, the first positive growth rates in 4 years.

2. **Rapid Digital Revenue Growth.** Digital drove 6% of music sales in 2005 vs essentially 0% in 2003. Digital music sales grew to >$1 billion in 2005 and we project will reach a compound annual growth rate of 80%

between 2004 (the first year of meaningful digital revenue) and 2007. In 1Q 2006, US online sales were up 124% yr/yr. Total iPod units ever sold reached 42mm units at 12/31/05. Total unique visitors to US itunes.com hit 9.3mm in December 2005 (up 3 -fold from 3.0mm in Dec 2004). International downloads grew from 13mm in 2004 to 67mm in 2005. Global users of subscription music services grew from 1.5mm in 2004 to 2.8mm in 2005 and we believe that new Apple (AAPL, Buy, Cross Research/Soleil Securities) competitors, such as Yahoo's (YHOO, Buy) music subscription service, will drive growth of subscription-based digital revenue.

3. **Mobile Revenue Growth** (Ring Tones & Ring Backs). The worldwide mobile market reached $3-4 billion of revenue in 2004, of which the US represented only $220 million. BMI estimates that mobile revenue hit $500 million in the US in 2005. Strategy Analytics estimates that revenue from these digital sources reached $1.9 billion in Japan plus $1.1 billion in Europe in 2005. Mobile music revenue should grow rapidly with the adoption of 3G phones (greater memory & functionality) and will likely be key profit driver in 2006 and beyond.

4. **Long-Tail Library Value Growth.** The library values of the music companies should experience an upward revaluation as online services have up to 1 million songs available for purchase (compared with 10,000 titles available in a music superstore). The Recording Industry Association of America (RIAA) data shows that specialized record stores represented 53% of US music sales in 1994 and only 33% in 2004, replaced by mass retailers (like Wal Mart). Music specialty stores had up to 50% of their inventory in catalogue titles whereas mass retailers are more likely to carry *only* the 50 most popular titles.

WMG Investment Positives

5. **Industry Structure Protects Profits.**

- 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. Unlike the film business, the margins in the recorded music business are positively correlated to market share. Historically, Universal Music Group, the largest music Major, has had the highest margins in the music industry, followed by EMI which is the world's largest music publisher. EBITDA margins average 10-15% in recorded music and 35-40% in music publishing.
- The record business is the only entertainment business with strong underlying economics with talent. Aggregate failure costs are low despite 100 releases required to generate 1 hit. The 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 4 majors represent approximately 80% of recorded music sales and 65% of

music publishing revenue. Market share shifts have been minimal.

6. **Tax Advantaged Structure.** WMG has a sizeable tax shield because it structured the acquisition of Warner Music as a purchase of assets which allows WMG to deduct the value of intangible assets (ie, most music assets). We estimate that WMG's effective tax rate will remain in the 20-25% range for the foreseeable future.

7. **Margin Expansion.** We estimate that the profit margin for online digital revenue is about 65% compared with 50% for physical music sales. The difference is manufacturing and distribution expenses, inventory costs and returns handling. Therefore, the shift toward digital revenue implies margin expansion.

8. **Dividend Yield Protection.** WMG has committed to pay a $0.52/share dividend, representing approximately $80 million annually. WMG's high dividend yield represents a degree of downside protection for equity investors.

WMG Investment Risks

WMG Investment Negatives

Risks to an investment in WMG include: (i) the sustainability of cost cutting; (ii) piracy and its ongoing effect on WMG sales; (iii) the potential negative effects of unbundling (consumers purchasing individual songs rather than an entire album/CD); (iv) high financial leverage and (v) the potential acquisition of EMI (not rated).

US unit sales of physical music (CDs, etc) were down 7.2% in 2005. However, much of this decline was attributable to artist rationalization at Sony BMG (SNE, Buy, Hudson Square Research/Soleil Securities) following their merger that resulted in a drop in their combined market share from 28.4% in 2004 to 25.6% in 2005 representing 600 basis points of the industry decline. YTD 2006, US physical sales are down only 3% (vs 7% YTD 2005), and flat when digital sales are added.

Valuation

We maintain our "HOLD" on WMG based on 8 forms of valuation.

Valuation Summary: We calculate 8 forms of valuation for WMG as detailed in Tables 6-12.

Table 2 Warner Music Group: Summary of Valuation Conclusions					
Embedded Expectations				**Embedded Growth**	
1	Perpetual Growth Rate	Table 3		2.0%	
2	Breakeven DCF	Table 6		2.4%	
Theoretical Valuation Models			**Value**	**Price 9/27/06**	**Upside**
3	Discounted Cash Flow (DCF)	Table 7	$27.73	$25.90	7%
4	Adjusted Present Value (APV)	Table 8	$27.66	$25.90	7%
5	Equity Value/Share (FTE)	Table 9	$26.40	$25.90	2%
6	Private Market Value (PMV)	Table 12	$27.90	$25.90	8%
	Average		$27.42	$25.90	6%
Other Valuation Metrics				**2007E**	
7	EV/Sales	Table 10		1.7	
8	EV/EBITDA	Table 10		11.9	
9	P/E	Table 10		52.5	
10	FCF/Share	Table 11		$1.41	
11	EV/FCF	Table 11		30.1	
12	FCF Yield (FCF/Current Price)	Table 11		5%	

Source: Media Metrics research.

We maintain our BUY on WMG, based on 8 forms of valuation:

1. The **"Implied Perpetual Growth Rate After 2011"** methodology is a quick check on whether the current share price embeds faster or slower growth than the economy over the long run. It is difficult for any company to sustain faster growth than nominal GDP (3%) forever. Table 3 includes the results of this valuation analysis.

Table 3 WMG: Implied Perpetual Growth Rate After 2011 in millions	
Market-Based Enterprise Value	$6,437
WACC	9.3%
Unlevered FCF in 2011 (See DCF, Table 7)	$470
Implied Perpetual Growth Rate After 2011[1]	2.0%

[1] Calculated as G = (Ent Value x WACC) - (FCF in year 5) / Ent Value
Sources: Company Reports, Media Metrics Estimates

2. 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 2.4% to justify its current share price. (Please see Table 6.)
3. The **Standard DCF** is widely used on Wall Street because it is a

rigorous bottoms-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 aside the calculation in Table 7.

4. The **"Adjusted Present Value"** analysis breaks the value equation into two pieces; the value created by operations and the value created by tax and debt shelters. That is, APV provides a clear and detailed picture of tax shelters from financing and debt capacity and can give early warning to potential debt repayment issues. (Please see Table 8.)
5. The **"Equity Value per Share"** is the most applicable valuation for equity holders. Traditional valuation metrics calculate the value of the enterprise, and then subtract debt to arrive at equity value. This model highlights the factors that enhance and/or impair equity value, without reference to debt. (Please see Table 9.)
6. In Table 10 we summarize several **valuation multiples** for Sales, OIBDA and P/E. WMG's EV/EBITDA trading multiple of approximately 11.9x 2007E OIBDA appears inexpensive giving the strong free cash flow and content library values for music.
7. In Table 11, we present **Free Cash Flow** valuation metrics. Our Free Cash Flow analysis shows that WMG is currently valued at 30.1x 2007E Free Cash flow and has a 5% free cash flow yield.
8. In Table 12, we present a **Private Market Analysis.** This analysis indicates that current trading levels represent about an 8% discount to the company's private market value.

Company Description

WMG is the world's fourth 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 others.

Table 4A

Warner Music Group Corp.: Quarterly Income Statement Projections, 2006E

$ and shares in millions, except per share data

	12/31/05A	3/31/06A	6/30/06A	9/30/06E	2006E
Revenue					
Recorded Music	$920	$676	$678	$761	$3,035
Music Publishing	$131	$129	$150	$137	$547
Eliminations	($7)	($9)	($6)	($6)	($28)
Total Revenue	$1,044	$796	$822	$892	$3,554
Segment Costs					
Recorded Music	($714)	($595)	($586)	($662)	($2,557)
Music Publishing	($110)	($82)	($127)	($88)	($407)
Corporate Expenses	NA	NA	NA	NA	NA
Total Segment Costs	($824)	($677)	($713)	($750)	($2,964)
Segment OIBDA					
Recorded Music	$206	$81	$92	$99	$478
Music Publishing	$21	$47	$23	$49	$140
Segment EBITDA	$227	$128	$115	$148	$618
Corporate Exp & Eliminations	($25)	($24)	($30)	($27)	($105)
OIBDA (after corp)	$202	$104	$86	$122	$513
Segment Operating Income					
Recorded Music	$166	$40	$52	$54	$312
Music Publishing	$6	$32	$9	$31	$78
Corporate Exp & Eliminations	($28)	($27)	($34)	($29)	($117)
Operating Income	$144	$45	$28	$57	$273
Interest Expense, net	($45)	($45)	($45)	($45)	($180)
Net Inv. Rel-Losses	$0	$0	$0	$0	$0
Equity in (Losses) Gains	$0	$1	$0	$0	$1
Other Income (Expense), net	$0	$2	$1	$0	$3
Minority Interest Expense	$0	$0	$0	$0	$0
Income Before Tax	$99	$3	($16)	$12	$98
Income Taxes (Expense)	($30)	($10)	$2	($9)	($47)
Net Income-Reported	$69	($7)	($14)	$3	$51
EPS (Reported)	$0.46	($0.05)	($0.10)	$0.02	$0.33
EPS (Operating)	$0.48	($0.05)	($0.10)	$0.02	$0.33
Avg Shs Out	151	151	144	150	149

Sources: Company Reports, Media Metrics estimates.

Table 4B

Warner Music Group Corp.: Quarterly Income Statement Projections, 2007E

$ and shares in millions, except per share data

	12/31/06E	3/31/07E	6/30/07E	9/30/07E	2007E	Q1	Q2	Q3	Q4	2007E
						Year/Year Change				
Revenue										
Recorded Music	$961	$706	$709	$795	$3,172	4%	4%	5%	4%	4%
Music Publishing	$136	$134	$156	$143	$569	4%	4%	4%	4%	4%
Eliminations	($6)	($6)	($6)	($6)	($24)	-14%	-33%	0%	0%	-14%
Total Revenue	$1,092	$835	$859	$932	$3,717	5%	5%	5%	4%	5%
Segment Costs										
Recorded Music	($754)	($615)	($603)	($701)	($2,672)	6%	3%	3%	6%	5%
Music Publishing	($113)	($86)	($126)	($93)	($418)	3%	5%	-1%	6%	3%
Corporate Expenses	NA	NA	NA	NA	NA					
Total Segment Costs	($867)	($700)	($729)	($794)	($3,090)	5%	3%	2%	6%	4%
Segment OIBDA										
Recorded Music	$208	$92	$106	$94	$500	1%	13%	16%	-5%	5%
Music Publishing	$23	$48	$30	$50	$151	10%	3%	29%	1%	8%
Segment EBITDA	$231	$140	$136	$144	$651	2%	9%	18%	-3%	5%
Corporate Exp & Eliminations	($28)	($28)	($28)	($28)	($110)	10%	15%	-7%	3%	5%
OIBDA (after corp)	$203	$113	$109	$116	$541	1%	6%	27%	4%	5%
Segment Operating Income										
Recorded Music	$163	$47	$61	$49	$320	-2%	17%	18%	-9%	2%
Music Publishing	$8	$33	$15	$35	$91	36%	4%	63%	11%	16%
Corporate Exp & Eliminations	($31)	($31)	($30)	($30)	($120)	9%	13%	-12%	3%	2%
Operating Income	$140	$50	$109	$116	$416	-3%	10%	295%	106%	8%
Interest Expense, net	($43)	($43)	($43)	($43)	($174)	-4%	-4%	-2%	-4%	3%
Net Inv. Rel-Losses	$0	$0	$0	$0	$0					
Equity In (Losses) Gains	$0	$0	$0	$0	$0					
Other Income (Expense), net	$0	$0	$0	$0	$0					
Minority Interest Expense	$0	$0	$0	$0	$0					
Income Before Tax	$97	$6	$3	$11	$117	-2%	108%	-119%	-6%	20%
Income Taxes (Expense)	($36)	($2)	$0	($4)	($42)	20%	-77%	-100%	-55%	-10%
Net Income-Reporting	$61	$4	$3	$7	$75	-12%	-156%	-122%	166%	248%
EPS (Reported)	$0.40	$0.03	$0.02	$0.05	$0.49	-12%	-156%	-121%	163%	246%
EPS (Operating)	$0.40	$0.03	$0.02	$0.05	$0.49	-12%	-156%	-121%	163%	49%
Avg Shs Out	152	152	152	152	152					

Sources: Company Reports, Media Metrics estimates.

Table 5

WMG: Annual Income Statement Projections, 2004A-2007E

$ and shares in millions, except per share data

	2004A	2005A	2006E	2007E	04-07 CAGR
Revenue					
Recorded Music	$2,859	$2,924	$3,035	$3,172	3.5%
Music Publishing	$601	$607	$547	$569	-1.6%
Eliminations	($23)	($29)	($28)	($24)	1.4%
Total Revenue	$3,437	$3,502	$3,554	$3,717	2.6%
Segment Costs					
Recorded Music	($2,590)	($2,618)	($2,557)	($2,672)	1.0%
Music Publishing	($444)	($466)	($407)	($418)	-2.0%
Corporate Expenses	NA	NA	NA	NA	
Total Segment Costs	($3,034)	($2,984)	($2,964)	($3,090)	0.6%
Segment OIBDA					
Recorded Music	$270	$401	$478	$500	22.6%
Music Publishing	$157	$141	$140	$151	-1.3%
Segment OIBDA	$427	$542	$618	$651	15.1%
Corporate Expenses	($94)	($225)	($105)	($110)	5.4%
OIBDA (After Corp)	$333	$317	$513	$541	17.5%
Segment D & A					
Recorded Music	($40)	($165)	($166)	($180)	65.1%
Music Publishing	($13)	($59)	($62)	($60)	66.5%
Corporate	($1,036)	($14)	($12)	($10)	-78.7%
Tot. D&A	($1,287)	($238)	($240)	($250)	-42.1%
EBIT (Operating Income)	($954)	$79	$273	$291	
Interest Expense, net	($82)	($182)	($180)	($174)	28.4%
Net Inv. Rel-Losses	($82)	$1	$0	$0	
Equity in losses or equity-method investees, net	($9)	($1)	$1	$0	-100.0%
Deal Related Costs/Other	($13)	$0	$0	$0	
Loss on Repay Bridge Ln	($63)	($35)	$0	$0	-100.0%
Unrealized Loss on Wmts	($6)	$17	$0	$0	-100.0%
Other Expense, net	($120)	$7	$3	$0	-100.0%
Minority Interest	($11)	($5)	$0	$0	-100.0%
Income Before Tax	($1,272)	($119)	$98	$117	
Income Taxes	($150)	($55)	($47)	($42)	-34.5%
Reported Net Income	($1,422)	($174)	$51	$75	
Net Income-Operating	($1,422)	$32	$51	$75	
EPS -Reported	($12.34)	($1.40)	$0.33	$0.49	
EPS-Operating[1]	($12.34)	$0.26	$0.33	$0.49	
PF Diluted Shares Out	119	129	149	152	8.5%

[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, Media Metrics estimates.

Table 6

WMG Breakeven Discounted Cash Flow (DCF) Valuation Calculation 2007E - 2016E

$ and shares in millions, except per share data

Valuation Conclusions		% of Total
Sum of PV of Free Cash Flow [1]	$3,041	45%
PV of Terminal Value Discounted at WACC [1]	$3,499	52%
Value of Operations (WACC Method)	$6,540	98%
Plus: Excess Cash at 9/30/07E	$200	
Plus: Non-Consolidated Assets (From PMV)	$0	
Less: Minority Interest	$0	
Less: Unfunded Retirement Liabilities	($50)	
Enterprise Value	$6,690	100%
Less: Debt at 9/30/07E	($2,250)	
Less: Lease Obligations	($400)	
Less: Preferred Stock Outstanding	$0	
Less: Value of Options & Restricted Sk, After-tax	($100)	
Common Equity Value	$3,940	59%
Fully Diluted Shares Out, 2007E	152	
Breakeven DCF Value/Share	$25.92	
Current Share Price @ 9/27/06	$25.90	
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 visibility 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)

FYE 9/30:	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
EBITDA (after option expense & corp):	$513	$541	$554	$567	$581	$595	$609	$623	$638	$654	$669
- Depreciation	($240)	($250)	($233)	($238)	($244)	($250)	($256)	($262)	($268)	($275)	($313)
+ Option Exercise Proceed	$5	$5	$5	$5	$5	$5	$5	$5	$5	$5	$5
+ Int & Inv Income only	$3	$3	$3	$3	$3	$3	$3	$3	$3	$3	$3
EBIT	$281	$299	$329	$337	$345	$353	$361	$370	$378	$387	$364
Cash Taxes (at 20%)	($56)	($75)	($82)	($84)	($86)	($88)	($90)	($92)	($95)	($97)	($91)
Plus: Depreciation	$240	$250	$233	$238	$244	$250	$256	$262	$268	$275	$313
Plus: Sk Based Comp Exp	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10
Working Capital Change	($43)	($45)	($39)	($40)	($41)	($42)	($43)	($44)	($45)	($46)	($52)
Less: Capital Spending	($36)	($38)	($39)	($40)	($41)	($42)	($43)	($44)	($45)	($46)	($52)
FCF from Operations	$396	$401	$412	$421	$431	$441	$451	$462	$472	$483	$492
PV Discounted at WACC [2]	-7%	$401	$377	$353	$330	$309	$289	$271	$253	$237	$221
Sum of PV of Free Cash Flow											$3,041
Terminal Value of 2016E FCF [3]											$7,797
PV of Terminal Value at WACC [2]											$3,499
Discount Period		0	1	2	3	4	5	6	7	8	9

Required LT Growth Rate: 2.4%

[2] Calculation of WACC:

10-Year Risk Free Rate ("RFR")	4.5%
Equity Risk Premium (Ibbotson-Arithmetic)	6.0%
Levered Beta (Bloomberg)	1.00
Target Equity/(Debt + Equity)	80%
Debt Rating	BB
Debt Spread	2.5%
Marginal Tax Rate ("T")	35.0%
WACC	9.3%

(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	9.3%
Long-term Nominal GDP Growth	3.0%
WACC-GDP Growth	6.3%
Terminal Multiple (1/(WACC-Growth Rate))	15.8

Sources: Company Reports, Media Metrics estimates.

