The Analysts' Perspective

Market Overview

To provide shareholders with a better understanding of the challenging market environment within which the Group operates, SCMP spoke to three leading media analysts in Hong Kong. Known for their solid coverage of the sector and authorship of numerous reports over the year, the analysts provided candid perspectives on a range of issues related to the development of media in Greater China.

Anne Ling
Director,
Head of Asian Consumer and Media Research
Deutsche Bank

Ramiz Chelat
Head of Consumer & Media Research, Asia
Macquarie Securities

Isabella Kwok
Assistant Director, Research, Media, Consumer & Gaming
BNP Paribas Securities (Asia)

SCMP: What is your forecast for the advertising market in 2007?

Ling: Hong Kong is considered to be a small media market when compared to China, but on a GDP per capita basis it ranks very high in Asia and Hong Kong should be compared to cities like New York and London. It is one of Asia's main fashion hubs. As a result new products are launched here and advertisers focus on this market, with a radiation effect that spans Asia.

Advertising growth in Hong Kong is related to the volatility of the economy. With the economy aiming for 5.3% GDP growth in 2007 the ad market is likely to expand 8% in terms of gross ad expenditures (adex), with net adex depending on the market competition between mediums. The major beneficiary of adex growth during boom times is broadcast TV, where advertisers spend more on image building. The growth rate is less volatile for newspapers, where advertisers focus on product promotions.

Online advertising is only a small percent of adex (around 2%) in Hong Kong. We estimate that it doubled in 2006, but from a low base. Media buyers are less keen on this area. From their view, it is more work for a lower margin, whereas with traditional media the buyer gets a 15% commission with one call. Advertisers need to be creative with online media to attract the youth market with total solutions that include events, mobile and online. It is also more difficult and time consuming to quantify the impact of online advertising. However, online advertising is the trend going forward.

China is the media trendsetter at the moment, specifically in new media. China is more receptive to new media than Hong Kong. Online ad growth reached about 40% in 2006 (4% of the pie). Going forward, we expect online ad growth of at least 45% to 50% per annum, though off a low base.

Chelat: We see advertising growth at about 6%. Within that universe outdoor and new media will outgrow newspapers and TV. Drivers for ad growth are wage inflation and mainland tourism, pushing retail spend and ad budgets upwards. As in 2006, mass market dailies will face heavy competition, the free sheets will take market share and the TV market will see fragmentation to new media. On the display side those catering to high end ads will outperform mass market newspapers.

However, I note that Hong Kong is behind Korea, Australia, Japan and the US in terms of the shift to new media. Internet only takes 3% of adex while the US is closer to 8%, Korea 6% and Australia 6%. In Japan new media is the third largest ad medium after TV and newspapers, ahead of magazines and radio.

The reason for this new media lag is that small portals are not willing to make content investment and the likes of Google focus on bigger markets. Yet, it is not a question of if online advertising will rise but when. Hong Kong online adex will get to 6% to 7% within five years. The rest of the world will probably move to 10% to 12% by then. China is already at 6%.

Kwok: The key problem for Hong Kong media is advertising growth. Despite healthy growth in the domestic economy, ad spend is projected to remain at 5% for 2007. That is not poor, but it is not great compared to 15% growth in China. In terms of ad growth, the print market is estimated to grow at 6% to 8% and broadcast is projected to expand at 3% to 5%. Media buyers believe that the recovery of property ads, which account for 5% to 10% of adex, will benefit print more than broadcast.

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> **Isabella Kwok**

The free dailies were a risk to print media last year, but if you look at what has happened in the market share grab the competition is leveling. The gains for free papers are less significant. The worst case is if free papers accelerate marketing campaigns or more sheets enter the market. If everything remains equal there is no risk. The free papers have not yet affected premium papers. However, if mass market papers slash prices that will impact everyone.

SCMP: What are the challenges of the traditional media companies?

Ling: There are two issues that impact print media in Hong Kong. One is the rise of free dailies and the second is the aging of readership due to changing reading habits of the younger generation.

Generally, the impact of free dailies is felt more by Chinese than English dailies. Free dailies tend to capture an older, more price sensitive reader. One can argue that free sheet readers are less affluent, but when advertisers see a decline in readership and circulation it is difficult to ask for more money.

Even without new media, the readership of Chinese dailies is aging. The youngsters do not read newspapers in the traditional format. The youth market sees itself as part of the news, they like to create their own content and become their own heroes.

We need to look at the behavior of readers as they age. Will they still get news from the Internet or will they turn to newspapers? Youth readers tend to go online to quickly glance at entertainment, product information and headlines. They seem to be less interested in politics or the economy at this stage in their lives; when they go into business that may change.

Chelat: Traditional media that evolves to the digital platform will survive as the demand for quality content is there, even with the prevalence of blogs and non-organized journalism. The question is whether traditional content can be monetized on a digital platform.

