

PALI RESEARCH

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Media Industry 2008 DVD Declines Accelerating with Wal-Mart Cutting Floor Space

Despite studio executives' hopes that 2007 DVD sales would finish the year up year-over-year, the 4Q failed to lift full-year results into positive territory, with 2007 becoming the first year in which consumer spending on DVDs declined (which we had predicted in our *DVD Party is Over* note on 10/6/2006). Unfortunately the key Hollywood studios waited (or rather fought) far too long to unify behind one next generation DVD format (Blu ray has now won) leading to even greater catalog DVD declines in 2008. We expect consumer spending on DVDs to decline by 4-5% in 2008 compared to a 2% decline in 2007, even with next gen (almost all Blu ray) spending tripling within that overall forecast. The key driver of the decline is accelerating catalog DVD declines and a first-time decline in TV DVD spending. See *Exhibit A* for our industry forecasts.

With media companies speaking at an investor conference this week, we hope to get a sense as to how each company is dealing with accelerating declines in its DVD business (ie. for TWX, we presume restructuring New Line is one example of changes, at least partially-driven by a more challenging DVD landscape).

The pressure on catalog DVD unit sales is being exacerbated by a decision from Wal-Mart senior management to "clean-up" the aisles within the company's stores – meaning scaling back/eliminating so-called "dump bins," many of which contained loads of ultra-low-cost DVDs.

- While the consumer perception of a DVD's value is likely to be improved by eliminating dump bins (good for the home entertainment biz longer-term), studios that have relied heavily on deeply discounted catalog sales (meaning the volume of catalog sales helped "hide" the effects of a weaker new release slate) will be negatively impacted in 2008.

While Blu ray's growth would normally be expected to slow the industry's decline in 2009/2010, we are increasingly concerned about bandwidth increases (from cable MSOs and RBOCs) over the next couple of years that may increase the industry's growing piracy problems. In addition, we are seeing an ongoing evolution in digital

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distribution (both paid download and advertising-supported models), which cannot be positive long-term for the physical formats such as the DVD. While “second session” DVDs (meaning DVDs that include a digital copy in iTunes, Windows formats) are becoming more visible, it remains to be seen whether consumers will pay more to purchase a movie that is simply packaged in multiple forms on a DVD.

Figure A: Consumer Spending on Home Video

\$ Billions	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007E	2008E
DVD	0.4	1.5	3.2	6.8	11.6	16.3	20.2	22.3	23.6	23.2	22.2
% Change		259%	118%	113%	71%	40%	24%	10%	0.1	-1.7%	-4.6%
VHS	13.3	13.2	12.8	10.1	8.5	5.7	3.8	1.5	0.5	0.1	0.0
% Change		0%	-3%	-21%	-16%	-33%	-35%	-60%	-0.7	-70%	-70%
Total Home Video	13.7	14.7	16.0	16.9	20.2	22.0	23.9	23.8	24.1	23.4	22.2
% Change		7%	9%	6%	19%	9%	9%	-1%	0.0	-3.0%	-5.0%
% of Home Video											
DVD	3%	10%	20%	40%	58%	74%	84%	94%	98%	99%	100%
VHS	97%	90%	80%	60%	42%	26%	16%	6%	2%	1%	0%
Rental	8.0	8.2	8.2	8.4	8.1	8.1	8.0	7.7	7.6	7.4	7.4
% Change		3%	0%	2%	-4%	0%	0%	-4%	0.0	-2.0%	-1.0%
Sell-Thru	5.7	6.5	7.8	8.5	12.1	14.0	15.9	16.1	16.5	15.9	14.8
% Change		13%	20%	10%	42%	15%	14%	1%	0.0	-3.4%	-6.8%
DVD Sub-Categories											
TV DVD Sell-Thru		N/A	N/A	N/A	0.8	1.4	2.3	2.9	3.2	3.3	3.2
% Change						75%	62%	25%	12%	4.0%	-3.5%
Catalog DVD Movie		N/A	N/A	N/A	N/A	5.1	6.2	7.4	7.5	6.8	6.1
% Change							21%	19%	1%	-9.0%	-10.0%
New Release Movie DVD		N/A	N/A	N/A	N/A	9.8	11.7	12.1	13.0	13.1	12.8
% Change							20%	3%	7%	1.1%	-2.1%
Standard Def										22.9	21.3
% Change											-7.3%
Next Gen										0.3	0.9
% Change											200.0%
DVD Household in US	1.2	4.6	13.0	25.0	40.0	47.0	65.0	84.0	92.0	97.0	99.0
% Change		283%	183%	92%	60%	18%	38%	29%	9.5%	5.4%	2.1%

Source: Kagan, Video Business, Variety, MPAA and Pali Research estimates.

APPENDIX

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OTHER DISCLOSURES

Companies Mentioned:

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Wal Mart (WMT, \$49.90, NYSE, not rated)

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