Table 7

WMG: Traditional DCF Calculation 12007E-2016E

$ and shares in millions except per share data

Valuation Conclusions		% of Total
Sum of PV of Free Cash Flow [1]	$3,161	45%
PV of Terminal Value Discounted at WACC [1]	$3,654	52%
Value of Operations (WACC Method)	$6,815	98%
Plus: Excess Cash at 9/30/07E	$200	
Plus: Non-Consolidated Assets (From PMV)	$0	
Less: Minority Interest	$0	
Less: Unfunded Retirement Liabilities	($50)	
Enterprise Value	$6,965	100%
Less: Debt at 9/30/07E	($2,250)	
Less: Lease Obligations	($400)	
Less: Preferred Stock Outstanding	$0	
Less: Value of Options & Restricted Sk. After-tax	($100)	
Common Equity Value	$4,215	61%
Fully Diluted Shares Out. 2007E	152	
DCF Value/Share	$27.73	
Current Share Price @ [illegible] 9/27/06	$25.90	
Upside Potential (DCF-Current Price/Current Price)	[illegible]7%	

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 visibility 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:	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	CAGR '07-16E
EBITDA (after option expense & corp):	$513	$541	$562	$585	$608	$633	$645	$658	$671	$685	$698	2.9%
- Depreciation	($240)	($250)	($233)	($238)	($244)	($250)	($256)	($262)	($268)	($275)	($313)	
+ Option Exercise Proceed	$5	$5	$5	$5	$5	$5	$5	$5	$5	$5	$5	
+ Int & Inv Income only	$3	$3	$3	$3	$3	$3	$3	$3	$3	$3	$3	
EBIT	$281	$299	$338	$355	$372	$391	$398	$404	$411	$418	$393	
Cash Taxes (at 20%)	($42)	($75)	($84)	($89)	($93)	($98)	($99)	($101)	($103)	($105)	($98)	
Plus: Depreciation	$240	$250	$233	$238	$244	$250	$256	$262	$268	$275	$313	
Plus: Sk Based Comp Exp	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10	
Working Capital Change	($43)	($45)	($39)	($40)	($41)	($42)	($43)	($44)	($45)	($46)	($52)	
Less: Capital Spending	($36)	($38)	($39)	($40)	($41)	($42)	($43)	($44)	($45)	($46)	($52)	
FCF from Operations	$410	$401	$418	$435	$452	$470	$479	$488	$497	$507	$514	2.8%
PV Discounted at WACC [2]		$401	$383	$364	$346	$329	$307	$286	$267	$249	$231	
Sum of PV of Free Cash Flow											$3,161	
Terminal Value of 2016E FCF [3]											$8,142	
PV of Terminal Value at WACC [2]											$3,654	
Discount Period		0	1	2	3	4	5	6	7	8	9	

[2] Calculation of WACC:

10-Year Risk Free Rate ("RFR")	4.5%
Equity Risk Premium (Ibbotson-Arithmetic)	6.0%
Levered Beta (Bloomberg)	1.00
Target Equity/(Debt + Equity)	80%
Debt Rating	BB
Debt Spread	2.5%
Marginal Tax Rate ("T")	35.0%
WACC	9.3%

(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	9.3%
Long-term Nominal GDP Growth	3.0%
WACC-GDP Growth	6.3%
Terminal Multiple [1/(WACC-Growth Rate)]	15.8

Sources: Company Reports, Media Metrics estimates.

Table 8
WMG: Adjusted Present Value (APV) Calculation
$ and shares in millions; except per share data

Valuation Conclusions		% of Total
PV of Free Cash Flow at Equity Cost [1]	$3,162	45%
PV of Terminal Value Discounted at Equity Cost [1]	$3,344	48%
Value of Operations (APV Method)	$6,506	94%
Plus: Value of Financing [2]	$298	
Plus: Excess Cash at 9/30/07E	$200	
Plus: Non-Consolidated Assets (From PMV)	$0	
Less: Minority Interest	$0	
Less: Unfunded Retirement Liabilities	($50)	
Enterprise Value	$6,954	100%
Less: Debt at 9/30/07E	($2,250)	
Less: Lease Obligations	($400)	
Less: Preferred Stock Outstanding	$0	
Less: Value of Options & Restricted Sk, After-tax	($100)	
Common Equity Value	$4,204	60%
Fully Diluted Shares Out, 2007E	152	
APV Value/Share	$27.66	
Current Share Price @ 9/27/06	$24.90	
Upside Potential (DCF Current Price/Current Price)	11%	

Adjusted Present Value (APV) Calculation

Why We Calculate: APV separates the value of a company into value contributed by financing vs operations.

Strengths

1 Identifies the value created by taxes and leverage
2 Can explicitly project capital structure changes
3 Allows forecasting of capital spending cycles

Weaknesses

1 Complex to calculate
2 Waste of time if capital structure is stable
3 Model offers few insights if there is little or no debt
4 Typically higher valuations as finance value is added

[1] Calculation of the Value of Operations (APV Method)

FYE 9/30:	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	CAGR '07-16E
FCF from Ops (See DCF)	$410	$401	$418	$435	$452	$470	$479	$488	$497	$507	$514	2.8%
PV Discounted at Unlevered Equity Co		$401	$383	$384	$346	$329	$307	$286	$267	$249	$231	
Sum of PV of Free Cash Flow											$3,162	
Terminal Value of 2016E FCF [4]											$7,446	
PV of Terminal Value at Unlevered Equity Cost [3]											$3,344	
Discount Period		0	1	2	3	4	5	6	7	8	9	

[2] Calculation of the Value of Financing

FYE 9/30:	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Debt Outstanding	($2,250)	$2,250									
Proceeds from Issuance											
Less: Issue Costs											
Less: Interest Expense		($158)	($144)	($132)	($119)	($105)	($91)	($78)	($64)	($50)	($35)
Plus: Tax Shelter on Int Expense		$55	$51	$46	$42	$37	$32	$27	$22	$17	$12
Principal Payments (50% of FCF from Ops)			($188)	($174)	($161)	($211)	($191)	($195)	($199)	($203)	($205)
Cash Flows from Financing (CFFF)		$2,148	($282)	($260)	($258)	($279)	($251)	($246)	($240)	($235)	($228)
PV of CFFF (at Debt Cost) [5]		$2,148	($270)	($238)	($226)	($234)	($201)	($188)	($176)	($165)	($153)
PV Value of Financing											$298
Discount Period		0	1	2	3	4	5	6	7	8	9

[3] Calculation of Cost of Unlevered Equity:

10-Year Risk Free Rate ("RFR")	4.5%
Equity Risk Premium (Ibbotson-Arithmetic)	6.0%
Levered Beta (Bloomberg)	1.0
Target Equity/(Debt + Equity)	80%
Unlevered Beta (L Beta x Equity/EV)	0.80
Cost of Unlevered Equity	9.3%

Calculated as RFR + (Equity Risk Premium x Unlevered Beta)

[4] Calculation of Terminal Multiple (APV Method)

Cost of Unlevered Equity	9.3%
LT GDP Growth x Target Equity %	2.4%
Unlevered Equity-GDP Growth	6.9%
Terminal Multiple (1/(Equity-Growth Rate))	14.5

[5] Calculation of Debt Cost

Debt Rating	BB
10-Year Risk Free Rate ("RFR")	4.5%
Debt Spread (Bloomberg)	2.5%
Yield on 10-Yr Notes	7.0%
Marginal Tax Rate ("T")	35%
After-Tax Cost of Debt (Yield x (1-T))	4.6%

Sources: Company Reports, Media Metrics estimates.

Table 9

WMG: Calculation of Equity Value per Share (FTE Model)
$ and shares in millions, except per share data

Valuation Conclusions		% of Total
Sum of PV of Free Cash Flow [1]	$1,992	50%
PV of Terminal Value Discounted at WACC [1]	$1,971	49%
Value of Operations (Equity Method)	**$3,963**	**99%**
Plus: Excess Cash at 9/30/07E	$200	
Plus: Non-Consolidated Assets (From PMV)	$0	
Less: Minority Interest	$0	
Less: Value of Options & Restricted Sk, After-tax	($100)	
Less: Unfunded Retirement Liabilities	($50)	
Common Equity Value	**$4,013**	**100%**
Fully Diluted Shares Out, 2007E	152	
Equity Value/Share	**$26.40**	
Current Share Price @ 8/27/06	$25.00	
Upside Potential (DCF-Current Price/Current Price)	2%	

Flows to Equity (FTE) Valuation

Why We Calculate: FTE details the factors that drive and/or impair shareholder equity value.

Strengths

1 Narrow equity shareholder value focus
2 Captures executive pay through options & warrants

Weaknesses

1 Can become optimistic, without EV anchor
2 Capital structure assumed to be constant

[1] Calculation of the Value of Operations (Equity Method)

FYE 9/30:	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	CAGR '07-16E
EBITDA (after option expense & corp):	$513	$541	$552	$563	$574	$580	$585	$591	$597	$603	$609	1.3%
- Depreciation	($240)	($250)	($233)	($238)	($244)	($250)	($256)	($262)	($268)	($275)	($313)	
- Interest Expense	($180)	($174)	($144)	($114)	($114)	($114)	($114)	($114)	($114)	($114)	($114)	
-Preferred Dividends	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	
+ Option Exercise Proceeds	$5	$5	$5	$5	$5	$5	$5	$5	$5	$5	$5	
+ Int & Inv Income only	$3	$3	$3	$3	$3	$3	$3	$3	$3	$3	$3	
EBT	$102	$125	$183	$219	$224	$224	$224	$224	$223	$223	$190	
Effective Corporate Tax Rate	($15)	($50)	($73)	($88)	($90)	($90)	($90)	($90)	($89)	($89)	($76)	
Plus: Depreciation	$240	$250	$233	$238	$244	$250	$256	$262	$268	$275	$313	
Plus: Sk Based Comp Exp	($10)	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10	
Working Capital Change	($43)	($45)	($39)	($40)	($41)	($42)	($43)	($44)	($45)	($46)	($52)	
Less: Capital Spending	($36)	($38)	($39)	($40)	($41)	($42)	($43)	($44)	($45)	($46)	($52)	
FCF from Operations	**$237**	**$252**	**$275**	**$300**	**$307**	**$311**	**$315**	**$319**	**$323**	**$327**	**$333**	3.2%
PV Discounted at Equity [2]		$252	$249	$246	$228	$209	$191	$175	$160	$147	$136	
Sum of PV of Free Cash Flow											$1,992	
Terminal Value of 2016E FCF [3]											$4,840	
PV of Terminal Value at Equity [2]											$1,971	
Discount Period		0	1	2	3	4	5	6	7	8	9	

[2] Calculation of Required Return to Equity Holders:

10-Year Risk Free Rate ("RFR")	4.5%
Equity Risk Premium (Ibbotson-Arithmetic)	6.0%
Levered Beta (Bloomberg)	1.00
Required Return to Equity Holders	**10.5%**

Calculated as RFR + (Equity Risk Premium x Beta)

[3] Calculation of Terminal Multiple (Equity Method)

Required Return to Equity Holders	10.5%
Long-term Nominal GDP Growth	3.0%
Equity-GDP Growth	7.5%
Terminal Multiple 1/(Equity-Growth Rate)	**13.3**

Calculation of Enterprise Value

Common Equity Value	$4,013
Plus: Debt at 9/30/07E	$2,250
Plus: Lease Obligations	$400
Plus: Preferred Stock Outstanding	$0
Plus: Options & Warrants Outstanding	$100
Enterprise Value	**$6,663**

Sources: Company Reports, Media Metrics estimates.

Table 10
WMG: Valuation Multiples (Sales, EBITDA, P/E)
$ and shares in millions except per share data

Valuation Conclusions		2007E
Market-Based Enterprise Value [1]		$6,437
2007E Sales (From Annual Projections)		$3,717
EV/Sales		1.7
Market-Based Enterprise Value [1]		$6,437
2007E EBITDA (From Annual Projections)		$541
EV/EBITDA		11.9
Target Price		HOLD
Target Price EV/EBITDA		NA
Current Price	9/27/06	$25.90
2007E EPS (From Annual Projections)		$0.49
P/E Ratio		52.5

[1] Calculation of Market-Based Enterprise Value		
Year End 9/30:		2007E
Current Share Price	09/27/06	$25.90
Fully Diluted Shares Out		152
Market Capitalization		$3,937
Less: Excess Cash		($200)
Less: Non-Consolidated Assets		$0
Plus: Unfunded Retirement Liabilities		$50
Plus: Debt at 9/30/07E		$2,250
Plus: Lease Obligations		$400
Plus: Preferred Stock Outstanding		$0
Plus: Options & Warrants Outstanding		$100
Market-Based Enterprise Value		$6,437

Sources: Company Reports, Media Metrics estimates.

Table 11
WMG: Free Cash Flow Valuation Metrics
$ and shares in millions except per share data

Valuation Conclusions		2007E
FCF/Share [2]		$1.41
Current Price	9/27/06	$25.90
FCF Yield		5.5%
FCF [2]		$214
2007E EBITDA (From Annual Projections)		$541
FCF Conversion Rate (FCF/EBITDA)		40%
Adjusted Enterprise Value [1]		$6,437
FCF [2]		$214
EV/FCF		30.1

Calculation of Free Cash Flow	
Year End 9/30:	2007E
EBITDA	$541
Plus: Option Exercise Proceeds	$5
Less: Cash Interest Expense	($174)
Less: Minority Interest	$0
Less: Preferred Dividends	$0
Less: Cash Taxes	($75)
Less: Change In Working Capital	($45)
Less: Capital Spending	($38)
Free Cash Flow	$214
Shares Outstanding	152
FCF/Share	$1.41

Sources: Company Reports, Media Metrics estimates.

Table 12
WMG Private Market Value (PMV), 2007E
$ and shares in millions, except per share data

Valuation Conclusions	2007E	% of Total
Consolidated Assets [1]	$7,303	107%
Consolidated Corporate Expense [1]	($462)	-7%
Non-Consolidated Asset Value [2]	$0	0%
Total Asset Value	**$6,841**	**100%**
Plus: Excess Cash at 9/30/07E	$200	
Less: Unfunded Retirement Liabs	($50)	
Less: Debt at 9/30/07E	($2,250)	
Less: Lease Obligations	($400)	
Less: Preferred Stock Outstanding	$0	
Less: Options & Warrants Outstanding	($100)	
Total PMV	**$4,241**	
Fully Diluted Shares Out, 2007E	152	
PMV Value/Share	$27.90	
Current Share Price @ 9/27/06	$25.90	
Upside Potential ((PMV-Price)/Price)	8%	

[1] Calculation of Consolidated Asset Value, 2007E

Year End 9/30:	EBITDA	Multiple	PMV
Recorded Music	$500	13	$6,246
Music Publishing	$151	7	$1,058
Consolidated Assets	$651	11	$7,303
Corporate Expense	($110)	4	($462)
Consolidated Value	$541	13	$6,841

[2] Calculation of Non-Consolidated Asset Value

	% Owned	PMV
Non-Consolidated Asset Value		**$0**

Sources: Company Reports, Media Metrics estimates.

Required Regulatory Disclosures

Analyst Certification
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Rating	Count	Percent	IB Serv/Past 12 Mos. Count	IB Serv/Past 12 Mos. Percent
BUY (BUY)	176	47.83	0	0.00
HOLD (HOLD)	164	44.57	0	0.00
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Media

Rating	Count	Percent	IB Serv/Past 12 Mos. Count	IB Serv/Past 12 Mos. Percent
BUY (BUY)	11	44.44	0	0.00
HOLD (HOLD)	16	37.07	0	0.00
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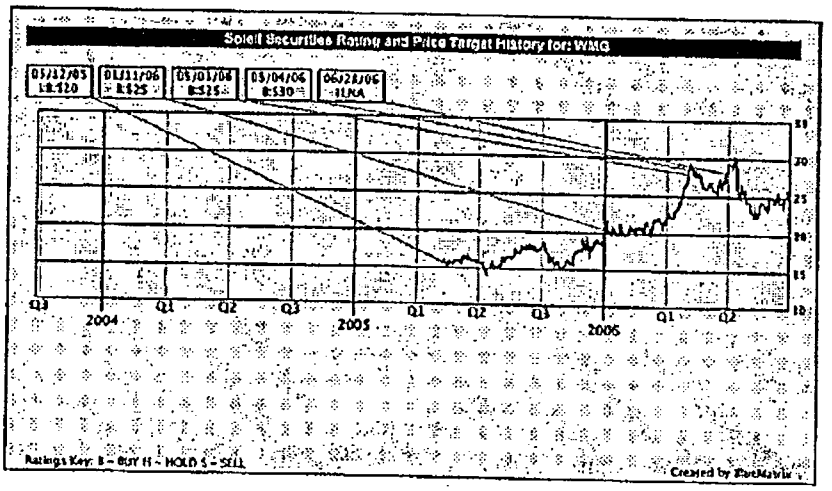

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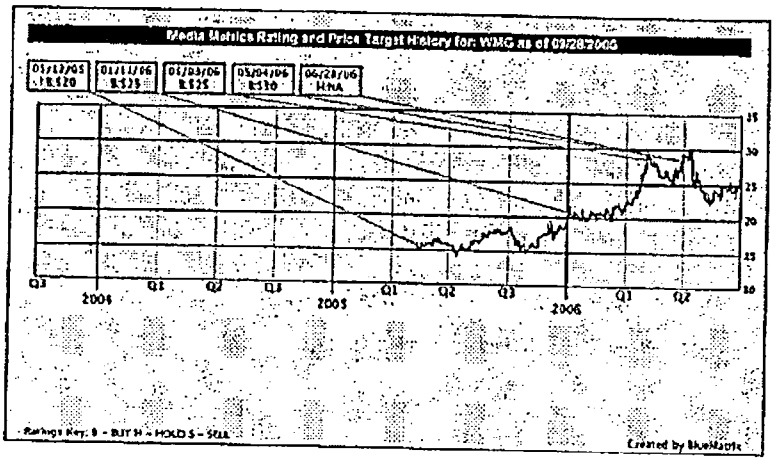

Companies Mentioned:
Apple Computer (AAPL, $77.01, Buy, Nasdaq)
Sony (SNE, $41.16, Buy, NYSE)
Yahoo! (YHOO, $25.33, Buy, Nasdaq)

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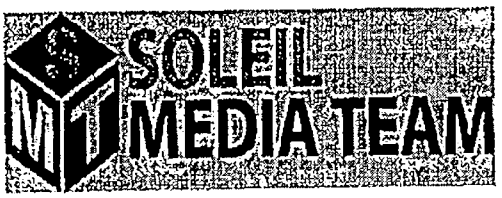

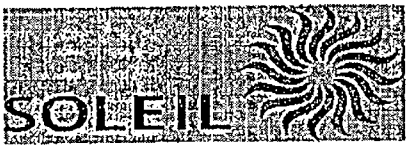

Equity Research
Soleil Media Monthly

Music Industry Review

Best Questions Answered

May 31, 2005

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The Soleil Media Monthly outlines important trends impacting media and entertainment company valuations, suggests winning strategies and identifies top stock picks based on this research.

Research Goals

This research report outlines the value creation ecosystem for music companies and identifies valuation threats and opportunities. We also attempt to answer the questions that most impact music company valuations.

Investment Conclusions

1. Recorded Music bottomed in 2002 at $32.3 billion and was flat in 2004 (including digital revenue), yet valuations of music companies continue to embed *negative* EBITDA growth. In the first quarter of 2005, several music companies reported an average of 40% quarter over quarter gains in digital music revenue (off a small base).
2. Music Publishing revenue has been stable with profits 4x higher than recorded music for the past 4 years, representing a stable revenue and profit stream for the big 4 music companies (Majors).
3. The record business is the only entertainment business with strong underlying economics with talent. This is no longer true of sports, film or television talent. The studio system still exists within the music industry. Actual failure costs are low despite 1,000 releases required to generate 25 hits. The talent cost structure in music drives value creation.
4. New technologies are often disruptive to media companies initially owing to piracy, just as the transition to digital delivery of music has proven to be. We believe piracy has stabilized owing to broadband penetration reaching saturation in the largest music consuming markets, more legal challenges and new legitimate alternatives.
5. In 2004, Apple was a key driver of legal digital music revenue growth through its iTunes service, and 2005 should be better given Yahoo's recent fixed-price "all-you-can-eat" subscription service announcement. We believe that digital music creates a boon for companies that own music assets.