Advertisers increasingly like the search-based model which generates a click thru, an ad view, a potential sale and a direct relationship with a customer. The trend to online ads will impact display ads, but the dailies' display ads can make the transition online better than classifieds. Classifieds is a risk. The newspapers are a distribution mechanism for classified. People do not need the front section if they just want classifieds. An online distribution platform with the critical mass can reach the target audience.

Kwok: Investors wonder whether there is a change in the reading habit from newspapers to online. The trend is happening, but at a slow pace. We see a change, but it will not cause a significant change for some time. People in their late 20s and above still prefer to read newspapers.

Yet, you must plan for changing reading habits and it is wise to focus online. The key is how to monetize revenues while not losing focus on existing operations. Just moving traditional media online is not the answer. If you ask advertisers to spend more online they will have difficulty transferring from traditional budgets. The rate card is totally different.

The key concern for traditional media is how to achieve the transition. Investors do not want to see earnings slip during the transitional period. If there is any kind of slip you have to provide a clear picture on how you are going to turn around that situation.

The other challenge is the presence of irrational players in the sector. If you talk about print media, price cuts and aggressive discounts on ads are disruptive. You can compare Singapore to Hong Kong. Growth is not there in Singapore, but media stocks have stable price performance as players are disciplined. There are no irrational price cuts and yields are stable. In Hong Kong it is unfortunate that there are irrational players in the market.

SCMP: What is the potential for Hong Kong media companies in China?

Ling: Hong Kong media players will have a tough go in China. There may be some opportunity in the less regulated outdoor media segment, but regulations in the content area make it difficult to expand.

Chelat: It is tough, but happening. TV broadcasters lead the way. Dailies have more difficulty as there is no real demand for their content. Even if government relaxes distribution it is a niche opportunity. And, if you buy a PRC media company you can control advertising but not editorial. That is not straightforward and examples we have seen have not worked. So unless regulations change media companies will be cautious in making acquisitions.

SCMP: Can you comment on the differences between the valuation of traditional and new media companies?

Ling: If traditional companies launch multimedia formats, and get the growth new media companies achieve, they will receive higher multiples. In the equity market it is all about anticipation of EPS and free cash flow growth. Simply adding an Internet component that does not contribute revenues will not help. You must launch a product that at least draws attention.

"The youth market sees itself as part of the news, they like to create their own content and become their own heroes."

Anne Ling

New media companies expect 25% to 30% earnings growth and ads range from 10% to 60% of the business, the rest is SMS, downloads and VAS (value-added service). Yet, when a new media company misses its numbers it pays the price. A high PE is associated with expectations that a stock makes or beats the market, which factors in high growth. However, new media business models are more flexible to adjust than traditional media, which makes it easier for them to adapt and to test new revenue models.

Kwok: China is always easier said than done. China growth is attractive, but anyone too aggressive can get hurt. We have seen many cases. I like to equate the situation of the media players to that of the retail industry. Many Hong Kong retailers have China earnings but they only account for 5%, which to investors is virtually nothing. While you can argue that you should attach higher PEs to that 5% of revenues it is small. When it gets to 20% then investors look closer.

The best way into China is to team with locals. In the newspaper market that is hard. There are 1000 newspapers circulating in a fragmented market. Even if you want to get in if you do not own content you are not a real media play, you are an ad agent. It is not that meaningful unless you can strike a deal that permits a say on content. There is nothing wrong with investing a small amount to learn about the market, but the opening of the PRC media market will not happen soon. It is true Hong Kong media companies look outside for expansion, but now they look more at South Asia.

Chelat: Investors pay for future growth. Dailies face a decline and online companies are expanding. If traditional media has an attractive demographic that can be shifted to a portal and monetized, investors will pay a high multiple if they know the category can grow. It is about building community. If you can win that loyalty, which is hard online as people change allegiance more than in print, you can be valued highly.

The new media companies have a business model that works for them. The markets are only going to give a higher multiple to traditional media with success. Five years ago the market would have given traditional media the benefit of the doubt. Now the markets are waiting to see execution in a fragmented market. I do not see the market putting huge valuations on new media stocks that have not executed.

It is hard to find an example where the new media portion of a traditional media player is material. Traditional media makes up 90% of revenues and players that have a leadership position are not getting the benefit as their revenue growth has fallen below GDP growth. The market will not pay a premium for leadership without growth.

Kwok: The argument is that traditional media is a dying breed. It may not be fair, but that is how it is perceived. Print media is going through a de-rating worldwide. Investors provide a lower valuation because they see risk ahead. The new media valuation is based on growth and target markets. Investors do not believe in top line stories. They have learned those lessons already.

SCMP: How do investors value content at a time when we are told that content is critical to success?

Ling: Content is king, but it depends on how you define content. The Internet space is creating different content, like blogs or self-generated content. So, the question is can print media deliver a different content model?

