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Biographical

That's Entertainment!

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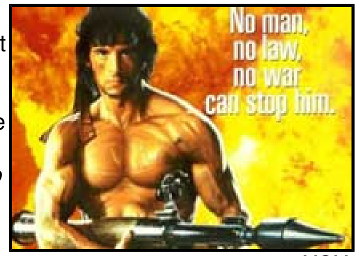

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Hollywood isn't looking for heroes. Actually, it's usually looking for the next villain. During the 80s Cold War, the Soviet Union made for a perfect enemy, producing classic bad guys like Ivan Drago (*Rocky IV*), the Russian Army occupying Afghanistan in *Rambo 3* and the entire Soviet Naval Fleet in *The Hunt for Red October*. And who could forget the now classic *Top Gun* in which our hero, Maverick - played by Tom Cruise - rumbled in the sky with "Soviet" MiG fighters?

But times change and so do our villains. At the end of the Cold War, Hollywood was scrambling to find new villains for its action heroes to face. What came next? The late-80s and early-90s conveniently produced *generic foreign terrorists* as the next bad thing. Bruce Willis took care of greedy terrorists in the unforgettable *Die Hard*. Wesley Snipes and Kurt Russell foiled airplane hijackers (separately) in the more forgettable *Passenger 57* and *Executive Decision* movies. And the ageless Arnold Schwarzenegger beat up all manner of terrorists in *True Lies*.

It's unclear who Hollywood has in mind for this decade's main villain, although North Korea seems to be off to a good start- namely, 007's nemesis in *Die Another Day*. Perhaps even Iraq, since conflict seems imminent there. Either way, Hollywood will surely find its next bad guy, because it makes for good business.

One might even get the impression that wars have been good for media types. After all, the Gulf War really propelled CNN into our living rooms. Journalists have historically built careers based on their reporting during serious conflicts. And the War on Terror has given the magazines and news publications plenty to write about. When was the last time *Newsweek* or *Time* published a magazine that *didn't* feature an article about one of the Axis of Evil countries or, at least, potential terrorist threats to the U.S.?

War, What Is It Good For?

It turns out, however, that although war has been good in producing content for entertainment companies - creating broadcast starts for the media companies, and, let's not forget, for building the future of entire news media operations - it hasn't proven to be very good for their bottom line. But the good news is that this occurs only in the short run. In the long run, the companies within these industries that *understand the consumer* and our insatiable appetite for improving entertainment, destinations, diversions and technologies will come out of any war-time scenario positioned for growth and prosperity.

A December 2002 Salomon Smith Barney study concluded that large cap entertainment stocks fell 32% during the Gulf War and destination travel stocks fell 52%. Theme parks are especially sensitive to wars. For instance, attendance at Walt Disney's U.S. parks declined 4.5% during the fiscal year in which the Gulf War occurred, compared to an increase of 1.4% during the prior fiscal year.

But there is reason to believe that the impact of a new Gulf War on these industries will be less significant than the aftermath of the last one. Many of these stocks have already experienced a "war discount" in pricing during recent weeks. In fact, entertainment stocks are trading at valuations well below pre-September 11th levels, when neither a war on

public opinion
How big a threat is North Korea compared to the USSR?
A larger threat
About the same
Not as big a threat
SUBMIT

terror nor a war against Iraq was at hand and economic conditions were comparable to today's situation.

There is also evidence of a recent trend toward smaller declines in entertainment stock values resulting from the impact of military situations. *Institutional Investor* All-American Leisure Analyst Jill Krutick of Salomon Smith Barney notes that while destination travel stocks fell on average by 45% after past military events, that group has only fallen by 21% after September 11th. Similarly, although the large-cap entertainment stocks have historically declined by 25% after military moves, the shares have fallen by just 16% post-9/11.

Furthermore, these stocks have been relatively quick to rebound from the impact of wars. While the S&P 500 took over six months to return to pre-Gulf War levels, entertainment stocks bounced back in less than three and a half months. Destination travel stocks - notably resorts, cruise lines, and also entertainment conglomerates with a high concentration of theme park revenues - came around more slowly because of soft post-war tourism conditions.

Getting Out Front

Because of this rebound effect, however, investors hoping to profit from that effect realize that they must own these stocks in *front* of the recovery. Some stocks for investors to consider are several larger-cap stocks in the entertainment sector. Large-cap entertainment stocks are generally more diversified in their businesses and therefore more likely to enjoy a speedier post-war recovery. Additionally, large-cap indexes in general outperformed small-cap indexes during the Gulf War, which may reflect a flight to quality during unpredictable circumstances.

The obvious consequence of war on consumers is its negative impact on the economy in general and on consumer confidence in particular. Tough economic times tend to produce lower disposable incomes, and consumers tighten their purse strings accordingly - especially when it comes to the bigger and higher ticket leisure goods and services. However, equally powerful is the effect of war on consumers' growing demand and need for entertainment. When the eerie drum beats of war start troubling us, entertainment is our natural form of escape.