Top Stock Picks

Our top stock recommendations based on analyzing winners and losers from this work are Warner Music Group, Univision, PortalPlayer, and Electronic Arts.

Important disclosure information is contained on the last pages of this report. Recipients of this report are directed to read these disclosures.

Answers to Best Music Industry Questions

1) What is the outlook for the music industry?

We project that worldwide recorded music sales will grow 1% in 2005 and 1% in 2006. We believe that the music industry can grow revenue going forward, based on the following analysis:

Music industry poised for growth...finally.

- **Ring Tones.** The US performing rights body BMI predicts that the retail value of ring tones will more than double, to $500 million, in the US in 2005.
- **Market Expansion.** The development of independent third party online services should expand the market. Consumers want all content to be available on a single service. This is best achieved by third parties, rather than by a music Major. In the first quarter, digital revenue grew 40% quarter-over-quarter for several music companies.
- **Success Attracts New Entrants.** New subscription services (Yahoo) and downloaded digital tracks (iTunes) should drive digital revenue growth, and the success of Apple to date attracts new competitors into the legitimate (legal) online music space.
- **Long Tail Demand.** The value of music libraries/catalogue is growing. Online services can sell the entire catalogue to consumers, up to 1m albums, and returns are minimal, whereas a large music store only has room for 7,000-10,000 CDs. One in 5 visitors to a music store typically goes away empty handed, compared with nearly 100% download online (either legal or illegal).
- **Broadband Drives Demand:** We expect the demand for music to increase with worldwide growth in PC and broadband penetration. As broadband penetration (which enables faster downloads) through cable modems and DSL increases, music will likely become more of a service rather than a product. Music is the only medium whose use actually increases with online PC penetration, as consumers multi-task, listening to music while they surf the web.

2) Has Piracy Stabilized?

Yes. Piracy appears to have stabilized. Evidence includes:

Piracy has stabilized.

- Worldwide recorded music revenue, including digital revenue, was flat at $33.6 billion in 2004, according to the International Federation of the Phonographic Industry (IFPI). US recorded music revenue grew 2.5% in 2004, after bottoming in 2003 at $11.9 billion, according to the Recording Industry Association of America (RIAA).
- Worldwide, more than 200 million music tracks were downloaded legally in 2004 (a tenfold increase over 2003) and there are now 1.7mm subscribers to legal subscription services, says the IFPI.
- There is some evidence that digital downloading represents promotion for increased sales of legal formats.

- Piracy is not coming from a zero base. We estimate that a third of the music market in unit terms is stolen through physical piracy.
- What is out there in MP3 format is out there, so is freely available through peer-to-peer (P2P) services. However, in any one year, 60% of music sales are current releases. Therefore, once meaningful DRM standards are adopted, the majority of demand should be protected.
- Most online pirate services that become successful become visible, and thus sueable, unlike physical piracy. Legal action has been visible and intermittently successful in stemming online piracy.
- Digital piracy grows with online penetration. The largest music purchasing markets are approaching full online penetration, which implies that the growth of digital piracy should slow. Chart 1 includes online penetration, ranked highest to lowest for certain large recorded music-consuming countries.

Chart 1
Online Penetration of Selected Countries

Rank	Country	Online Penetration	Internet Users	Population (est.)	Source & Date
1	Sweden	77%	6,913,676	8,995,900	Nielson Jan/04
2	United States	68%	199,096,845	294,540,100	Nielson Jan/04
3	Australia	67%	13,474,392	20,226,100	Nielson Jan/04
4	Netherlands	66%	10,806,328	16,364,500	Nielson Jan/04
5	Hong Kong	63%	4,661,589	7,394,170	Nielson Jan/04
6	Iceland	63%	186,600	298,400	ITU Dec/02
7	Denmark	63%	3,375,850	5,405,600	Nielson Jun/02
8	Korea	62%	29,220,000	47,135,500	KRNC Dec/03
9	Singapore	60%	2,100,000	3,499,500	ITU Dec/03
10	Switzerland	60%	4,430,800	7,433,000	Nielson Jan/04
11	United Kingdom	59%	34,765,774	59,157,400	Nielson Jan/04
12	Germany	55%	45,315,037	82,633,200	Nielson Jan/04

Sources: Please see the right column of the table above for country by country sources.

3) Does DRM Limit Music Industry Revenue Growth?

Yes.

What is DRM? Digital Rights Management (DRM) technology enables content holders to control the use of copyrighted material and restrict access to that content to those who have paid for it. However, those controls often impose restrictions, even on consumers who have actually paid for the content.

DRM remains a challenge for the music industry.

- For example, an owner of a CD may play that CD in an unlimited number of environments, over an unlimited period of time. A consumer may play a purchased CD in their living room, bedroom, at work, in their car, or even in a rental car.
- By contrast, DRM limits the number of devices authorized to play a given piece of content, and each new device must be registered with a central service.

How does DRM limit music industry revenue growth? In theory, digitization should make content distribution and consumption easier, but current technologies and lack of standards often limit usage. We believe that DRM limits online revenue demand, because:

- Today, there are 2 primary digital rights management (DRM) technologies. Apple (iTunes) and Microsoft (Napster, Real Networks, and Yahoo's new subscription service) have the primary DRM ecosystems. Microsoft's JANUS DRM technology is NOT compatible with the DRM on the Apple's iPod, and vice versa. A song purchased on iTunes, will not play on a non-iPod. You can *not* stream a song from your iPod to your PC or your stereo system (unless the receiving unit has a special Apple DRM reader in it and there is only one available today). You can not copy that song on many other devices either.
- We foresee that either Apple or Microsoft will lose the DRM battle, or that a third technology will integrate the two.
- Until then, we believe that multiple incompatible DRM standards will slow the growth of digital music.

Since the future of music is digital, in our view DRM needs to be easier for consumers to use, or online growth will not reach its full potential. In order for digital music to have the same mainstream appeal as a CD, the DRM technology and rights systems will need to be considerably less complex for the average consumer, in our view. Microsoft's DRM technology know as JANUS (used in the portable subscription services recently launched by Napster, Real Networks and Yahoo) allows content holders to dynamically alter the usage rights from file to file. *Bottom line, however, currently incompatible DRM systems confuse consumers and limit digital music revenue growth, in our view.*

4) Will the Music Industry Adopt New Business Models?

Yes. The music industry is working to find new business models in which people pay for the consumption of recorded music. Part of the industry friction (read: resistance) comes from the fact that several of the new business models move music from a product basis (albums, singles) to a service basis (unlimited plays per month).

New business models can accelerate music industry growth.

Another issue slowing industry adoption is that today, legitimate on-line purchases are almost entirely dependent on the purchaser having a credit card. This has negative implications for the music industry as many of their target consumers are too young to have credit cards. This forces theft. In addition, several growth regions, such as Latin America, traditionally have much lower credit cards usage than Western Europe or North America.

The mobile phone, ISP and multi-channel video markets have demonstrated consumers' preference for a fixed price subscription model. Yahoo recently

announced a $6.99/month subscription price for unlimited access to 1 million music tracts. Teenagers may buy cards or vouchers to purchase music online while adult users may pay a monthly fee via credit card for "unlimited" downloads or streams. In addition, such services can accept cash payments.

5) Will the Big Get Bigger?
Yes and No.

More consolidation is likely.

Yes because:

- There are important cost economies of being huge and global. In addition, size smoothes revenue streams in what is otherwise a hit-driven business.
- Although European regulators have vetoed an acquisition of EMI by both Time Warner (before Warner Music was independent) and Bertelsmann, we expect the Majors to consolidate further (WMG + EMI), assuming they can get regulatory approval.

.....No because:

- There will likely always be thousands of independent record labels that together represent 20-25% of total music industry sales either because of talented creative producers who refuse to be part of the studio system, or owing to the niche nature of their recording artists.
- Local music is an important driver of growth. Although infrastructure costs are higher to launch local content, the advances to talent are lower than in the US so the profitability of acts is high.
- Sony BMG Music Entertainment is a 50%/50% JV between Sony Corporation of America and Bertelsmann, and provides the soundtracks to Sony's top movie franchises including Spiderman.
- Hispanic multimedia giant Univision Communications added Music in 2001 and continues to build this business. UVN uses its record label and recording artists as competitive advantages for content on its radio and TV stations.

6) Does Portability Benefit Music Value?

Portability increases the value of music catalogues.

Yes, because:

- Content such as TV, games and the Internet is becoming increasingly portable. Music is easily portable and more distribution channels mean new revenue streams for content owners.
- The success of the iPod has added new value to music. Consumers increasingly want convenience, implying the need for several content forms on a single device. While video content to mobile phones is the current 'buzz', music is likely to benefit from increased content consumption on cellular and other new portable devices.

Top Stock Picks

Top Stock Picks: WMG, UVN, PLAY, & EA.

Warner Music Group (WMG, Buy). 1) At $16/share, our calculations show that WMG's valuation has embedded a 4% *NEGATIVE* EBITDA growth rate annually for the next decade, which we think is too low. 2) We think piracy has stabilized and digital revenue streams (although small) are growing at 40% quarter-over-quarter. 3) We believe the success of Apple's iPod & iTunes products will attract new legitimate music products to the market, like Yahoo's recent subscription service, and some money for music is better than theft. 4) New technologies often experience high piracy at the beginning but content library owners usually win in the end.

Univision (UVN-Hold). Univision launched its music business in 2001. In June 2001, the Company acquired a 50% interest in Mexico's Disa Records, one of the largest independent Spanish language record labels in the world. In April 2002, the Company acquired Fonovisa, Grupo Televisa's (TV-nr) record and music publishing business. Univision's Music Group sells more Latin music recordings in the U.S. than any other company. The Music division generated roughly 10% of UVN's $1.8 billion of total revenue in 2004. Univision also uses its music on its radio and TV programs and re-enforces the Univision brand through music. For example, Univision recently announced a new, multi-year partnership with the Latin Recording Academy. The Company's recent Music Awards show, featuring many of its own artists, achieved record ratings, attracting over 6.3 million TV viewers.

Portal Player (PLAY, Buy). As the sole supplier of processors to Apple's hard-drive based iPods, and as a vendor to several leading iPod contenders like iRiver and Samsung, Portal Player is one of the best positioned public companies that benefits from the migration to digital music. In addition, PLAY recently released a high speed processor with integrated analog functions targeted at the high volume flash based market. We recently raised our 2005 sales estimate from $190M to $197M and our EPS estimate from $1.03 to $1.17 following a better-than-expected 1Q05. PLAY shares currently trade at 15.8x our 2005 EPS estimate (and 11x if we exclude $5 cash/share), compared with a group average of 26x.

Electronic Arts (ERTS: Market Perform). EA's games reach a broad demographic and often sell over a million units. EA has begun to incorporate top music hits into its video games. Sports programming is often a target for music, and EA's market leadership in the sports genre positions it well to take advantage of cross-promotion opportunities. To most effectively capitalize on the opportunity, EA has formed a joint venture with Cherry Lane Music Publishing called Next Level Music LLC, which will act as an intermediary to license music to play within EA video games, produce albums based on EA game soundtracks, and license out EA's existing music assets for commercials, movies, ring-tones, etc.

Music Industry Overview

The worldwide music industry contains 2 primary categories: recorded music and music publishing. In 2004, Worldwide Music Revenue was $37.2 billion globally. This was made up of $33.6 billion of recorded music revenue plus $3.6 billion of music publishing revenue in 2004. Although the recorded music business is about 10x larger than the music publishing (library/catalogue) business, it is hit driven (more volatile) with lower margins.

Music Publishing

Music Publishing was 1/10th the size of the recorded music market in 2004, at $3.6 billion, compared with $33.6 billion for recorded music. Music Publishing positives include:

Music Publishing is profitable and stable, albeit small.

- Despite its smaller size, the margins in the music publishing business are three-four times as high as in recorded music.
- Music publishing also represents a more consistent revenue stream with above average growth prospects, growing at 3-5% the past 2 years, which is meaningfully higher than recorded music industry growth.

Rapid Growth Driven by Mobile
In 2004, music publishing revenue grew 5% to $3.6 billion. This followed 3% growth in 2003 to $3.44 billion and marks the second consecutive year of growth. Growth was driven by significant revenue increases from:

- Broadcasters; and
- Digital sources, most notably ring tones.

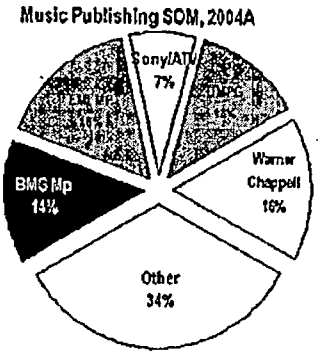
Music publishing should be a beneficiary of online and digital music growth.

- In 2004, EMI which has been the most active music publisher in the digital sector, reported that its digital revenue rose by 130% off a small base. In total, digital music represented $10 million of revenue, or 1.8% of EMI's total revenue in 2004.
- In 2003, digital revenue represented 0.5% of BMG's (Bertlesmann, Not Rated) total revenue, up from 0% in 2002.

Both EMI and BMG have stated that they foresee rapid growth of digital revenues in 2005 and 2006.

Music publishing market shares
Music publishing is more fragmented than recorded music. For example, the 4 majors control only about 66% of the music publishing market, compared with 75-80% of the recorded music market. Chart 2 includes the market shares of music publishers in 2004.

Chart 2
Music Publishing Market Shares, 2004

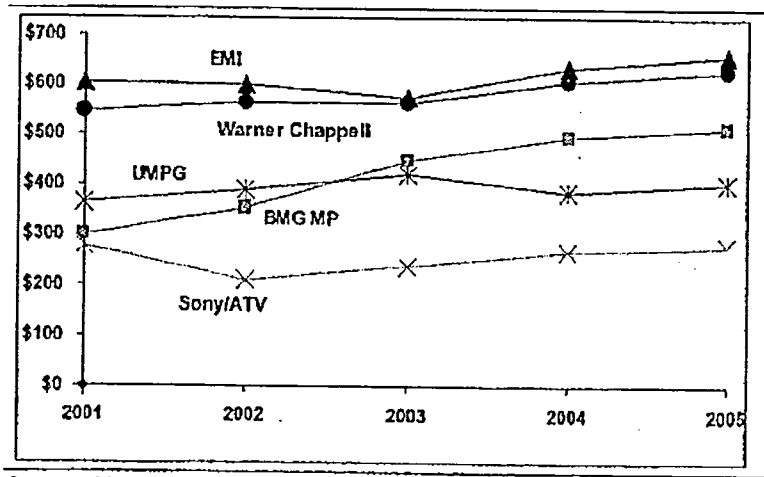


Source: Music and Copyright Magazine, Soleil Media Team estimates.

During a period of recorded music declines, music publishing revenue remained flat and recent trends in music publishing are positive, with growth reported in 2003 and 2004 for most of the music publishing majors. We expect 2005 to continue this growth trajectory.

Chart 3 includes music publishing revenue trends for the majors between 2001A and 2005E.

Chart 3
Music Publishing Revenue Trends, 2001A-2005E
$ in millions



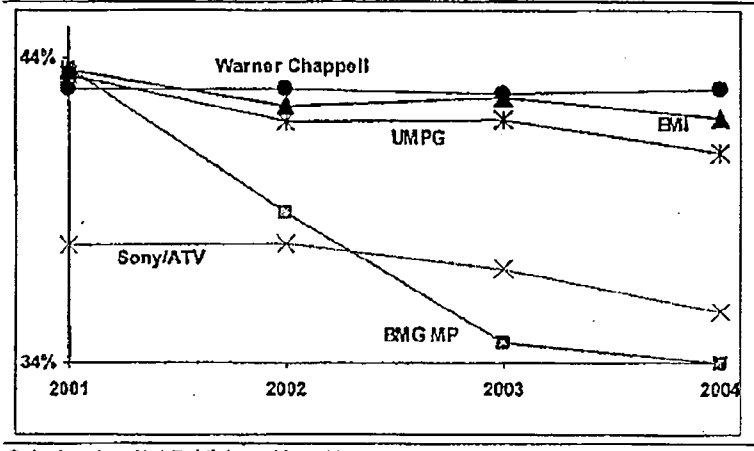
Sources: 2001-2004 = Company records, Music and Copyright. Results for 2004 are annualized for EMI & UMPG and estimated for the final 2 months of Warner Chappell. 2005 is Soleil Media Team estimates.

Margins on Music Publishing

Music Publishing margins are high and stable for most Majors.

Music publishing is a substantially more profitable business than recorded music, with margins of up to 45% (4x recorded music margins). In fact, profit margins for music publishers generally fall within a very narrow range, typically between 35-45% annually. In fact, 3 of the music publishing majors (Universal, EMI and Warner) have reported constant profit margins at 42-44% annually. Sony's are lower but steady. BMG's profit margins are falling rapidly, for reasons we don't understand. Chart 4 includes profit margin trends for the music publishers between 2001 and 2004.

Chart 4
Music Publishing Profit Margin Trends, 2001-2004



Calculated as Net Publishers Share/Revenues.
Sources: Company reports, Music & Copyright Magazine.

Music Publishing Sources of Revenue

Music Publishing revenues are derived, on behalf of artists and songwriters, from Performance, Mechanical and Synchronization revenue. Performance royalties are the largest, followed by Mechanical and then Synchronization. A brief description of each follows:

- Performance, royalties paid for the broadcast on TV, radio or any live performance of the song.
- Mechanical, a royalty on every album sold, which is correlated to music recording unit sales,
- Synchronization, royalties paid for the synchronization of music with visual images, such as in films, ads, videos or computer games.

Music Publishing Value Chain

There are three primary participants in the music publishing value chain. There are:

- authors and writers (explained above);
- publishers (explained above); and,

- collection agencies. The collection agencies manage the payment of mechanical royalties to the music publishing companies who in turn typically pay around 50-75% to writers. The importance of collection agencies should increase with more digitalization of music as music is unbundled from the traditional recorded formats (albums).

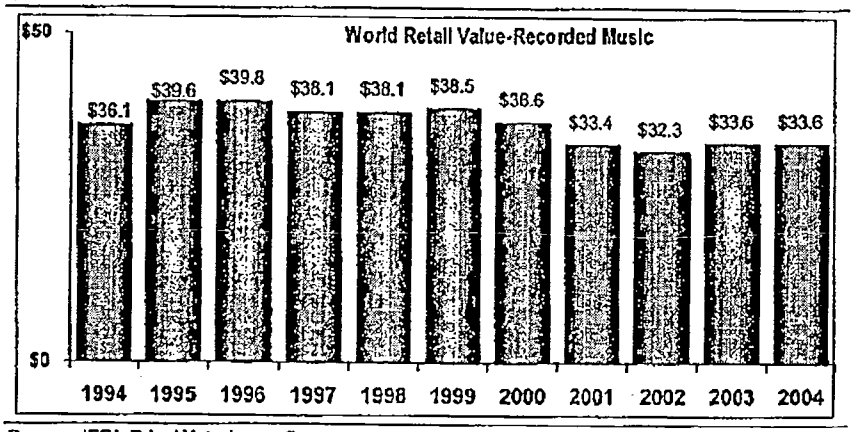
Music Publishing Valuations (private vs public):
In 2000, Rondor was acquired for 20x Net Publisher's Share. This compares to a public market valuation of about 9x trailing Net Publishers share for EMI's music publishing assets, by our calculation.