The broadcast media segment is giving it a try and most traditional media players have entered new media with different distribution channels. Still, traditional media must create something new. Archives are useful, but you have to attract non-traditional readers.

Chelat: New media thrives on user generated content and revolves around blog topics and online interaction. It is not reliant on traditional content to capture audiences. They do not need journalists in the field. Still, there is no doubt that traditional and new media can coexist. I do not see one as a complete substitute for the other.

Print media has roughly 20% of revenues coming from circulation. They need to find a way to get users to pay for information in the form of online subscriptions. Initially, you give away subscriptions for free then you supply a premium pay service. The challenge is for traditional media to not replicate online what they do offline. They need a more interactive, updated, online version. The new generation does not want to be dictated to.

People will still pay for a service that breaks stories. If a newspaper covers a breaking deal, that is something an investor needs to know. Traditional papers must move from generic reporting to exclusive stories. Content generates eyeballs. We feel that the market is not as yet valuing content as highly as it should in some cases and we feel those companies strong in distribution and poor in content will struggle.

SCMP: Private equity investors seem to place a higher valuation on traditional media than public investors?

Chelat: Private equity does pay hefty PE multiples in the high teens to 20 times and above on forward earnings. They are comfortable that traditional media can make the new media transition and the net revenue is attractive. Private equity that has paid these multiples feel that traditional media will survive. The public market is not fully valuing the business or content, focusing more on near term earnings as opposed to what will happen ten years away.

Kwok: Private investors are watching Hong Kong media. Sir Run Run Shaw to exit TVB, Wharf to privatize i-CABLE, Kerry Group to privatize SCMP, tycoons in talks to acquire Oriental Press Group, these are all hot market topics. We believe M&A speculation remains the key theme for the media space. Materialization of these acquisitions would translate into an upgrade in valuations as these plays are trading at an average 34% discount to full value.

While many may see the Hong Kong media sector as not going anywhere, we believe this space is undergoing a restructuring which could unlock the hidden value of these plays. In light of the current developments in the sector, M&As are going to be the next big theme.

So far, we have seen a tycoon invest in a private paper, the Hong Kong Economic Journal. There is speculation that investors are interested in media plays like TVB and Oriental Press. While the growth outlook may not be dazzling, they are attractive to potential acquirers due to: leverage buyout possibilities (especially for less regulated print media); platforms to enter the PRC for robust growth; selective picks set to see decent growth with three-year earnings CAGR at 15% and average dividend yields of 4.2%; and a platform to exercise influence on the public.

SCMP: What does the evolution to new platforms mean for a traditional media valuation?

Ling: It used to be that if you were in the print business you stuck to that business. Now the trend overseas is to melt all media into large conglomerates. Even TV companies buy print properties. However, there are cross-ownership regulations in Hong Kong and in other countries that need to be observed.

Convergence does not just mean new media acquiring traditional media. It could be the other way around. TV may challenge the Internet and new media may challenge traditional media. People will step into each other's turf and during this process players may over-expand and get in trouble, creating acquisition opportunities. At this stage, everything is very much in development as the market evolves. It is interesting to try and figure out the next phase.

Chelat: These days it is fairly easy to distribute content on any platform. It comes down to quality content. If people want a news update, every telco is going to supply a service that will come straight to your phone. People will want more. If a newspaper breaks news people pay. If a newspaper focuses on its niche then its content can converge to a digital platform. Will companies be able to monetize what they do offline online? That is harder to say. But print media has to start making that transition aggressively.

In terms of convergence we are watching the telecom companies. For instance, China Mobile just purchased 20% of Phoenix. They are jumping into media to fill a pipeline, but they do not produce content. They simply use their infrastructure to distribute. It is a skill to produce content that people want. Distribution platforms are increasing but content is in short supply.

> *People will want more from content providers. If a newspaper breaks news people will pay for that service.*
>
> **Ramiz Chelat**

Kwok: New media is a focus for traditional media, but arguably the market share is small and will not be mainstream soon. Newspapers should go online, but I see a risk that readers will access free content and subscriptions will be cannibalized. Going online is alright for certain sections, like classifieds, but putting a whole newspaper online is a risk. You have to make the transition online with great care.

SCMP: Where do you see Hong Kong media five years from now?

Ling: Traditional media market share will shrink, but not at a rapid rate. There will be more companies involved with more than just one media outlet. Multimedia formats are likely to be the order of the day.

Chelat: We are going to see changes, but it's not going to be a complete overhaul. People are still going to read a newspaper, while 10% to 20% may want news only on a digital platform. Newspapers are going to have to be flexible and have the technology to distribute tailored content on different platforms. Those that do that on the right distribution platform will be the winners.