Moreover, entertainment and media companies are expected to benefit from new technology, including video on demand, DVD and digital distribution technology. The new availability of video on demand over cable television in many markets would open up a powerful new method of distribution. And although DVD's have been around for some time, now that DVD players are priced for the mass market - dropping in price from almost $500 in 1997 to less than $100 today - entertainment companies should capture even more revenue from increased DVD adoption. As DVD's fulfill past technological promises, Digital distribution technology is poised to deliver future promises. Film delivery via fiber-optic lines and disc-based digital storage could significantly improve cost dynamics for entertainment companies by lowering both print and distribution costs.

Who Benefits?

A company that has the potential to benefit from these trends is **Viacom** (NYSE: VIAB), which sets the standard for entertainment conglomerates by offering advertisers a unique platform to reach customers across nearly every demographic and through almost every form of media. The company's operations are diversified into six major segments and filled with major brand names: cable networks (MTV, VH1, Nickelodeon); television broadcasting (CBS), production (Spelling Entertainment, Kingworld) and syndication; radio broadcasting (184 Infinity Radio stations); filmed entertainment (Paramount Studio); video (Blockbuster); and publishing (Simon & Schuster).

Viacom has been generating strong cash flows, and its revenues from operations are spread relatively evenly across all segments. The combination of these factors position the company well to not only survive an economic downturn caused by war, but also to really profit from a post-war recovery and the demand for content and goods that results as countries emerge into a state of peace and euphoria. Plus, the company has seen its stock price unnecessarily suffer from investor concern over management infighting - specifically, at the very top of the ladder. But, have no fear - any discord on the part of the two leading men will not affect the operation of Viacom. Both are too smart, ambitious and motivated as shareholders to let that happen.

News Corporation (NYSE: NWS) is another company poised for growth. (In the interest of full disclosure, please note that I am a contributor on the Fox News Channel, which is part of the News Corporation umbrella.) The company boasts a high level of vertical integration between both content and distribution assets, with extensive interests in film and television production and distribution, satellite, cable broadcasting, sports programming distribution, printing and publishing. News Corp. has been investing in new markets (in Europe and Asia) as well as in new technologies (BskyB's satellite TV operations), which feature the potential for long-term growth. Investors should also note the company's possible acquisition of General Motor's stake in Hughes Electronics. Hughes' DirecTV network is the nation's top satellite television provider and could offer strategic benefits to News Corp.'s operations.

Those with greater interests in pure entertainment can invest directly in News Corp.'s majority-owned subsidiary (approximately 81% equity interest, with a 97% voting stake), **Fox Entertainment Group** (NYSE: FOX). Fox's principal activities are carried out through four segments: filmed entertainment (42% of fiscal 2002 revenues), television broadcasting network (21%), television stations (19%) and cable network programming (18%). The company is reaping the rewards of its history of smart investments, which have positioned it to generate substantial cash flow, to experience strong cable growth (with continued future upside remaining) and to ride a wave of solid box-office performances. Highlighting this trend is Fox Entertainment's acquisition of Chris-Craft, which not only added revenue, but provided ample operating efficiencies as well.

Goldman Sachs Entertainment Analyst Richard Greenfield believes that both Fox and Viacom are the best-positioned entertainment companies to take advantage of continuing improvement in the advertising market. He states, "We view both [Fox and Viacom] as strong growth stocks that are significantly less complex than their media peers, generate significant free cash flow and when combined with low relative leverage, give both financial flexibility. For growth-minded investors, we believe both of these stocks offer attractive risk/reward at current levels, as we expect them to significantly outperform in 2003."

The diversity of operations and revenue streams these entertainment companies enjoy should certainly enable each of them to prosper during an economic recovery. But even during a war with Iraq they might actually do better than we expect. Entertainment spending has been growing as a share of personal consumption in recent years, and there are indications of an "escape effect," where during troubled times, consumers gravitate toward entertainment to escape reality.

Now as we escape from reality, the question remains: which villain will Hollywood choose in its quest to entertain us? Ironically, in the James Bond movie, *Tomorrow Never Dies*, it was a media/entertainment company. Super-villain Elliot Carver (played by Jonathan Pryce) runs the powerful international media company and eliminates many who get in the way of his company's objective: to create wars and other crises that generate the news from which his company richly profits.

Could it be that if there's a lesson to be learned from this movie (and believe me, there really aren't many), it must be that we should stay away from entertainment companies? No, that wouldn't be very entertaining. Maybe the lesson, then, is that the fortunes of entertainment companies fluctuate during times of crisis. Savvy investors recognize this as an opportunity to find heroes in the market amongst the villains. And in doing so, they may stand to reap substantial rewards for their investment.

Now, *that's* entertainment!

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