Recorded Music

The Music Industry is Recorded Music
Because recorded music is 10 times larger than music publishing, most of the stats kept on a worldwide basis relate to recorded music. Therefore, the balance of this report focuses on recorded music. Chart 5 includes the worldwide retail value of recorded music for the past decade, between 1994 and 2004.

Recorded Music is 10x larger than Music Publishing.

Chart 5
Worldwide Retail Value of Recorded Music, 1994-2004
$ in billions



Source: IFPI, PriceWaterhouseCoopers.

Industry Growth History
Since 1969, the recorded music industry experienced two periods of double-digit growth. Each phase of rapid growth was driven by a new format.

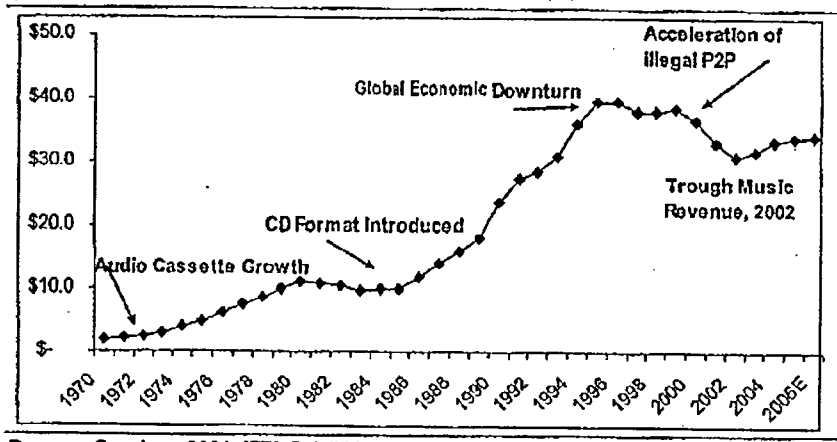
Historical Music Industry growth has been driven by the introduction of new technologies

- The first growth phase, between 1969 and1979, reported a compound annual growth rate of 18% owing to the internationalization of music and growing penetration of cassette players.
- The second growth phase, between 1985 and 1995, reported a compound annual growth rate of 15% driven by the library replacement cycle as CDs replaced LPs and cassettes in consumer

home libraries.

Chart 6 includes worldwide recorded music revenue since 1970.

Chart 6
Worldwide Recorded Music Revenue, 1970-2006E
$ in billions



Sources: Sanghera 2001, IFPI, Soleil Media Team estimates for 2005 & 2006.

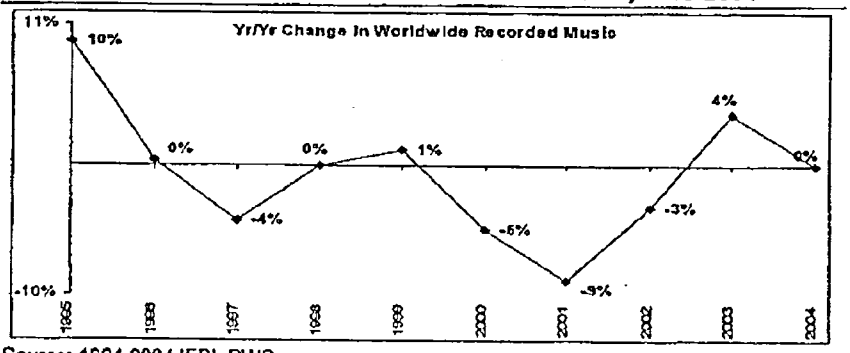
Industry Contraction History

Historical Music industry contraction periods have been driven by recession and piracy linked to new technologies.

Since 1969, the global music industry experienced two periods of contraction. Each phase of decline was driven by piracy and recession.

- The first contraction phase, between 1980 and1984, reported a compound annual rate of *decline* of 4.1% owing to a global economic downturn and the widespread copying of music onto cassette tapes.
- The second contraction phase, between 1999 (peaked at $38.5 billion) and 2002 (troughed at $32.3 billion), reported a compound annual rate of *decline* of 5%. Chart 7 includes the timing and magnitude of contraction in the most recent period.

Chart 7
Year-over-Year Growth in Worldwide Recorded Music, 1995-2004



Source: 1994-2004 IFPI, PWC.

This most recent period of contraction can be attributed to an economic slowdown and growing online piracy, the maturing of CD hardware penetration, changing music tastes, and the entry of mass market retailers into the music retail market. Details include:

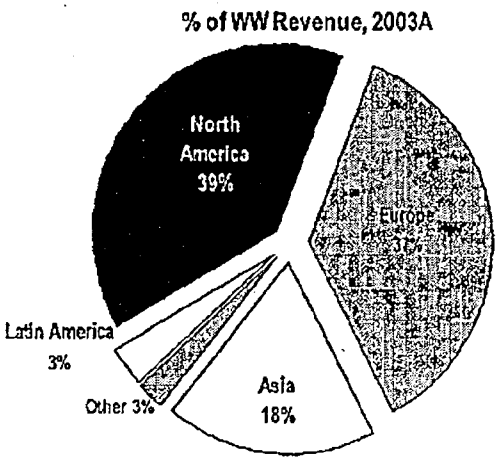
The most recent music industry contraction resulted from many things, NOT just online piracy.

- In the last 5 years, piracy has exploded, both online with peer-to-peer (P2P) networks, and with the growth of CD burners in homes. In our view, growth in online piracy is being driven by a proliferation of free P2P providers. (See Chart 13)
- The completion of the CD hardware replacement cycle in Western economies, as vinyl and cassettes are done being swapped into CDs in home libraries.
- A shift in music tastes away from traditional rock and pop toward narrower niche genres such as Rap/Urban, Christian and Hip Hop. This took some of the majors by surprise, although Universal and PolyGram were early pioneers through the Def Jam and Interscope labels respectively.
- Mass market retailers such as Wal Mart, Best Buy, and grocery stores in the US took market share from music-only retailers and drove them into bankruptcy. Mass market retailers typically sell Top 50 hits only. This narrow selection cuts the music choice widely available and therefore cuts overall sales.

Key Geographic Markets for Music

The key geographic markets for recorded music sales are North America, Europe, Asia and Latin America. Chart 8 includes the mix of recorded music revenue in 2003.

Chart 8
Worldwide Retail Value of Recorded Music, 2003



Source: IFPI

The geographic dispersion of worldwide recorded music revenue is actually greater than the above chart would indicate. In 2003, the US reported nearly $12 billion of retail sales of music. The next closest country was Japan at less than half (just under $5 billion). The third largest country was the UK at about $3 billion. Total sales fell sharply after that.

Chart 9 includes the ranking of countries, based on their retail sales volume of recorded music in 2003.

Chart 9
Worldwide Retail Recorded Music Sales Ranked by Value, 2003

2003 Rank	Country	Value-($000,000 US)	% of Ten
1	USA	$11,845	43.6%
2	Japan	$4,910	18.1%
3	UK	$3,216	11.8%
4	France	$2,115	7.8%
5	Germany	$2,022	7.4%
6	Canada	$676	2.5%
7	Australia	$674	2.5%
8	Italy	$645	2.4%
9	Spain	$596	2.2%
10	Netherlands	$499	1.8%
	Total	$27,201	100.0%

Source: IFPI

Concentration of Music Sources

The US and UK provide the majority of worldwide music sales, representing about 60% of annual global music sales. This has been declining over the past decade.

Trend Toward Local Music

The music market used to be primarily international artists exported from the US and UK, with heavy competition between labels for major artists. The past decade has seen rapid growth of local artists. Including in the US and UK, sales of locally signed artists in their home territories represent nearly 70% of worldwide recorded music sales. Local music tends to be more profitable as artists often do not demand onerous upfront royalty advances.

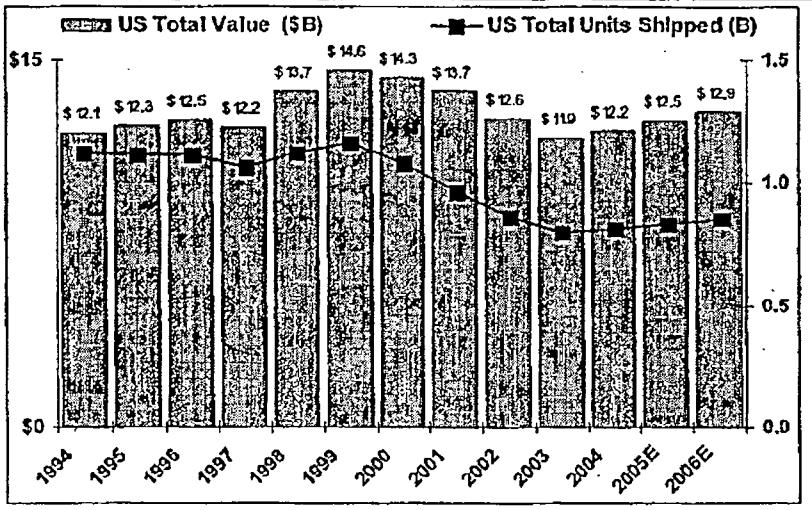
The US market is about 1/3 of total music sales.

The US is the Largest Music-Consuming Country

The US is the largest music country in the world, based on total recorded music retail revenue, and its sales trends impact total industry revenue. By genre, urban rap/dance, religious and film tracks have grown as a proportion of revenue, at the expense of rock and country, although rock remains by far the biggest category. US music consumers increasingly show cross-over interest, which accounts for the growth of rap to be the second largest

category, overtaking country. Chart 10 includes the recent history of US units shipped and recorded music sales volume.

Chart 10
US Retail Value and Units Shipped of Recorded Music, 1994-2006E



Source: RIAA, 1994-2004A. Soleil Media Team estimates for 2005 & 2006.

Industry Structure

The music industry is bifurcated into the huge and the tiny. Nothing in the middle survives.

The Majors

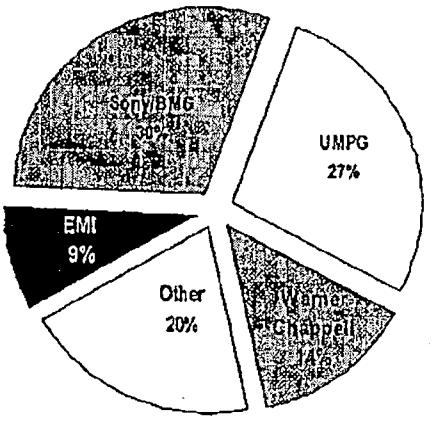
The huge includes the four major music label incumbents (the "Majors") which together account for 75-80% of the global music market. These four companies are (from biggest to smallest) Sony/BMG (Bertelsmann), Universal Music (a subsidiary of Vivendi), Warner Music Group, and EMI.

Disciplined industry structure includes 4 Majors + many independents.

The big players realized that by buying more labels or merging together, they could diversify their music portfolio and decrease their risk of failure from any one market. Following the acquisition of PolyGram by Universal in 1998 and the merger of Sony music and Bertelsmann Music Group (BMG) in 2004, the music market consolidated into four majors, Sony/BMG, Universal, Warner Music, and EMI. Together, these four majors controlled approximately 80% of the worldwide music market in 2004.

The share of the market held by the music majors has remained about the same since 1997, although partly because music majors buy up successful new independents. Chart 11 includes our estimates for 2004 market share for recorded music, as the IFPI numbers are not yet available.

Chart 11
Recorded Music Market Share, 2004E



Source: Soleil Media Team.

Value Drivers for the Majors

The primary drivers of profitability for the major music labels are:

- *Worldwide Market Share:* The worldwide market share of a major music company is directly linked to its profitability, unlike the film business. This is because global market share indicates the percent of successes compared with total investment outlays of the music company.
- *Economics of scale* of physical product production increases asset utilization;
- A large *network spreads overhead* over a wider revenue base and release schedule;
- A large *diversity of artists* assures a steady flow of releases. Release schedules are the largest driver of earnings volatility quarter to quarter;
- *Local artists* improve diversification and typically demand lower advances, which improves economics;
- The size and depth of the *music catalogue* can smooth volatility with 3x higher margins in case hits in the recorded music segment become scarce for a period of time;

Value drivers for Majors drive consolidation.

The Independents

The remaining 20-25% of the worldwide recorded music market consists of small, independent labels, often with a niche position and a small roster of acts. Often, as an independent label grows, it is purchased by one of the Majors.

The market share of Independent labels varies substantially by territory. For example, Independents account for over 40% market share in Japan/SE Asia compared with less than 10% in Western Europe.

Challenges for the Independents
In the US and Europe, the independents' market share has declined steadily over the past decade. Shrinking market shares are symptomatic of several important challenges facing Independent music companies. These include:

Challenges for Independents drive consolidation.

- Rising costs of marketing a worldwide artist- These escalating costs keep many Independents tied to a major label;
- High costs associated with developing a digital and Internet strategy;
- Independents are subject to more risk than the Majors, as consumer tastes for music are fickle and Independents typically have a narrow music focus; and,
- Independents often specialize in creative, but have little power in the worldwide marketplace.
- However, because the release costs (particularly to artists under the studio system) are so much lower than for movies, music is often a way to cross-promote talent with relatively low risk. For example:
  - World Wrestling Entertainment hopes to promote two relative newcomers into superstars. One, John Cena, stars in a low budget upcoming movie produced by WWE Films, *The Marine*, and recently launched a hip-hop album, You Can't See Me.
  - Disney has indicated that Music (pop music and edgier) will be a bigger focus in the future than in the past and is promoting artists like Lindsay Lohan, who also star in Disney movies and TV content.

New Technologies: Opportunities and Risks

Biggest Opportunities: Greater Choice, More Applications
New technologies of the past have driven two of the most rapid expansion phases in the music industry's history: 1) the introduction of cassettes; and, 2) the introduction of CDs. Digital music offers the third great potential growth engine to tap new global markets with greater differentiation by geography or narrowcasted genre and customization of music to individual listener's tastes.

New technologies offer music consumers greater choice and more applications.

Online Penetration Drives Growth
Online penetration is high in much of the music-buying part of the world. As online penetration grows, music becomes more of a service. That is, music companies have historically sold albums or CDs; now they must sell subscriptions to a music service. Music is the only medium whose use increases with online PC penetration, as consumers multi-task; they listen to

music while they surf the web.

As broadband penetration (which enables faster downloads) through cable modems and DSL increases, this drives rapid legitimate online music revenue growth. Such services include iTunes, Real Networks, Rhapsody and Sony Connect.

Portability Drives Revenue Growth
Mobile Network usage also drives new digital revenue streams. Music wants to be mobile. People can listen to music while they move around. Portable music services started in South Korea and Japan, then migrated to Western Europe, and most recently reached the US. As 3G technology and handset penetration increase, new services including music content and downloads will be launched. Today, ring tones are popular in Japan and certain countries in Western Europe and their popularity is growing in the US.

The music companies are embracing ring tones and downloads of music to mobile devices. The business structure has typically been promotional partnerships between mobile operators and music companies, allowing mobile subscribers to stream and sample new music as well as offering personalized artist-related material via the handset. In fact, according to a study released recently by The Management Network Group, 37% of mobile phone users are interested in receiving broadband multimedia content, with music services representing "the most immediate and attractive opportunity."

Video Games Drive Music Revenue
Video Games are becoming another means to distribute music and reach a broader audience than in the past. An increasing percentage of the core music demographic plays video games. As a result, certain video game companies have recently transitioned from paying a license fee to music companies toward being a primary outlet for some of the hottest music on the Billboard charts. Today, some of the top music *is created for* video games. Examples of music's symbiotic relationship with video games include:

- A song that plays during *Madden NFL* or *Need For Speed Underground* can reach millions of consumers in the key age target audience for music.
- Several games available for the Sony PlayStation Portable (PSP) include the MP3s of the game soundtrack which can be enjoyed outside the context of the game.
- Vivendi Universal games division will soon launch a video game called *50 Cent Bulletproof* featuring rapper 50 Cent and his music, from its sister company Universal Music.
- Video game companies sometimes advertise on MTV. This was true of the recent launch of the Xbox 360 which was broadcast as a 30-minute star-studded programming event worldwide.

- Next generation consoles will allow gamers to choose their own soundtrack, customizing the game to play their favorite downloaded music.

Lee Stimmel, vice president of marketing for Atlantic Records, stated in an EA press release in August, 2002: "Games are a great outlet for breaking new artists. When you look at *Madden NFL* football, *NBA Live* and other EA titles, you realize that the time people spent playing these games is enormous and the number of impressions a new song can make is in the hundreds of millions."

As the market has become more competitive, Electronic Arts has established a joint venture with Cherry Lane Music Publishing called Next Level Music LLC. This joint venture will act as an intermediary to license music to play within EA video games, produce albums based on EA game soundtracks, and license out EA's existing music assets for commercials, movies, ring-tones, etc. We believe this is an innovative partnership that could help turn music from a cost center into a revenue stream that could partially offset video game development costs.

Primary Risks: Theft & Disintermediation

Piracy Overview

For most of the past 5 years, piracy has eroded the revenue and margins in the music industry, with the industry reporting negative growth between 1999 and 2002. We estimate that physical piracy (copying of CDs, etc) was about 30% of all music units sold in 2004. We note that:

New technologies increase piracy & disintermediation risks.

- Piracy has always been an issue in the music industry and this is recognized by music industry executives.
- Theft often occurs until copy protection catches up with thieves. For example, there were also disruptions when pay-TV began, as piracy was rampant. HBO fought piracy and sued college kids who were stealing content.
- Some level of piracy represents trial of new music that results in a legitimate music purchase.

Physical Piracy

Physical piracy, as measured in unit terms and in value, has stabilized over the last five years, according to the IFPI. The growth of local music has made some governments realize that they are effectively stealing from themselves. China especially has done a better job of controlling physical pirates owing to its admittance into the World Trade Organization.

Home-based penetration of CD burner equipment and PC "ripper" software for copying CDs is growing rapidly, especially in the US and the UK, and is a more serious home piracy threat than copying music onto analog cassette

tapes from the radio in real time. However, home recording has always been a part of the music industry and it is acknowledged by the music industry as a form of peer promotion that serves as a valuable "underground" marketing vehicle. In music, word of mouth amongst consumers is very important.

How big is physical piracy and how broad-based? Physical piracy is a structural problem for the music industry on a global basis.

Chart 12 includes estimates of physical piracy on a worldwide basis, by country. We note that many countries have physical piracy (illegal CD manufacture and sale, etc) of over 50%.