Fragmentation has accelerated in the last few years. The market is aware that something is going on, but it is not aware of where the market may be five to ten years from now. People are largely near-term focused. Things are moving rapidly, but not rapidly enough. You are not going to see a quantum change in five years, you will see a material change. If traditional media does not make the leap online they will take a reduced share, but they can survive.

I started to cover media at the end of the dotcom boom. People paid for concepts before valuations crashed. Now people pay a premium for delivery and valuations have returned. They look for companies that have done it. However, when AOL bought Time Warner that acquisition destroyed value. That mistake can be made again. People can get projections very wrong on new media.

Kwok: Within Hong Kong the change will not be substantial because the market is still irrational and tycoons tend to rule the day. If you are talking about purely commercial terms, Hong Kong should be undergoing a huge consolidation. As it is, there will likely be a modest restructuring of ownership. In the end, deep pockets are important that those without major backing may not be able to survive medium-term.

Analyst Biographies

Anne Ling
Ling joined Deutsche Bank, a leading global investment bank with a strong private client franchise, as the Regional Sector Head of Consumer and Media Research in 2004. She has over 10 years of experience as an analyst and pior to joining Deutsche Bank, Ling worked as an analyst at HSBC, Crosby Securities and Dharmala Securities.

Ling has won a number of awards for her work. Ling was voted the top analyst in the Regional Consumer sector by Asiamoney for 2005-2006 and voted as the top Hong Kong Retail analyst overall in the same poll. She took the runner-up position in the Institutional Investor 2004-2005 poll and runner-up for the regional media sector in 2005-2006.

Ling has a degree in Arts & Social Sciences, majoring in linguistics and English literature at Hong Kong's Baptist University.

Ramiz Chelat
Ramiz Chelat is the Head of Consumer and Media Research for Macquarie Securities in Asia. Ramiz transferred to Macquarie Hong Kong in 2004 to cover media stocks across Asia, with key stocks focused on including TVB, SCMP, Singapore Press, and BEC. Macquarie Securities is part of Macquarie Bank Limited, Australia's leading investment bank.

Prior to this, Ramiz was a member of Macquarie's media research team in Australia for four years, covering the domestic media sector and key media companies such as News Corporation. Before joining Macquarie in 2000, Ramiz worked as a Finance Analyst at Optus mobile division and was a Senior Accountant for Ernst and Young's Assurance and Advisory services. Ramiz holds a BComm from Macquarie University in Sydney and is a qualified Chartered Accountant.

Isabella Kwok
Kwok covers the Media and Consumer sector as an analyst for BNP Paribas. Kwok is a core member of BNP Regional Consumer team, which ranked runner-up in the latest Institutional Investor poll. She ranked highly in the Asiamoney analyst poll.

Prior to covering the Media and Consumer sector, Kwok was a member of the regional transport and infrastructure team, which was rated top three in the 2002 and 2003 Asiamoney polls. Before joining BNP Paribas, Kwok worked as an analyst at CSFB, an accountant at Daimler Chrysler Group, and as an assistant accountant at Deloitte Touche Tohmatsu.

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Ling compiled the following reports on the Hong Kong media market:
5 February 2007: Clear Media Ltd.: Access China – Beijing 2007
29 January 2007: DVN Holdings Ltd.: Tuning into the Right Signals
12 December 2006: Next Media Ltd.: Cloud 2HFY07 Outlook
6 December 2006: SCMP Group Ltd.: Company Outlook
6 January 2006: Consumer & Media: A Buyer's Guide

Chelat compiled the following reports on the Hong Kong media market:
16 February 2007: Clear Media: ASP hikes take their toll
13 February 2007: Clear Media: Occupancy to start recovering
24 January 2007: Television Broadcasts: The show is over for now
14 December 2006: Television Broadcasts: An improving ad outlook
15 November 2006: i-Cable: Game Over
7 November 2006: SCMP Group: Getting the all clear
5 October 2006: Television Broadcasts: Some positive signs emerging
1 September 2006: SCMP Group: Good results on notice

Kwok compiled the following reports on the Hong Kong media market:
TVB
11 January 2007: Stronger, but not strong enough
13 December 2006: Solid demand seen from ACS
25 August 2006: A strong set of results? Think again
6 July 2006: Slow property market dents ad growth
26 April 2006: Digitisation is a double-edged sword
23 March 2006: Good results but slower growth ahead
9 January 2006: Less attractive growth profile

SCMP
1 September 2006: Here the paper delivers
4 August 2006: Display and N&A ads drive growth
7 April 2006: Results below expectations

i-CABLE
4 January 2007: Going downhill
18 August 2006 Operating landscape sees improvement
14 August 2006: Challenges ahead
21 July 2006: Substantial decline expected in 1H06
3 March 2006: Let's wait until the dust settles
13 February 2006: De-rated to utility-like valuations

Oriental Press
23 October 2006: Bottoming out
10 July 2006: Disappointing results