Chart 12
% of Unit Sales Lost to Pirated Product, 1997 and 2002

	1997	2002		1997	2002
Western Europe			**Asia**		
Greece	10-25	50+	Pakistan	50+	50+
Italy	10-25	25-50	Malaysia	10-25	50+
Portugal	10	25-50	Indonesia	25-50	50+
Spain	10	25-50	China	50+	50+
Belgium	10	10-25	Thailand	25-50	25-50
Finland	10	10-25	Taiwan	10-25	25-50
Netherlands	10	10-25	Phillippines	10-25	25-50
Austria	10	10	India	25-50	25-50
Denmark	10	10	Hong Kong	10-25	25-50
France	10	10	South Korea	10-25	10-25
Germany	10	10	Singapore	25-50	10-25
Ireland	10	10	Australia	10-25	10
Norway	10	10	New Zealand	10	10
Sweden	10	10	Japan	10	10
Switzerland	10	10			
United Kingdom	10	10	**Latin America**		
			Argentina	10-25	50+
Eastern Europe			Brazil	25-50	50+
Romania	50+	50+	Colombia	10	50+
Russia	50+	50+	Mexico	25-50	50+
Czech Republic	25-50	25-50	Uruguay	10-25	50+
Hungary	10-25	25-50	Venezuela	25-50	50+
Poland	10-25	25-50	Chile	10-25	25-50

Source: PriceWaterhouseCoopers, IFPI.

Digital Piracy

The emergence of online connectivity and digital music over the past decade has driven the growth of new entrants into the music industry value chain. Internet and digital technologies have resulted in strong negative growth trends in music sales from digital piracy during most of the past five years. Bottom line: *these new technologies change not only the format in which music is sold and distributed but the way it is produced, marketed and consumed.*

P2P networks become incredibly powerful in a broadband world. Because P2P networks are difficult to sue, as they are driven by decentralized software with no central server, record companies did not act fast enough via legal prosecution to stem theft. In the past several years, industry bodies such as the International Federation of the Phonographic Industry (IFPI) and the Recording Industry Association of America (RIAA) have begun to vigorously pursue piracy through litigation against individual users and illegal web sites around the world. The litigation strategy is a global one. Public opinion generally supports prosecution of music theft, although sympathy varies on a country by country basis.

Chart 13 includes selected P2P sites and shows their download statistics and litigation status as of 2003.

Chart 13
Peer to Peer Networks, 2003

NAME	DISTRIBUTOR	BUSINESS MODEL	LITIGN. STATUS	NUMBER OF DOWNLOADS
Kazaa	Sharman Networks	Advertising supported	Sued by RIAA, MPAA	228 million
Morpheus	Streamcast	Advertising supported	Sued by RIAA, MPAA	112 million
iMesh	iMesh.com	Advertising supported	Not sued	49.7 million
Grokster	Grokster	Commercial service, ad supported	Sued by RIAA, MPAA	7.9 million
eDonkey	Jed McCalleb	Advertising supported	Not sued	50 million
BitTorrent	Bram Cohen	Freely available technology	Not sued	1.4 million
Gnutella	Various (open source)	Some advertising supported, others not	Not sued	Unknown

Source: Borland, 2003

Industry groups also resorted to educating consumers. By 2003, through advertising, the music industry had achieved 66% worldwide awareness that file swapping was illegal.

Another thing that elongated rampant online piracy was that legitimate alternatives were slow to develop. That changed in 2004, and we expect the success of Apple and other legitimate services to attract new competitors (like Yahoo) and greater price competition (which should accelerate music sales growth) in 2005.

Another Threat: Disintermediation by Artists

A second threat posed by the Internet is the potential disintermediation in finding new acts, marketing, and distribution. However, we believe that the online disintermediation threat to music Majors from artists is overblown. Artists are using the Internet at the beginning and end of their careers, but not in the middle. The beginning and end of an artist's career tend to be the least profitable.

Most artists that have become successfully recognized on the Internet are signed by music labels. Artists still need the Artist & Repertoire (A&R), marketing and distribution backing provided by music labels to maximize their earnings potential. In addition, the labels pay advances and bear the risk of failure.

Digital Rights Management

As discussed earlier, physical piracy and digital piracy both deplete value from the music industry. Intellectual Property issues are at the center of the music industry. To retain the demand/value link, Digital Rights Management (DRM) must be added to delivery platforms.

DRM remains a challenge.

- The music majors need to have effective CD copying control software. With a CD, the consumer can do whatever he/she wants. He/she can play it in the car, the living room, bedroom, log cabin, house boat, at work, on the kids' CD player, or in the office. They can even rip the CD (legally) to any number of devices without restriction.
- Secure delivery must be one of the key functions in the new online value chain, especially working with the P2P software providers to offer secure DRM solutions. This becomes more urgent now that broadband is well penetrated in so much of the music-buying part of the world.
- We believe DRM software is likely to be broken by professional hackers but the scope of the piracy will be in a minority: since each piece of DRM-wrapped content has a unique number, it is possible to trace the source of the piracy.

Music Industry Value Chain

The stages of value creation within the music industry are:

- Artists & Repertoire (A&R), which includes finding new acts;
- recording music, which includes recording studios, production, composition, and the licensing of copyrighted material;
- manufacture of mechanical recording onto compact discs (CDs), cassettes, mini-discs, vinyl, etc;
- distribution and logistics;
- promotion and marketing; and
- retail distribution channel management.

This section describes how the music industry works.

Music Industry Value Chain Participants

Composer / Songwriter: The songwriter is the original author of the music. This can either be an artist or band, or a separate company or individual. The composer receives a share of the royalties.

Artist / Band: The most visible part of the music value chain is the band or artist. These are also the creative elements of the recording process. In the

traditional music industry the only way to earn revenues from the creative process is to be signed by a record label. The artist often receives an advance against his share of record sales plus fees per unit sold.

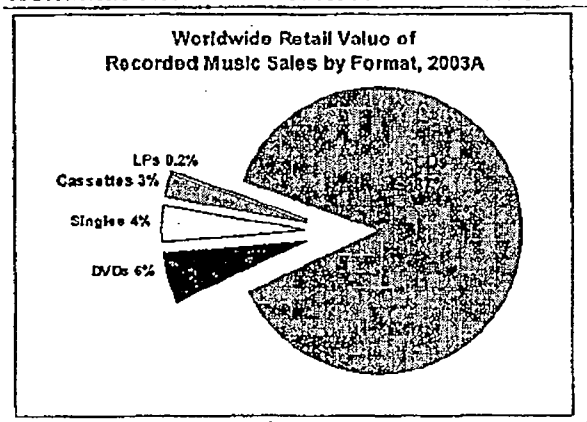
Publisher: A music publisher is the librarian of music intellectual property. The publisher represents and administers the copyright of songs and collects royalties from any licenses granted to use the music in records, movies, television programs, films, restaurants, radio, advertising, etc.

Manufacturing
Until recently, manufacturing was often done by the huge record labels themselves. Typically, the independent labels do not have their own pressing facilities. Packaging and artwork for CD covers is an integral part of this step.

Today, the primary form of physical manufacturing is CDs. CDs have steadily grown in percentage terms, with cassettes and singles declining. CDs are the main format for retail sales, with cassettes declining on a worldwide basis except in Eastern Europe, Asia and Latin America. In Western Europe, cassettes sell to older people and have held up owing to the installed base of cassette machines in cars. LPs (vinyl) are virtually gone. Singles are generally loss leaders to attract young buyers.

Chart 14 shows the mix of physical production of recorded music.

Chart 14
Worldwide Retail Value of Recorded Music: Sales Mix by Format, 2003



Source: IFPI

Marketing
Marketing and promotion of music is an important value creator in the value chain. The Majors all do this themselves and often regard it as a core competence. Radio, TV, MTV, press, Billboard charts and personal appearances are all used to maximize the exposure of artists to consumers.

Radio Stations
Radio Stations are the primary source of promotion for new music. Radio Stations are often given music by record labels as promotions. Gaining radio airtime for their acts is a key promotional tool for record labels, and "play lists" of heavily promoted songs and artists do influence consumers' buying habits. The launch of satellite radio companies that fragment audiences through greater choice, and the explosion of niche radio stations (e.g., Jazz FM) threaten the role of radio stations as the promotion vehicle of choice for recorded music.

MTV
MTV is an important source of promotion for new music. The music companies typically give videos to MTV at no cost as a promotion in order to gain awareness for a new album, song or artist.

Internet Marketing
With the arrival of the Internet, the possibility of narrowcasting target audiences with music has increased substantially. Marketers must increasingly appeal to a more sophisticated music-buying public. New media and Internet promotion is becoming increasingly common.

Distribution
This activity involves getting the CD, DVD or cassette from the manufacturer to retail outlets. Typically, the Majors handle this activity themselves. In addition, there are several specialist distribution firms and wholesalers that are used by the independent labels.

Retail Distribution Channel Shifts
The final stage in the music value chain has historically been through stores that sell music to consumers.

Over the past decade, distribution through low margin non-music retail stores (such as Wal Mart) has exploded. Mass market retailers markedly increased their share of the retail music market, from nearly 20% in 1990 to about 45% in 2004 in the US. We estimate that Wal Mart alone represented about 20% of all music sales in the US in 2004. Mass marketers sell a much narrower range of music, typically only the top 50 hits. Supermarkets and other non-specific music retailers use a low price point with low margins to generate traffic to their store. This put enormous pressure on music-only retailers, and

resulted in bankruptcies and bad debts.

From a demand point of view, the shrinkage of the number of record stores has reduced the distribution and range of music available, affecting total physical sales since 1996, when Wal Mart, Kmart and Best Buy entered the market. The profile of music buyers at these stores is skewed to younger people (16-34), but bookshops such as Borders and Barnes & Noble have been successful in selling music to older demographics in the US.

Unconventional retail channels are also emerging. For example:

- Starbucks is driving music sales as a growth strategy. Starbucks introduced its "Hear Music" Coffeehouse concept in 2004, which gives customers an 'interactive listening bar' that allows them access to CD burning to create personalized CDs from a digital library of music. Starbucks is testing this concept in select retail stores.
- Regal Entertainment is increasingly using its theater base as a venue for digitally simulcasted presentations of live concert events, generally timed concurrent with the release or re-release of a CD. This is a promotional boon for Music content owners, as it allows them to cast a wider net for concert attendance and has the added benefit of promoting CD sales.

Music distribution is one area where the Internet is playing an important role, both as a vehicle for physical product sale (successful websites such as CD.com and CDnow.com) and digital downloads such as iTunes. The rise of digital delivery should make music sales less sensitive to economic downturns, as it lowers physical product shipments to music and general stores that could turn into bad debts. However, music Majors must be careful not to upset their music retailers as they pursue online sales.

Consumers
Consumers are the end users of the music. Customers historically have purchased the physical product on a storage medium such as a CD, DVD or cassette. However, increasingly, consumers are using online forms of distribution to purchase their music, such as downloaded MP3 files.

Our Projections for Recorded Music Growth

For 2005 and 2006, we forecast 1% growth in recorded music, which is consistent with flat revenue in 2004 for recorded music.

We project 1% music industry revenue growth in 2005 & 2006.

Unit Sales
We project unit sales to grow 2% in each of the next two years, driven by physical piracy crack-downs in the worst offending countries and by the growth of legitimate online music services that will allow music companies to get paid for their music again.

Pricing
Music pricing has had various influences. Average pricing of music benefited from the growth of the higher priced CD vs. cassette format as consumers replaced their libraries. However, more recently, retail pricing has suffered from heavy sales by mass market retailers who are selling CDs at low margins as traffic generators, to tempt people into their stores to spend on other goods.

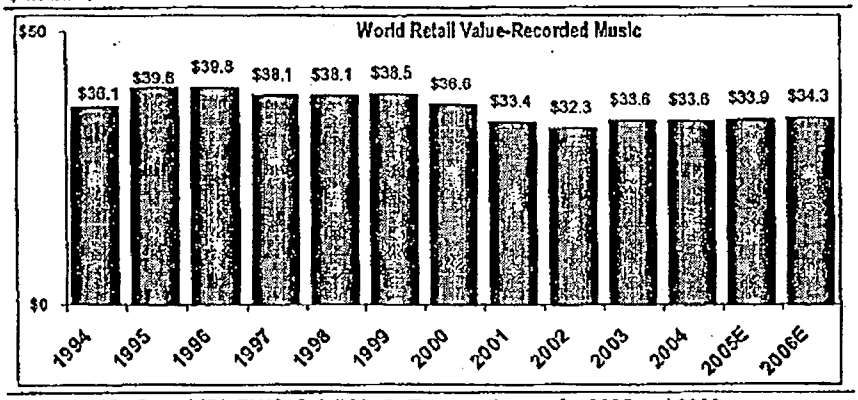
Given the rapid growth of online music demand, we expect music prices to continue to fall as downloading transcends national boundaries and creates lowest common denominator pricing.

Margins
Unlike the film business, the margins in the recorded music business are positively correlated to market share. Sony/BMG and Universal Music Group, the largest music Majors, have the highest margins in the music industry, followed by EMI which is the world's largest music publisher.

We project flat margins. We believe that downward pressure on pricing in the download world, plus the need for additional marketing and file management and protection costs will be offset by the removal of manufacturing and distribution costs. In the physical world, Majors have recently pools their manufacturing and distribution which should achieve greater cost efficiencies.

Chart 15 includes the worldwide retail value of recorded music between 1994 and our estimates for 2005 and 2006.

Chart 15
Worldwide Retail Value of Recorded Music, 1994-2006E
$ in billions



Source: 1994-2004 IFPI, PWC. Solell Media Team estimates for 2005 and 2006.

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Blockbuster	BBI	$9.42	Hold	Microsoft	MSFT	$25.90	Not Rated
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JAKKS Pacific	JAKK	$20.49	Not Rated	Vivendi	V	$31.00	Not Rated
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Digital sales reached $1.1bn, but global value of recorded music still fell in 2005

The trade value of digital global recorded music sales rose by 188% to $1.14bn in 2005 from $397m in 2004, according to international record industry association IFPI. Despite this huge rise, however, the combined trade value of digital and physical recorded music sales fell by 3%, to $21bn (*see table on page 6*) and the combined retail value of digital and physical recorded music sales fell by 1.6%, to $21bn.

The reason for the fall was the continued decline in the physical recorded music market, which fell 3.7% in 2005 to $32.36bn in current dollar terms, according IFPI (*see table below*). The fall in 2005 was the sixth successive annual drop in the global value of recorded music sales; the apparent rise in 2004 was as a result of the fall in value of the dollar against the world's major currencies. IFPI reported that the value of all physical formats fell in 2005 (*see table on page 2*). The trade value of CDs fell 6% to $17.2bn, the trade value of singles fell to $721m and the combined trade value of MCs, LPs and others fell 30% to $372m. Even sales of music DVDs, which had previously been seen as a format that would produce several years of growth in the physical market, fell by 4% to $1.54bn. This meant that, at $1.1bn, digital in 2005 was the third largest revenue stream for record companies. It looks certain to overtake music DVDs and be second in 2006.

World recorded music sales: Growth and decline in current US dollars, 1993 – 2005 (%)

	Retail value ($m)	Value change (%)
1993	30,775.0	+10.6
1994	36,128.2	+14.9
1995	39,620.9	+6.2
1996	39,765.7	+5.5
1997	38,082.8	+2.0
1998	38,074.7	+3.0
1999	38,532.1	+1.5
2000	36,630.1	-1.3
2001	33,373.8	-5.0
2002	30,980.9	-7.2
2003	32,012.2	-7.6
2004	33,613.6	+5.0
2005	32,356.0	-3.7

Source: IFPI

A comparison between the physical and digital markets shows that in general digital sales increased the trade value of a recorded music market by some 1%. Thus in Canada, where the value of physical sales fell by 4%, the combined value of digital and physical sales fell by only 3%. The respective figures for France were similar at -3% and -2% (*see table at the top of page 3*). However, in the more developed digital markets, such as those of Japan and the US, which together at $914m accounted for 83% of the value of the digital sales in the Top 10 digital markets in 2005, the impact of the move to digital was far more striking. Whereas in Japan the trade value of physical sales fell by 2%, the combined value of digital and physical sales rose by 1%. The respective figures for the US were even more dramatic at -8% and +0.6%.

In view of the fact that at $1.1bn the Top 10 accounted for 97% of global digital sales of recorded music in 2005 and that the digital market is continuing to grow internationally, it would seem that this uplift will continue, possibly at a higher rate. However, what is less clear is whether the rate of decline of physical sales, which was less in 2005 than was expected, will remain steady or will rise.

Leaving aside the matter of piracy, which is set to be a constant feature of the recorded music market, it is becoming increasingly clear that the physical and digital markets are as different as they are similar and that, accordingly, several of the factors affecting physical sales, such as increased competition from other entertainment products, will continue. Another limit on

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World sales

physical sales would be any extension on copy-protection which would further curtail what consumers could do with CDs and, accordingly, restrict their appeal. There has been some growth in the physical market. For example, in the US the childrens' recorded music market grew significantly in 2005 and continued to do so in 2006 (*see* M&C 317/3). However, for the most part such growth has been in niche areas that because of their size can account only for marginal growth compared to the general continued decline of the mainstream market. Hit albums continue to sell in large quantities. For example, Coldplay's *X & Y*, which was the best-selling album of 2005, (*see table on page 6*), according to IFPI, sold a little over 8m units. However, the overall figures for best-selling albums are falling. In the US, whereas the Top 100 albums sold 153.3m units in 2004, in 2005 they only sold 128.1m units; a fall of 16%. The same is generally true of other mature recorded music markets.

In contrast, the digital market has far more potential. In 2005 there were three significant digital channels: online *a la carte* sales (which accounted for 44% of all digital sales), mobile (49%) and online subscriptions (7%). Moreover, within the *a la carte* market there is growing evidence that single track downloads comprise a significant proportion of album tracks as well as tracks designated as singles and furthermore that a number of them are 'bundled' whole albums. There is some evidence that bundling is growing (*see separate story on page 8*) and becoming a significant part of the digital download market. Certainly as Classical music takes an increasing share of the online market, a trend already visible now (*see separate story on page 13*), bundling will inevitably grow.

Equally importantly, whereas in the past the

World: Trade value of recorded music sales by format in 2005

	Value ($m)	% change on 2004
CD	17,019	-6
DVD	1,540	-4
Digital sales	1,143	188
Singles	721	-12
Other physical product	372	-30

Source: IFPI

great fear of record companies was that of cannibalisation, that any growth in their digital sales would be at the expense of physical sales, it is clear that consumers make a far wider use of digital music product than they do of physical product. Evidence for this can be seen in the table at the foot of page 3. The percentages for the mobile and online sectors of the various digital markets have been as regionally diverse as the general usage differences, with Asian consumers having migrated to the mobile consumption of recorded music far faster than their European and North American counterparts.

However, there are signs that this is breaking down. Whereas in Japan mobile accounted for 91% of digital sales, Italy, rather than as one might have expected South Korea, had the second highest percentage of mobile use (69%). The increase in the avenues through which the mobile consumption of recorded music in the US has taken place in 2006 (*see Tracking in previous issues passim*) confirms that there is a clearly defined mobile market as opposed to the online market and that both markets looks set to grow. In 2005, master ringtones largely supplanted simple monophonic ringtones. However, within the mobile market, over-the-air (OTA) downloads are growing rapidly. This will only increase

the big figure:

$1.91bn

The loss to British music producers over the past three years due to piracy, according to a report released by UK-based research group TNS. The trade value of this is £650m ($1.13bn). TNS calculated that the cost to British music producers in 2005 of people illegally file-sharing rather than paying for music was £414m ($718m).

as dual OTA downloads – downloads sent to a mobile telephone and a PC – become a significant part of the music market.

In the past, the record industry saw the expansion of the ways of consuming recorded music entirely in physical terms, in which a new format, such as the CD, replaced a (failing) format, such as the LP or MC. Thus, when sales of the new format, in this case the CD, faltered the solution was seen to be the introduction of a new physical format such as the MiniDisk, SACD or DualDisc. While some of these formats have found niche markets, they have failed to significantly expand the (physical) market for recorded music in the way that the digital sector has. Moreover, whereas physical formats largely meant separate patterns of consumption both at retail and within the home, in the digital sector, as the Hi-Fi, television, PC and portable device have become increasingly intimately connected – so much so that the lack of interoperability is now seen as a problem – so the patterns of consumption have grown together rather than apart.

From this perspective, MUSIC & COPYRIGHT considers that, even without a return to growth of the physical recorded music market, the major international record companies will report profit growths rather than profit falls in 2006 and beyond. Evidence or this is the recent results of Sony BMG, and WMG, both of which reported increased profits on lower revenues (*see* M&C 316/2, 315/5), while UMG even managed to increase its revenues as well as its profits (*see* M&C 317/5). The levels of profitability have been considerably less than in the past. However, if the promise represented by the online and mobile revenue streams is fulfilled and the major international record companies maintain their control on costs, which they have set as a priority over the past few years, it seems possible that the recorded music industry could return to a higher level of profitability, if not to the very high levels of a decade ago.

The growth and decline of the physical and digital markets compared in selected territories (%)

	Physical market	Digital and Physical market
Australia	-11	-10
Canada	-4	-3
France	-3	-2
Germany	-0.5	0
Japan	-2	+1
US	-8	-0.5

Source: IFPI

In 2005, North America at $7.56bn accounted for 36% of the trade value of all recorded music sales, with the US reporting an overall fall in sales of 0.6% and Canada a fall of 3%. In Europe, the fall in value was generally less in the major territories, such as France, Germany and the UK. Another difference was that in several European territories, for example, Austria, France, Italy and Spain, mobile recorded music sales were higher than online sales, suggesting that, whereas previously such a trend was restricted to Asia, it could well become a global one in 2006-2007.

Within Asia, it is likely that the growth of legitimate online services, which has been hampered by a large number of unauthorised services, will result in an greater proportion of the dig-

Continued on page 4

The World: The trade value of the Top 10 recorded music digital markets in 2005

	Total Digital Market			Digital sales by Channel	
Country	Value ($m)	Local currency	Value (local currency)	Online	Mobile
USA	636	USD	636	68%	32%
Japan	278	JPY	30,587	9%	91%
UK	69	GBP	38	62%	38%
Germany	39	EUR	31	66%	34%
France	28	EUR	22	47%	53%
Italy	16	EUR	13	31%	69%
Canada	15	CAD	18	71%	29%
South Korea	12	KWR	12,045	42%	58%
Australia	7	AUD	10	41%	59%
Netherlands	5	EUR	4	82%	18%
TOTAL	1,105				

Source: IFPI

continued from page 3

Global recorded music sales

ital market being accounted for by legitimate services. In Japan the launch of iTunes in August had a dramatic effect and as a result MUSIC & COPYRIGHT expects that the percentage of recorded music sales accounted for by the mobile sector in 2006 will fall significantly from 2005's 91%. It also seems likely that such a trend will also be seen in Australia, where over one third of the trade value of digital sales, $7m, took place in the last two months of the year following the launch of iTunes there.

There was no significant digital market in Latin America in 2005. The one minor exception was Brazil where digital recorded music sales accounted for 1% of the trade value of overall sales (*see table on page 6*). However, this produced no uplift for the market as a whole which fell by 12%, largely as a result of the collapse of the mid-price market and the far harsher credit terms operated by the majors in the wake of the large number of entertainment retailer bankruptcies in 2004 (*see* M&C 311/8). In contrast the severe credit terms in Mexico and a series of lower price campaigns resulted in a 10% increase in the trade value of sales in Mexico. However, as yet there is no significant digital market there. That looks likely to change in 2006.

IFPI's 2005 figures are based on the trade rather than the retail prices of recorded music product. Previously IFPI's figures have been based on the suggested retail prices that retailers sell recorded music at. This had the effect of inflating the value of recorded music sales, particularly at a time of heavy discounting which has been the main strategy adopted by retailers seeking to preserve the physical market and their share within it. By using trade values, what record companies actually receive rather than the retail prices of recorded music product, they are far more accurate than they have been in the past.

Internet brings growth to Classical music, although physical sales continue to decline

The Internet is starting to stimulate sales of Classical music, the physical sales of which have been falling across the world for several years.

In the UK, for example, in 2004, the latest year for which figures are available, the trade value of Classical sales was £50.2m ($91.3m), the lowest since 1986, and accounted for 4.6% of total physical sales (*see table below*). However, in 2005, despite the limited selection of titles available and its poor search engine, Classical music accounted for 12% of sales of the UK iTunes music store. The contrast is even more striking in the US. According to Nielsen SoundScan, which collates offline and online sales there, whereas sales of classical CDs fell by 15% in 2005, digital downloads of Classical albums, grew by 94%. While this growth is from a small base, it seems to be a general trend. In 2005 a number of record companies reported that their share of the download market at 7% was more than double that of their share of physical sales.

In the wake of this partial revival, the major international record companies, who had significantly reduced their commitment to Classical music, have once again returned to the Classical market (*see below*).

The current value of the offline Classical market is in contrast to the period 1986-1991 when, largely led by the CD boom, the retail value of the global sales of Classical music doubled to $2bn to account for 7.3% of 1991's global sound-carrier sales of $27.5bn, according to international record industry trade association IFPI. The decline took place despite a wide range of marketing activities by record companies, including presenting Classical performers as sexy and/or akin to rock stars, stretching the definition of the music – the best selling Classical albums of 2004 in the UK, according to UK record industry trade association BPI, included the soundtrack to *Lord of The Rings – The Return of the King* and *The Very Best of Classical Chillout Gold* – to associating classical performances (and a few performers) with hugely popular (sporting) events, as in the case of the Three Tenors. Although there have been criticisms of 'dumbing down', all these strategies have had limited success.

However, offline Classical sales overall continued to fall. Moreover, it has been impossible to adapt such strategies, which work best on titles featuring a few star performers, to the

Classical music as a percentage of sales in the Top 10 markets by value in the world in 2003 and 2004 (%)

	2003	2004
US	3.0	2.0
UK	5.8	4.6
Germany	6.0	6.0
France	5.0	5.0
Australia	4.0	4.0
Canada	6.0	5.0
Italy	4.0	4.0
Spain	7.0	6.0
Netherlands	5.0	4.0

Source: IFPI, National IFPI groups

core symphonic and operatic works of the Classical tradition which require symphony orchestras and costly and carefully planned recording schedules in which it only makes sense if several associated works are scheduled for recording. This issue of cost was directly addressed by Naxos, which made low cost recordings and sold them at low cost, and the many labels that sprung up in its wake. While they found a niche market for themselves they did not seriously challenge the economics of Classical recording when it came to large orchestras and large projects.

In response to the continued fall in sales the major international record companies began to significantly cutback on their Classical recordings. A dramatic example of this was the decision by UMG Classical record label Deutsche Grammophon not to continue with the recording of the Bach cantatas by conductor John Eliot Gardiner who had planned to tour and record the cantatas, which would have resulted in some 50 CDs, in 2000 – 2001. Gardiner, who already ran his own choir and orchestra, responded by forming his own record company, SDG, to record the cantatas, the first of which were released in 2005. Paying the performers royalties, as opposed to fees in advance, and recording live at concerts, which is much cheaper that lengthy studio recordings, the recordings are profitable for all concerned with sales of around 5,000, which is far lower than if they had been recorded and released by one of the majors. Other orchestras have taken a similar approach. Thus, the London Symphony Orchestra has created LSO Live.

Initially created with the idea of generating supplementary live revenues – live recordings were initially sold at concerts – the Internet, where shelf space and stocking policies pose no problems, has significantly increased the availability and sales of such recordings. In 2005, 31% of LSO Live's US revenues came from digital sales. A further mark of the potential the Internet offers Classical music came in June 2005 when UK public broadcaster BBC made the complete Beethoven symphonies available for free on its website for two weeks and there were 1.4m downloads. While record companies complained that the recordings, which were in competition with their own, were for free, the exercise demonstrated that there was a far bigger online market for Classical music than had been previously thought.

This, and the possibility of making low-cost/high-quality recordings, has renewed the interest of record companies in Classical music. In June 2005, UK Classical independent Chandos Records launched a download music store at its website from which it sold CDs. Initially the website had three CD orders to each download but within a year the ratio was reversed and now there are 8,500 tracks on the website available for download, the equivalent of around 850 CD albums. Because the simple price per track introduced by iTunes, which makes sense for Pop and Rock music, is not applicable to classical music Chandos introduced a price by time plan, charging £0.40 ($0.72) per five minute download or close equivalent. Chandos is currently in negotiations with other Classical independents to make their recordings available at its download store.

There are also online websites in the US, such as eClassical.com, Classical.com and classicalarchives.com, but these are mostly signposts to established online stores, such as iTunes. As such they have not significantly expanded the online Classical music market.

That looks set to change with the recent moves by a number of the majors and other record companies which have sought to exploit both new and back catalogue material online. UMG has announced *DG Concerts* and *Decca Concerts*, which have been constructed in partnership with selected orchestras and will combine digital downloads with traditional CD releases. Starting with the New York Philharmonic, and the Los Angeles Philharmonic, UMG plans to release an average of four live concert recordings per orchestra each year for digital downloading only. In addition, one concert per year, chosen as the highlight of the season, could be released on CD. The first *DG Concerts* release, a recording by the New York Philharmonic of the last three Mozart symphonies, which retails at $9.99, last week topped the iTunes US Classical charts and was in the overall iTunes Top 50 downloads.

UMG's three year agreement with the New York Philharmonic is indicative of the economics of the new classical market. As part of the contract, the members of the Philharmonic receive royalties rather than the usual flat fee up front. However, in return the recordings remain the property of the Philharmonic and are merely licensed to UMG. Because the recordings will be of live performances by the orchestras, UMG will have no studio session costs, which would normally be between $150,000 and $250,000 for such major recordings. After the performance, the orchestras will provide the record companies with edited tape of it and UMG will do the mastering, prepare the material for downloading, create artwork and liner notes and handle the promotion of the finished product via the established online music stores.

UMG has also moved to use the Internet to take advantage of the fact that digital music providers offer extended shelf space, compared to bricks and mortar retailers, to repertoire that typically sells slowly over the long term. In 2005, to celebrate the 80th birthday of Pierre Boulez, UMG made 10 of his out-of-print albums available for download only and produced a special compilation showcasing him as conductor and composer. Earlier this month WMG launched its archive of Classical recordings online. It initially make 300 albums available online and if the programme is a success plans to nake 25,000 titles available. Later this year, in what looks set to be a major event in the Classical market, EMI will make its entire collection of operas and recital programs by Maria Callas available to download.

Smaller companies are also taking advantage of the new market for Classical recordings. Naxos US, which said that in 2005 its digital sales accounted for 8% of its total sales and projects that in 2006 this will rise to 13%, is currently seeking to exploit its repertoire of 85,000 tracks via a growing number of digital service providers, all of which are interested in extending their reach into the appealing demographics of the Classical music audience.

The world: The trade and retail value of recorded music sales in the leading 20 markets

		Trade Revenues 2005					Retail Value 2005	
		Value ($m)	Value (Local Currency)		% Change	% Digital	Value ($m)	Value (Local currency)
1	USA	7,012	USD	7,012	-3	9	12,269	12,269
2	Japan	3,718	JPY	409,845	1	7	5,448	600,497
3	UK	2,162	GBP	1,189	-3	3	3,446	1,895
4	Germany	1,457	EUR	1,166	0	3	2,211	1,769
5	France	1,248	EUR	999	-2	2	1,990	1,592
6	Canada	544	CAD	659	-3	3	732	1,886
7	Australia	440	AUD	576	10	2	674	883
8	Italy	428	EUR	343	0	4	669	535
9	Spain	369	EUR	295	-5	1	555	444
10	Brazil	265	BRL	645	-12	<1	394	958
11	Mexico	263	MXP	2,863	-10	<1	412	4,487
12	Netherlands	246	EUR	197	-14	2	431	345
13	Switzerland	206	CHF	257	-3	1	261	334
14	Russia	194	RUB	5,477	-37		388	10,961
15	Belgium	162	EUR	129	-7	2	262	209
16	South Africa	159	ZAR	1,010	-10	<1	254	1,618
17	Sweden	148	SEK	1,107	-9	2	240	1,795
18	Austria	139	EUR	111	-5	3	285	228
19	Norway	133	NOK	857	-12	1	253	1,627
20	Denmark	113	DKK	679	-2	1	180	1,080
	Other	1,387			-8	6	2,096	
	Total	20,793			-3	5	33,456	

Source: IFPI

For coment see story page 1

Best-selling albums in the world in 2005

	Artist	Title	Record Company
1	Coldplay	*X&Y*	EMI
2	Mariah Carey	*The Emancipation Of Mimi*	UMG
3	50 Cent	*The Massacre*	UMG
4	Black Eyed Peas	*Monkey Business*	UMG
5	Green Day	*American Idiot*	WMG
6	Madonna	*Confessions on a Dance Floor*	WMG
7	Kelly Clarkson	*Breakaway*	Sony BMG
8	Eminem	*Curtain Call*	UMG
9	James Blunt	*Back to Bedlam*	WMG
10	Robbie Williams	*Intensive Care*	EMI

Source: IFPI

For coment see story page 1

COMMENT: The two tables on the immediate right on page 7 offer a detailed account of the US recorded music market in recent years as collated by US record industry association RIAA. The top table offers a comprehensive account by format (units and value) of offline physical sales over the period 2001-2005, and the one below offers a detailed picture of digital recorded music sales in 2004 and 2005.

The most notable feature of the physical sales table is that in 2005, with the one exception of music DVDs which grew slightly by 3% in unit terms (but fell by 1% in value terms), sales of all recorded music formats fell in both unit and value terms. The impact of the fall was most clearly seen in the performance of the leading releases of the major international record companies. Whereas in 2004, according to SoundScan, the Top 100 albums collectively sold 153.3 units, in 2005 they sold 128.1m units a fall of 16%.

While the huge rise (485%, from $183.4m to $1.07bn) in total digital sales did not fully compensate for the fall in offline sales, growth within the various digital streams was impressive.

US: Sales of physical recorded music, 2001–2005

	2001	2002		2003		2004		2005	
CD singles (units m)	17.3	4.5	(-74)	8.3	(+86)	3.1	(-62)	2.8	(-12)
CD singles (retail value $m)	79.4	19.6	(-75)	35.9	(+84)	15.0	(-54)	10.9	(-27)
Vinyl singles (units m)	5.5	4.4	(-21)	3.8	(-14)	3.5	(-7)	2.3	(-35)
Vinyl singles (retail value $m)	31.4	24.9	(-21)	21.5	(-14)	19.9	(-7)	13.2	(-33)
LPs & EPs (units m)	2.3	1.7	(-24)	1.5	(-12)	1.4	(-12)	1.0	(-25)
LPs & EPs (retail value $m)	27.4	20.5	(-25)	21.7	(+6)	19.3	(-11)	14.2	(-26)
MC albums (units m)	45.0	31.1	(-31)	17.2	(-45)	5.2	(-70)	2.5	(-53)
MC albums (retail value $m)	363.4	209.8	(-42)	108.1	(-49)	23.7	(-78)	13.1	(-45)
CD albums (units m)	881.9	803.3	(-9)	745.9	(-7)	767.0	(+3)	705.4	(-8)
CD albums (retail value $m)	12,909.4	12,044.1	(-7)	11,232.9	(-7)	11,446.5	(+2)	10,520.2	(-8)
Music video (units m)	17.7	14.7	(-17)	19.9	(+36)	32.8	(+65)	33.8	(+3)
Music video (retail value $m)	392.2	288.4	(-12)	399.9	(+39)	607.2	(+52)	602.2	(-1)
Total rec music (units m)	958.5	859.7	(-11.2)	798.4	(-7.2)	814.1	(+2)	748.7	(-8)
Total rec music (retail value $m)	13,740.9	12,609.2	(-8.2)	11,847.9	(-6.0)	12,157.4	(+3)	10,477.5	(-8)

The figures in brackets are the percentage changes on the previous year. Figures may not add up due to rounding

Source: RIAA

US: Digital deliveries, 2004–2005

	2004	2005	change
Download single (units m)	139.4	336.9	(+163)
Download single ($m)	138.0	363.9	(+163)
Download album (units m)	4.6	13.6	(+199)
Download album ($m)	45.5	135.7	(+199)
Music Video (units m)		0.7	n/a
Music Video ($m)		1.0	n/a
Total units (m)	143.9	383.1	(+166)
Total Value ($m)	183.4	503.6	(+175)
Mobile (units m)		170.0	n/a
Mobile ($m)		421.6	n/a
Subscription services (units m)		1.3	n/a
Subscription services ($m)		149.2	n/a
Total digital, mobile and sub ($m)	183.4	1074.5	(+485)
TOTAL DIGITAL & PHYSICAL ($M)	12,338.1	12,269.5	(-0.6)

Source: RIAA

The Top 10 singles recorded music market in 2005

	Singles sales (units m)	% of singles that were digital
US	372	99
Japan	76	16
UK	53	49
France	34	25
Germany	33	46
South Korea	12	99
Canada	11	97
Australia	10	21
Italy	4	76
Belgium	14	32
Total	609	74
Others	90	n/a
GRAND TOTAL	699	n/a

Source: IFPI

For comment see story page 1

The value of mobile recorded music sales (including ringtones, ringbacks and other artist-related content) reached $422m, download sales grew to $500m, of which $135.7m (or 27%) was accounted for by full album downloads, and recorded music subscription revenues was $149m. The 198% increase in album downloads, at a time when the general view has been that single track downloads would cannibalise such sales, is particularly significant, suggesting that on the Internet there is a place for both bundled and unbundled recorded music.

Investors rally behind WMG, but some ask whether the company's plans are short or long term

WMG reported revenues of $1.04bn for the three months ending December 31 2005. This was down 4% from the corresponding period in 2004 and flat when adjusted for foreign exchange rates and the sale of its sheet music business. However, for the same period WMG's operating profits rose 11% (*see table on page 9*) This performance was similar to that of Sony BMG which reported a 1% fall in but a rise in operating profits in the same period(*see* M&C 314/2), while UMG reported a 1.7% fall in revenues to $2.04bn and a fall in profits for the period (*see* M&C 316/5).

These results follow a lengthy period in which restructuring and retrenchement were the norm and valuations of recorded music companies were low. There is a new confidence in some music and music publishing major players Thus, Vivendi Universal, the parent company of the world's largest record company UMG and of a far smaller music publishing operation, the Universal Music Publishing Group (UMPG), has both restated its commitment to music as a core activity and has said that it is actively seeking to increase its music publishing interests. Others, seem more concerned to take advantage of the increased valuations placed on music companbies by the investment community. Thus, German media group Bertelsmann has let it be known that, in order not to become a public company, it is considering selling its 50% share in Sony BMG and its wholly owned music publishing company BMG Music Publishing (*see separate story in Tracking*).

In view of the more positive valuations that have been placed on both music publishing and recorded music companies by analaysts recently, the performance of WMG, which with EMI is the only pure music company, has been widely seen as an indication of what the future of recorded music sales might be in the digital age. Such views come despite the fact that, according to international record industry association IFPI, the trade value of overall recorded music sales in 2005, including both digital and offline, fell by 5% to $20.8m (*see separate story page 1*).

This continued return to profitability – in 2004-2005 it reported operating profits of $84m – comes at a crucial time for WMG. In mid-2005, WMG, looked to be in turmoil. Ahead of its controversial Initial Public Offering (IPO) in May there were condemnations of executive pay bonuses and the placements of bonds that in effect meant the original members of the consortium who had bought WMG from Time Warner recouped their investments at the cost of increasing WMG's debts to initial investors (*see* M&C 297/8).

This led to suggestions by several analysts that the new management team did not see their investment as a long term one and that their aim was to make their real profits from a sale/merger with EMI. Evidence put forward for this was that in addition to general cost-cutting WMG also significantly cut back its investment in new acts on the recording side and even more drastically within music publishing. Then in the lead up to the IPO WMG had a public dispute with Linkin Park, one of its biggest acts. Finally, the IPO only raised $554.2m, 20% less than its initial target, and the stock slipped below its offering price of $16 per share.

The turbulence surrounding WMG continued into the second half, albeit at a lesser pace. One reason for this was that, in part, the issues WMG faced were industry wide. In November the company became the second major international record company after Sony/BMG to acknowledge and halt all payola to radio stations and their employees. New York Attorney General Elliot Spitzer's investigation of pay-for-airplay between recording companies and radio businesses forced a settlement out of WMG, including an Assurance of Discontinuance under which the company admitted to improper conduct, agreed to fully disclose all items of value provided to radio stations, and to provide $5m for music education through the Rockefeller Philanthropy Advisors to New York State. Spitzer's investigation has subsequently started to examine the actions of broadcasters and both he and the US Department of Justice have started investigations into the pricing of online music downloads (*see* M&C 316/2).

WMG's return to profitability

WMG's operating profits rose by 11% to $144m, compared to the same period in 2004. Further confirmation of WMG's profitability was that operating margins of 1.9 percentage points to 13.9% and its operating income before depreciation and amortisation (OIBDA), an indicator commonly used by entertainment companies, rose by 6% to $202m, resulting in a 1.8 percentage point increase to an OIBDA margin of 19.3%. The question raised by WMG's recent success is whether it is temporary and/or aimed at the investment community or the first stages in a restructuring of the company that might form the groundwork of a long-term plan for sustained further growth.

Restructuring

Since becoming president Edgar Bronfman Jr has sought to restructure WMG, leaving much of the organisational detail to Lyor Cohen who has run the US unit of WMG since leaving Island Def Jam in early 2004. Cohen's re-organisation of the company has resulted in the departure of Jason Flom, formerly Atlantic Records co-chairman and CEO. He was replaced by Craig Kallman, who became chairman, while long-time Cohen associate Julie Greenwald continued as president. Later Lava Records, created by Flom and known for Matchbox 20, Rob Thomas and more recently The Click Five, was fully absorbed into Atlantic. In February this year, WM International (WMI)

WMG: Revenues by source for the the year ending September 30 2005 and for the last three months of 2006 ($m)

	Full year		Q1 2005 – 2006	
Recorded music revenues	2,924	(+2)	920	(-2)
Recorded music operating profit	215	(+123)	116	(+9)
Music Publishing revenues	607	(+1)	131	(-15)
Music Publishing operating profit	82	(+11)	6	(-40)
Total revenues*	3,502	(+2)	1,044	(-4)
Total operating profit	84	(+109)	144	(+11)

* Excludes inter segment payments. The figures in brackets are the percentage change on the same period a year earlier.
Source: company accounts

chairman and CEO Paul-Rene Albertini left the company a month after he was awarded a $4m bonus for his division's performance and Patrick Vien, formerly an executive with NBC Universal, was installed as head of WMI. Albertini's departure was widely seen as being in part the result of a dispute with Cohen over James Blunt, who was signed by then-head of Elektra Sylvia Rhone and dropped from the label when Rhone left. Blunt was then signed by Atlantic UK, which was overseen by Albertini. Blunt subsequently has had great international and US success, topping the *Billboard* charts earlier this month.

While there has clearly been an element of executive rivalry behind these recent moves, they also reflect Bronfman's concern to bring all his executives together – quite literally on one floor of WMG's New York headquarters. To this effect Bronfman relocated Richard Blackstone the newly appointed head of Warner/Chappell, WMG's music publishing division, from California, where historically it has been based, to New York to better integrate the actions of the recorded music and music publishing divisions. Analysts remain divided as to the virtue of such a monolithic view of management. While there are clear advantages to having better communications between the recorded music and music publishing divisions, to run WMI from New York seems outdated. In the past, US recorded music sales accounted for the majority of recorded music sales of any US-based record company and hence its interntional division was seen as subservient to its North American operations and operated as such. That is no longer the case. In 2005, for example, when North American sales accounted for 36% of the trade value of recorded music sales according to IFPI, WMI accounted for at least 56% of WMG recorded music sales. Currently no other major runs its international department from the US.

WMI

The re-location of the headquarters of WMI comes at a time when WMG's improved profitability comes in great part from its success outside of the US. As the table on page 10 shows, with the exception of the small market of Norway, where its market share declined marginally, from 11% in 2004 to 10.9% in 2005, WMG increased its market shares in a large number of international territories. The best indicator of WMI's success is the four percentage point increase in its Euro chart album share, which covers sales across the whole of Europe, to 18.8%, and its increased market share in Japan, the second largest recorded music market in the world, from 4% to 5.5%. Another mark of WMG's success is that whereas in 2004 it did not have a title in the Top 10 selling albums of the world, as reported by international record industry trade association IFPI, in 2005 it had three of the Top 10 selling albums, *American Idiot* by Green Day (No.5), *Confessions on a Dance Floor* by Madonna (No. 6) and *Back To Bedlam* by James Blunt (No.9).

With the exception of James Blunt, WMG's international success has been largely based on US repertoire. In many countries Warner has small domestic rosters. In response to this, in Australia last year WMG bought Festival Mushroom Records (FMR), whose artists include Kylie Minogue and Olivia Newton John, from Rupert Murdoch's News International (*see* M&C 307/14). In October 2004, WMG had a 14.4% market share in Australia, according to international record industry association IFPI. MUSIC & COPYRIGHT calculates that WMG and FMR's combined *pro forma* market share in 2005 was just over 20%. Subsequently, WMG Australia has re-launched Mushroom Records as its imprint for new Australian and New Zealand signings. The first releases on the label will be recordings by guitar band Eskimo Joe, Hip Hop acts Butterfingers and Scribe, and singer Chloe Lattanzi (the daughter of Olivia Newton-John)

As well as increasing its presence and market share in the offline world internationally, WMI has also been active in the mobile and online worlds, even attempting to marry the offline and the online. Using software from Bounce Technology, the developers of the MyTone software, WMG has released a CD with selectable ringtone capability in the UK, *Baby* by rapper Fabolous. Its integrated software allows buyers to select any 30-second section of the single to download to their phones.

WMG has also been actively licensing content for mobile use in territories around the world. In December, WMG Japan teamed with KDDI Corporation to offer the industry's first mobile music bundle: a package of audio, video, graphic and text products in a single, downloadable file. Marketed as WAMO Packs, the files contain videotones, mastertones and Flash screensavers and menus, as well as bonus material such as video commentary, cover art and links that allow for the full customisation of a mobile phone. The first featured artist in the deal was Sean Paul, with new WAMO Packs for Japanese singer Ayaka and teen dance group DDD due out shortly.

In the UK, WMG joined the launch of British Telecom's television-over-broadband service with a range of interactive and on-demand music programming and in the spring of 2005, Warner signed a global agreement with France Telecom to provide digital content across a range of platforms. (In the US

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WMG already offers videos through telecommunication company Verizon's VCast service, and unlimited video streams to AOL subscribers through AOLMusic.com.) Separately, in September, WMG concluded a deal with MTV Networks for the use of music videos from WMG artists in original mobile programming across MTVN's range of branded channels. How consumers buy and pay for the content is decided by the carrier in each territory and can include both subscription and *a la carte* pricing. MTV International's mobile video distribution deals give it access to more than two-thirds of the world's video-enabled handsets across Europe, Asia and Latin America, available to some 670m mobile subscribers outside the US.

WMG in the US

In 2005 WMG and Universal were the only majors to increase their US market share. According to Nielsen SoundScan, WMG's album market share rose to 17.3% from 14.7% in 2004, outperforming the U.S. industry by almost 5%, while its current album share, the best measure of success with new product, rose from 13% to 16% (*see* M&C 312/6). This increase continued into 2006. WMG's total US album market share rose by over one percentage point to 17.7% in the first three months of 2006.

For the first time in a decade, Warner Bros Records was the leading label in the US in 2005. This was despite having only one title in the Top 10 selling albums of the year (*American Idiot* by Green Day, which sold 3.4m units). However, WMG had a wide spread of best-selling albums, led by Madonna's *Confessions on a Dance Floor*, and Michael Bublé's *It's Time* and including Linkin Park and Jay-Z's Mash-up album *Collision Course* and A Simple Plan's *Still Not Getting Any....*

Last year WMG instituted an incubator system through Asylum to provide promotional, sales and marketing services to independent music companies. Five urban and three rock artists have benefited from the programme and all have subsequently been signed to WMG labels in joint venture deals. Four of the releases debuted in the Top 10 on Billboard's Top 200 chart in 2005, including Mike Jones' *Who Is Mike Jones?* (Warner Bros/Asylum/SwishaHouse) at No.3 in April; Webbie's *Savage Life* (Trillville/Asylum) at No.8 in July; Paul Wall's *The People's Champ* (SwishaHouse/Asylum Records) at No.1 in September; and Bun B's *Trill* (Rapalot/Asylum) at No.6 in October.

Building on this, and the purchase of Ryko (*see below*) which extended its involvement in the US independent sector, in April WMG created a new division, the Independent Label Group (ILG). Consisting of Asylum Records, East West Records, and the new Cordless Records, WMG has positioned the ILG as a means securing greater access to the growing number of US independents that are having greater success than previously and might feel limited by their current deals. ILG, which is headed by Todd Moscowitz, the president of WMG's Asylum label, is another example of the realisation by the majors that one result of their restructuring and cost-cutting, which inevitably has involved reducing rosters, is that a close relationship with the independents, who have not reduced their rosters to the same extent and who have been generally more imaginative in their signings, is essential.

WMG: Recorded music market and chart shares in selected territories in 2005 (%)

Argentina	14.3	13.8
Belgium	9.7	8.4
Brazil	15.1	12.0
France	14.2	14.0
Italy album chart shares	22.5	20.5
Japan	5.5	4.0
Norway	10.9	11.0
Russia	6.0	5.5
UK corporate album shares	13.1	12.0
US Total album market shares	17.3	14.7
US current album market shares	16.0	13.0
Euro album chart shares	18.8	14.3

The figures in the second column are the market shares in 2004.

Source: National IFPI groups; UK Official Charts Company; Nielsen SoundScan; music & copyright research

In 2006, WMG had a significant cross-Atlantic success with *Back to Bedlam* by UK singer James Blunt. WMG's share of Rap, a genre with which historically the company has had little success with, rose 20% in the first three months of 2006, an increase of nine percentage points over the same period the year before, on the back of releases from Notorious B.I.G., D4L, Trina, Mike Jones and Sean Paul. WMG also scored a major coup in March when *It's Hard Out Here for a Pimp*, a track from the soundtrack to *Hustle & Flow*, won an Academy Award for Best Song. That success continued into 2006. Last week, WMG recording artist T.I. debuted at No. 1 on the *Billboard* album chart with his new album, *King* which had sales of 520,000, the biggest first week sales in 2006. The album was also No. 1 on the iTunes, and the Top Ten digital albums charts in the US. Released on WMG's Atlantic label it meant that Atlantic ranked as the No. 1 label in the US that week, according to SoundScan, with a 12% current album market share, almost double that of the second-ranked label.

This general level of success, which was reflected in WMG's first quarter results in 2005-2006 (*see table on page 9 and* M&C 315/5), has changed the attitudes of the investment community both to WMG and to the record industry as a whole. Pali Research, Bank of America Equity Research and Deutsche Bank, which previously had been very negative about WMG, all

recently issued positive briefs on the company, citing its success in the offline market and a significant jump in its digital sales (*see below*). This newfound investor confidence in the recorded music industry overall has been bolstered by an acceleration in average weekly digital downloads, including bundled digital album tracks, in the past two quarters compared to the first three quarters of 2005, and the slowing decline in physical sales – down 5.5% in the first quarter of 2006, the lowest quarterly drop since the third quarter of 2004. More specifically, WMG's physical sales at present are declining more slowly than the industry as a whole. In the most recent quarter physical and digital album units overall fell by 6.5%, while Warner's total album units fell by just 0.3%.

The analysts' view of WMG

Two other significant factors make WMG particularly attractive to investors at the moment. The news that Bertelsmann is seriously considering selling its 50% stake in Sony BMG is seen by most analysts as de-stabilising for Sony BMG and offering additional opportunities to its competitors. Separately, the continued speculation about a potential merger of WMG with EMI that would remove a competitor and provide a wider combined territorial spread for the two companies means that there is the possibility of even greater profits for investors in WMG. A mark of this is that, although WMG's share price initially slipped below the offering price of $16, by early February it was trading at around $20.

These reasons for investor confidence in WMG are largely to do with circumstances out of the control of Bronfman and his key executives. Bronfman has consistently highlighted WMG's successes is the digital arena, which the company suggests is greater than that of the other majors. The company's digital album share in the U.S. is 23%, some 6% above its physical album share. MUSIC & COPYRIGHT estimates that only EMI had a higher share of digital sales in the US in 2005 than its offline album market share. The spate of digital distribution announcements made in the past nine months has bolstered the perception of WMG's aggressiveness at exploiting its catalogue, and has been borne out by recent results. For the full year 2005, total digital revenue increased more than four-fold to $157m, with a 73% to 27% split between US and international. In the first quarter of 2005-2006, digital revenues were $69 m, or 7% of total revenues, and up 30% from the fourth quarter of 2004 – 2005 and 176% from $25m in the same quarter last year. Pali Research forecasts digital revenues for WMG in 2005 – 2006 of $310m, up 98% from $157m in 2004 – 2005, representing 9% of revenues this year compared to 5% in 2005.

The digital revolution

WMG reports that roughly 70% of its digital revenue comes from the US, and that the revenue split between online and mobile is approximately 50/50. Online makes up a larger portion of domestic digital music in the US, whereas the opposite is the case internationally, although the company expects this distinction to erode over time.

Just as WMG has experimented in the offline world with its incubator system (*see above*), so it has experimented in the online world. In November WMG launched Cordless Recordings to release recordings by acts with an established fan base in a variety of digital formats, making use of available online and mobile technologies. Cordless will make use of these digital resources to implement innovative marketing programs to promote its roster of artists. Rather than exclusively releasing music in the traditional album or single configuration, every few months, the label will release clusters of three or more songs by an artist. In addition, Cordless will have the ability to draw upon the resources of WMG's major labels on select releases. Cordless has met with some success: at the end of February, Cordless artist Dangerous Muse was the Download of the Week on iTunes UK and new music from Cordless artist Nozzle was licensed to a forthcoming movie.

Separately, in the UK WMG has launched its own online music store, warnerclassics.com, which will eventually offer its entire Classical music catalogue for download with 50 albums added each week. The same albums will also be made available to the various online services, such as Apple's iTunes music store. The launch will be accompanied by a promotion marking BBC Radio Three's broadcast of Richard Wagner's *Ring Cycle*, conducted by Daniel Barenboim on April 17. In conjunction, there will be four free downloads available from warnerclassics.com, one extract from each of the *Ring* operas. The promotion will run between April 10 and May 10.

However, while continuing to experiment with the new opportunities that the online world offers, WMG has been particularly concerned to maximize the potential of online sales from established acts. With this in mind WMG has been very active in seeking to increase online sales of its bundled product – complete albums, often plus additional product - as opposed to single tracks from albums.

According to Pali Research, whereas in the first quarter of 2005 the percentage of digital tracks downloaded as a part of the downloading of a digital album was 28%, in the first quarter of 2006 this rose to 33%. Bundling is seen as a way to move beyond single-track sales, and is a way to charge higher rates for content. WMG says that its premium album bundles, which contain album-only bonus content including videos, liner notes, lyrics, bonus tracks, artist interviews, concert tickets and behind-the-scenes footage retail for between 20% and 80% more than the standard $9.99 digital album. Recent such titles offered by WMG via iTunes include releases from Madonna, James Blunt and Depeche Mode.

Around 75% of the sales of *Confessions on a Dance Floor* via iTunes came from album bundle purchases. While such tracks, called Premium Tracks on the iTunes online music store, comprise only a very small percentage of iTunes sales overall, WMG has had significant success in this sector in the US. It claims an 85% share of such sales via iTunes, compared to 38% for EMI, 26% for Sony BMG and 14% for UMG in the

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period May 2005 to mid-February 2006. In view of the potentially greater profits for all concerned, WMG has had discussions with a wide range of online and mobile operators and distributors as to how they could increase the percentage of bundled rather than unbundled product they offer consumers.

At the same time the company has been very aggressive in using online and mobile media to generate offline sales. The classic example of this is Madonna's *Confessions on a Dance Floor*, which was primarily marketed via ringtone, streaming, making the single available early to those who pre-ordered the digital album and offered as a rich bundle, rather than via the traditional radio promotion method. The result, despite little advance radio play, was Madonna's biggest album in recent years, selling over 7m worldwide and generating a minimum of $100m for WMG.

WMG has also been active in the US mobile market. In January it agreed a deal to make a range of master recordings available as ringtones for about $1.50 with Skype, the free VoIP (Voice over Internet Protocol) technology that currently has over 74m registered users. Under the deal, the first selected artist at Skype's newly opened online retail store, which includes a featured artist section and links to artist-branded websites, was Madonna. Master ringtones of *Hung Up*, *Push* and *Sorry* as well as catalogue hits such as *Like a Virgin* and *Vogue* are all on sale at the store.

Short or long term?

Licensing deals require little investment from WMG beyond making its catalogue available. However, there is growing evidence that, after a period serious cost-cutting, WMG is starting to invest in new acts and repertoire sources. This suggests that the management of WMG is looking to long term profits rather than short term ones. The company claims that it has continued to make significant investment in A&R, pointing to the success of its Atlantic label as an example of that. It notes that its US revenues from the label rose more than 50% in the last three months of 2004 – 2005 over the comparable quarter last year when it had more than double the artist releases in the fourth quarter 2004 – 2005, with a third of the increase coming from new artists.

Separately, earlier this month WMG announced that it had signed a definitive agreement to acquire Ryko Corporation, an independent, integrated music and entertainment company from an investment group led by JP Morgan Partners for $67.5m (*see* M&C 317/14). Ryko, which MUSIC & COPYRIGHT calculates had revenues of around $80m in 2005, owns a catalogue of more than 1,000 titles of Rock, Folk, Jazz, World, Blues and Alternative albums. It also operates as an independent distribution company. The incorporation of this will inevitably reduce the costs of WMG's own independent distribution company ADA.

The purchase of Ryko, like that of FRM, suggests that the restructuring period at WMG is over and that the company is starting on a cost-conscious process of expansion. However, it remains to be seen whether that expansionist scenario will extend to WMG's music publishing division Warner Chappell, the second largest music publisher in the world after EMI Music publishing, and which since Bronfman's takeover of WMG has been the subject of the greatest cost reductions.

Music publishing

Warner Chappell generated $607m in revenue in 2005, up 1% year-on-year. The sale of the sheet music business in May brought in an extra $35m for 2005, and $49m for 2004. Excluding these amounts from both periods, Warner Chappell's revenue's grew 1% in 2004-2005. One reason for the growth was that WMG severely curtailed Warner Chappell's investment in new writers and catalogues, a fact that in later years could have a serious impact on Warner Chappell's revenues. Executive changes have also been a recent feature at Warner Chappell. Richard Blackstone became chairman and CEO in May, taking over from Les Bider. Warner Chappell subsequently announced in February that president Rick Shoemaker, who had worked closely with Bider, was also leaving the company.

Digital revenues from music publishing accounted for 3% of the total, or $20m, in 2004 – 2005. Synchronisations were up on the year following increased film, advertisement and video game revenues, as well as increasing sales of DVDs. For the most part these gains were offset by declines in mechanical and performance revenues, which WMG notes reflect declines across the industry as a whole. At the same time WMG says that the period of cost cutting at Warner Chappell is over and its investment in new writers has increased. However, the performance of Warner Chappell in 2004 – 2005 suggests that cost concerns were paramount. Operating income increased 11% to $82m on a 1% increase in sales to $607m, yielding an operating margin of 13.5%, up 1.2% year-on-year. Music publishing OIBDA was $141m, down 2% from $144m the year before, leading to a margin decline of 0.7% to 23.2%. More indicative of the increased investment promised to Warner Chappell was the fact that in the first quarter of 2005 – 2006, Warner Chappell's operating profits fell by 40%. An example of Warner Chappell's renewed committment to investing was the deal it struck last week when it extended its publishing agreement with with George Michael. Under the agreement, Warner Chappell will administer the rights to Michael's catalogue of songs, including those written for Wham!, worldwide. Previously, Warner Chappell, which has administered the rights to Michael's catalogue since 1982, did not represent him in the UK and Ireland.

Warner Chappell signed the publishing rights for several WMG label artists in 2005, including T.I, Mike Jones, Paul Wall, Germany's Nena, and the UK's Paolo Limiti. It also renewed or

expanded deals with artists including Dr. Dre, Staind, A Simple Plan, the Strokes, Joey Ramone and the late Lou Rawls. In 2005 Warner Chappell signed a worldwide administration deal with Lucas Arts, which controls the musical copyrights for the *Indiana Jones* films. Other agreements include a deal with Nashville songwriters Tim Nichols and Connie Harrington (This Music). Warner Chappell's biggest publishing successes of the year were compositions associated with Green Day, Madonna, Tim McGraw (whose *Live Like You Were Dying* won every major country music song award), the Urban hits *Pon de Replay* by Rihanna and *1,2 Step* by Clara, and Kelly Clarkson's *Breakaway*. Among its roster of writers, Warner Chappell's John Rich achieved success with Gretchen Wilson's *All Jacked Up*, Faith Hill's *Mississippi Girl*, and Big & Rich's *Comin' to Your City*, while John Shanks wrote Ashlee Simpson's *La La* and *Boyfriend*, Bon Jovi's *Have a Nice Day*, and Keith Urban's *Better Half*.

Internationally, Warner Chappell announced a major Chinese deal last year under which it now exclusively supplies repertoire for dramas and soap operas on state-owned television network CCTV, which includes some of the most widely watched programming in the country and as such is a generator of hit songs. Beijing-based online talent agency Music365.com.cn is a partner in the deal, and will farm out singers and songwriters for all music used in the CCTV shows.

Until very recently, analysts took the view that Edgar Bronfman's WMG was created to be either sold or merged with EMI or simply pillaged. That now seems less likely. But the question still remains as to precelsely what WMG's new management has in mind, beyond the simple hope of benefitting from the digital age.

German authors' society GEMA reports a 6% rise in collections and and distributions in 2005

German authors' society GEMA, which collects royalties from both the performing and mechanical right and is the world's largest collection society in terms of revenues, has reported that in 2005 it collected €852m ($1.04bn) in royalties, an increase of 5.7% on 2004. This follows a 1% fall in 2004 to €813.6m ($914.2m) (*see* M&C 298/10).

The amount available for distribution to GEMA's members and affiliates also rose, by 6% to €732m ($893m). However, although the society's costs rose, by 1% to €120m ($147m), GEMA's costs as a percentage of collections fell, from 14.4% in 2004 to 14.1% (*see table below*). GEMA noted there was growth in all its royalty streams but that the prime reason for its 2005 growth was non-recurring payments of €30m ($35.6m). Excluding this GEMA's collection at €822m ($1bn) represented a 2% increase on 2004's collections.

The major part of the one-off payment made to GEMA was money placed in an escrow account by German record companies when they sought a reduction in the mechanical rate. Last April the society won a key ruling on the local mechanical rate, on behalf of all its members. The Arbitration Board of the German Patents and Trademarks Office rejected the rate of 6.57% proposed by local IFPI affiliate BVP (*see* M&C 296/1). The BVP decided not to appeal against the Arbitration Panel's decision and accordingly released the amount placed in an escrow account that represented the difference between the rate they proposed and the existing rate. GEMA noted that this payment meant that its audio-visual mechanical royalties rose by 15.9%, or €32.5m ($39.6m), but that if the phono-mechanical element of that payment is excluded GEMA's phono-mechanical collections actually fell by 0.5% to €104.8m ($127.8m). While mechanical collections reflect the physical sales of the previous three months, the 0.5% fall in GEMA's phono-mechanicals generally parallels the performance of the German record market in 2005, which was flat (*see page 6*).

At 3% of the trade value of the German recorded music market, digital sales remain low in Germany, particularly online sales. This is reflected in GEMA's online royalty collections, which were €1.4m ($1.7m). GEMA's collection from ringtones, although higher at €4.1m ($5m), were also comparatively low. It seems likely that these amounts will rise in 2006, particularly after the appeal by the BVP against the tariffs proposed by GEMA on the basis that the existing agreements between record companies and GEMA already included the use of music online and ringtone melodies, was rejected by the Arbitration Board of the German Patents and Trademarks Office in February.

At the time of the announcement of its results GEMA highlighted its concern that as part the planned amendment of the German copyright act it felt that the government was paying to much attention to hardware and manufacturing companies who were lobbying for significant reductions in and restructuring of the existing private copying levies.

GEMA: Collections in 2005

	Revenues (€m)	Revenues ($m)	change
Collections	852.2	1,039.3	+5.7
Amount available for distribution	731.9	892.6	+6.1
Costs	120.3	146.7	+0.9
Costs as a % of collections	14.1		14.4

The percentage changes are in local currency and currency conversions are at the average 2005 exchange rate.

Source: GEMA

Record industry

THERE HAS BEEN widespread press speculation that German media group Bertelsmann is considering disposing of its music interests, BMG Music Publishing (BMG MP), and its 50% share in Sony BMG. The reason put forward is that the privately held company wants to avoid going public by buying the 25.1% held in it by Groupe Bruxelles Lambert (GBL), which has said it plans to take GBL, and therefore Bertesimann, public. GBL is valued at around $6bn. Sony has the first option on buying Bertelsmann's stake in Sony BMG, which is valued at around $1.4bn, but analysts think it unlikely that Sony would want to expand its music interests. Similarly, after the restructuring and cost cutting at Sony BMG, which last year was in excess of $300m, Bertelsmann's stake in Sony BMG might look less appealing to venture capital groups. A further problem would be that pulling out of the joint venture would be extremely complex. Far simpler and more appealing to investors would be selling BMG MP, which has been valued at around $1bn and has already attracted significant interest. However, such a sale would on its own not raise enough money. Moreover, whereas Sony BMG has been a source of organisational and financial problems for Bertelsmann, BMG MP is widely seen as a valuable asset.

WMG UK ACT Gnarls Barkley made music history last week when its debut single *Crazy* topped the UK singles chart on download sales alone. Following a recently-activated rule allowing download sales to count towards the main combined singles chart the week before physical release, Gnarls Barkley, which comprise former Goodie Mob member Cee Lo and Gorillaz producer Danger Mouse, were the first to reach No 1 ahead of a CD release.

UK-BASED ZEST GROUP, which specialises in the acquisition of music publishing catalogues, has bought independent Reggae record company and music publisher Greensleeves Records for £3million ($5.2m) plus £250,000 ($434,000) of shares in the Zest Group.

OPTICAL DISC REPLICATOR Sonopress, which is owned by Bertelsmann, has opened a CD and DVD plant in Russia with a capacity of 13m CDs and 11m DVDs in 2006.

Legal

LAST MONTH, Germany passed its strictest law yet on file-sharing. The law, which takes effect January 1, 2007, categorises the act of downloading copyrighted music or movies without permission as a felony. Those convicted could face up to two years in jail, and five years if the act is committed for commercial purposes.

US INDEPENDENT TSR RECORDS last month filed a lawsuit against WMG over payola allegations. The action is a companion suit to the one filed by TSR against Sony BMG in October three months after the major international record company settled a payola investigation with New York State attorney general Eliot Spitzer. WMG settled a similar investigation last December. The suit, which alleges antitrust violations and interference with the company's potential business profits, follows two similar complaints filed last week in the US District Court in Los Angeles by the same lawyers, for New Jersey-based Radikal Records. All the suits claim that the majors kept independent record company artists off radio airwaves to exclusively promote their own artists.

THE US ATTORNEY'S OFFICE for the Northern District of California on Monday announced two guilty pleas resulting from Operation Remaster, an undercover law enforcement operation in Northern California targeting the large-scale suppliers of pirated copyrighted music, software, and movies. In October 2005, raids on 13 locations in California and Texas resulted in the seizure of more than 0.5m CDs, 1 million CD inserts, and more than 5,500 stampers, the metal discs used to press multiple CD copies. Some 85% of the counterfeit CDs seized in these operations were of the Latin genre.

US ARTIST Jayceon 'The Game' Taylor has filed a lawsuit against Koch Entertainment and related companies. He claims 81 copyright infringements for releasing five CDs and a DVD without securing licenses for his compositions. The basis of the complaint is that, before the release of his 2005 multi-platinum debut album *The Documentary*, Taylor recorded a number of songs with Joseph Tom, a.k.a. JT the Bigga Figga, and his Get Low Recordz in 2001 and signed an agreement giving Tom and his company the right to release the recordings, provided Taylor was paid 50% of all gross profits. The suit claims Tom did not honour this agreement and did not assign Taylor's 50% copyright interest in the sound recordings for his performances as the lead singer or any copyright interest in the compositions for his words or lyrics. Furthermore, Taylor alleges that Koch, which released the CDs and DVDs through its Fastlife Records, did not secure rights or licenses from him; he has not received any compensation for those releases. The suit asks the federal District Court in Los Angeles for an injunction against Koch and damages for release of *The Game: Untold Story*, *The Game: Untold Story Vol. II*, *The Game: Untold Story Chopped and Screwed*, *The Game: Untold Story Chopped and Screwed Vol. II* and *The Game: Untold Story Special Addition* (CD and DVD).

Music publishing

THE HARRY FOX AGENCY (HFA), the US mechanical licensing organisation, which represents over 28,000 music

publishers, and offers nearly 1.5m songs for mechanical licensing in the US, and G Columbia House, the largest direct-to-customer distributor of music and movies in the US, have concluded a licensing arrangement regarding mechanical rights for record clubs. Music publishers affiliated with HFA will have the option of making their catalogues available to BMG Columbia House for licensing at 75% of the statutory rate. This agreement will remain in effect for four years, with automatic annual extensions. BMG Columbia House will use HFA's suite of online licensing tools for their licensing activity. The current statutory rate is 9.1¢ per copy for compositions five minutes or less in duration and 1.75¢ per minute, rounded up, for compositions over five minutes. The 75% rate is 6.825¢ and 1.3125¢, respectively. These license terms for HFA publishers will supersede any licensing terms to which the parties agree in the settlement of the class action suit known as the Ory case (*see* M&C 299/1). The settlement has been approved preliminarily by the court. HFA was not a party in that suit, but objected to the initial settlement terms. These issues have been addressed in the revised settlement agreement between the plaintiffs and BMG Columbia House.

Online

PAYPAL EUROPE, which provides secure payment systems for online purchases, projects that paid downloads will grow ten-fold by 2010 in Europe and account for some 15% of the overall recorded music market and that over the period 2006-2010 download sales will be worth $656.7m. PayPal also estimates that the average British consumer will download 25 tracks and spend £15 ($42.1) on music downloads by 2010. Separately, PayPal predicts that in Europe mobile-based music will be worth $346m by 2010. #

ILLEGAL MUSIC DOWNLOADING is continuing to grow in the UK according to research consultancy XTN Data. A March survey of 1,000 UK music consumers found that 28% admitted to downloading music without paying. XTN Data reported 25% were downloading illegally in September last year. Separately, XTN Data reported that iTunes was the most popular commercial download service with a 44% market share while quasi-legal site AllOfMP3.com took second place with 14% of the market. Napster was third with an 8% share and Wippit was fourth with 6%, while MyCokeMusic and Tesco had marginal market shares.

FORRESTER RESEARCH predicts that in Europe, although physical recorded music sales will fall by 30% over the next five years, digital revenues will multiply tenfold to €3.9bn ($4.7bn) a year. It also forecasts that in 2011 overall recorded music revenues will rise from €9.5bn ($11.45bn) to €11bn ($13.26bn).

US INDEPENDENT TVT has signed an agreement with Advanced Technology Industries (ATI) to make its entire catalogue available through ATI's Qtrax legal peer-to-peer (P2P) music service. The soon-to-be-launched Qtrax service will allow users to freely share and download authorised content. However, each music file will include a targeted advertisement in order to generate royalties for music providers. The Qtrax P2P network uses Audible Magic's content filtering technology to prevent users from sharing unauthorised content.

KOREAN P2P SERVICE PROVIDER Soribada has started to charge users for music downloads. The move is part of its attempt to establish a paid service after losing a legal appeal against the Korea Music Producers' Association (KMPA) last November. The rates which have been set by Soribada and the KMPA are 500 won ($0.51) for digital rights management (DRM) protected downloads, 700 won ($0.71) for DRM-free tracks and $0.25 for poor sound-quality downloads. Soribada, which one of several Korean P2P networks in discussions with KMPA, says it will use acoustic fingerprinting to track the use copyrights.

Mobile

MOBILE OPERATOR Hutchison 3G UK, commonly known as 3, has reported its one-millionth, over-the-air (OTA) mobile music download. Separately, 3G said it was selling over 200,000 tracks per month, which meant that it had more than a 50% of the British, OTA market in 2006, according to the Official Charts Company.

US-BASED research company ABI Research forecasts that global revenues from over-the-air (OTA), full-track mobile music downloads will increase from $12.4m in 2004 to $9.3bn in 2011.

US WIRELESS OPERATOR SPRINT reports that it has distributed over 2m Sprint over-the-air (OTA) download in the US since it launched its service last October. While around 20% of those were promotional giveaways, Sprint said that the practice was discontinued on January 14. The Sprint Music Store currently offers 400,000 songs from all four major labels, and each track costs $2.50.

FRENCH MOBILE MUSIC COMPANY Musiwave has reported that 1m full-length mobile music tracks have been downloaded through the 22 mobile music services using its Music on Demand Service (MODS), which allows users to download DRM-protected tracks directly to 2.5G and 3G mobile devices. Musiwave also announced the launch of Smart Radio, a streaming mobile music service for Java-enabled handsets.

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music and video applications on their phones as average mobile subscribers, according to US-based research body M:Metrics. According to M:Metrics, iPod owners only account for 14.4% of all mobile phone users, but represent nearly 30% of those who listen to music and watch videos on their mobile devices. The report notes that iPods and mobile music services could co-exist, just as camera-ready phones co-exist with stand-alone digital cameras.

Broadcasting

JAPANESE BROADCASTER Nippon Broadcasting has launched a free streaming service over the Internet in April. The service, which will offer a number of music-oriented programs and will be available at the company's website daily from 9am to 9pm, will be the nation's largest online music programming service by a major radio broadcaster. Some 130 recordings will be available daily, which users can stream but not download the tunes to personal computers and other devices. Nippon Broadcasting has obtained licences for the use of music from eight record companies, including Sony Music Entertainment (Japan), Toshiba-EMI and Pony Canyon, under which it will pay fees for the use of their recordings in its programmes.

Retail

US-BASED books and entertainment retailer Borders Group will open its first store in the Republic of Ireland this autumn. The store, which will be in Dublin, will feature a selection of approximately 200,000 books, music CDs, periodicals and DVDs. It will also include a Paperchase-branded gift and stationery outlet and a Starbucks Coffee shop. Borders currently operates 36 superstores in city centres and 33 small format high street and airport bookshops in the UK.

US-BASED entertainment company Trans World Entertainment (TWE) has bought a controlling interest in Mix & Burn, which offers a range of kiosk-based digital music options, including the ability to create digital playlists and burn them onto CDs. The deal follows an earlier kiosk agreement between Tower Records and TouchMedia, which last month started installing 330 digital media stations throughout 89 Tower stores in the US. The TouchMedia technology has been integrated into existing CD listening stations, offering interactive touch screen media discovery, preview capabilities, and the ability to port promotional music to portable storage devices.

Consumer electronics

US-BASED toymaker Fisher-Price, a subsidiary of Mattel, is to launch a MP3 player and music download service. The Kid-Tough FP3Player will come pre-loaded with six songs and two spoken word stories. Minneapolis-based Digital River will build and manage the new download service, which is scheduled to launch during the summer of this year.

KOREAN MANUFACTURER Samsung has launched a new music phone. The SPH-S4300 is tiny but has a capacity of 1GB. The swivel-style device resembles a small, MP3 player when closed, including external controls and a 2-inch screen. A quick slide exposes a phone keypad, which is discretely tucked underneath the mini player. Other capabilities include an FM radio, a video player, 1.3 megapixel camera and an external sound recorder.

SONY HAS ANNOUNCED a new range of portable music player additions. The flash-based players will come in three storage levels, 512MB, 1GB, and 2GB, and support MP3, ATRAC and unsecured WMA formats, with the 512MB and 1GB players also offering an optional FM tuner. The players will be released in Europe later this month.

MUSIC & COPYRIGHT now regularly includes music DVD videos and videocassettes in its value figures. The phrase *recorded music* indicates that both audio and video sales are included, while *soundcarrier* refers only to audio sales. All dollar figures are US dollars and historical conversions in both text and tables are calculated at the average US dollar rate as published by the IMF for the year in question. Where relevant, MUSIC & COPYRIGHT publishes both local currency and US dollar values and shows the percentage changes in both in order to give a better sense of the performance of a company or market. All US dollar conversions in this issue, except where noted otherwise, are at close of business on March 24, 2006.

EXHIBIT CO 0972

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