RADIO'S PREMIER MANAGEMENT & MARKETING MAGAZINE

RADIO INK

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Our Mission: *Radio Ink*'s role is passionately to empower radio management to be more successful by providing fresh, actionable, reality-based ideas, inspiration, and education in a quick, easy-to-read, positive, pro-radio environment.

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When Internet And Radio COLLIDE

{By Editor-In-Chief Ed Ryan}

Drew Marcus is a name well known to a lot of radio executives and managers. Before launching Sugarloaf Rock Capital, Marcus was vice chairman of global banking for Deutsche Bank and a member of its media/telecom group, and before that he served as Deutsche Bank's global head of media equity research and was a top-ranked media-industry analyst. Sugarloaf, launched in 2009, manages SLRC Media Opportunities Fund, which invests in technology, media and telecom equities, and debt securities, with a focus on media.

Drew's brother Larry Marcus is managing director at Walden Venture Capital, which focuses on "sprout stage" investing in the digital media and cloud services spaces. (A company at the "sprout" stage is typically looking for its first round of capital after initial seed or angel financing.) Before Walden, Larry was in digital media sell-side equity research in the '90s, first covering PC software and later video game software, broadband, and the Internet. Now he's focused on mobile, social, and tablet devices, and the services that can uniquely leverage their capabilities. *Barron's* has called him the "Music VC' because of his involvement with Pandora, SoundHound, and Rootmusic, all of which have broken out in their respective spaces.

The Marcuses have covered the evolution of media companies across all stages of development, Larry specializing in startups while Drew looks at later-stage companies, including takeover targets and companies in bankruptcy. The brothers often advise each other and look to one another for ideas across the investing spectrum.

Larry, obviously, the big deal right now is Pandora. Can you talk about your early involvement?

LM: When I first met Tim Westergren of Pandora, the company had a different name and was licensing its recommendation technology, the Music Genome Project, to enterprises including AOL and Best Buy. I was very intrigued by Tim and the technology and spent some time looking at a dashboard that gave a window into the Genome Project. I spent hours on it. It was absolutely captivating, and I became excited about leveraging the Genome to power our own consumer-facing service. I led a round in early 2004 that was essentially the rebirth of the company into this new opportunity.

We were fortunate to bring in a great outside director and co-investor and immediately started recruiting. Within just a couple of quarters, we had the current management team in place: Jessica Steel in business development, Tom Conrad in product, and our talented

Larry Marcus has a deep love of technology, and even has a modest dead-hardware museum, with notable pieces of technology from the '60s and beyond, including early home computers, mobile phones, and video game systems. There's the Apple Lisa, the Altair 2200 (Paul Allen wrote his first code for Microsoft on it), the NextCube (the machine on which the Internet was invented), the Magnavox Odyssey (the first video game system), the first Polaroid camera, a Betamax VCR, the Audible Player, and the first Tivo and ReplayTV models. Some of these, of course, were notable for their success — while others, like the 3DO game console, ended up as overhyped failures.

CEO, Joe Kennedy. The team honed the value proposition, built the product, re-branded to Pandora, and launched the service in 2005. Thereafter we've been able to attract some very talented management, investors, and directors.

We all got really excited about it, because radio is about listening to the next great song that you'll love. There was a collective belief that a personalized radio experience could be dramatically better for consumers and that the core tech was uniquely suited to empower this. Management kept the product very simple and intuitive. After gaining initial traction, we began creating the infrastructure so Pandora could ultimately support many kinds of connected devices. After experimentation on many that never really amounted to much, the iPhone shipped. What an incredible mobile Pandora player that is! Adding on the Android phones, connected DVDs, and next-generation telematics in cars, Pandora is mostly consumed outside the computer desktop.

Drew, you were an early fan of traditional radio. Why was that? Are you still a fan?

DM: I was an early fan of Pandora — in fact, I co-invested with Larry. Larry and I work together on a lot of deals. I am an investor in his fund, and he is an investor in my fund. I also helped Pandora meet a lot of people in the radio industry. I recognized early that Pandora was a great listening experience.

But you are still a fan of traditional radio, correct?

DM: I was the first analyst on Wall Street to recommend radio stocks, back in 1987; I wrote the first report on Wall Street on radio, recommending stocks like Clear Channel, Infinity, and Malrite. In 1992, I wrote a report talking about how radio duopoly was going to change the industry.

We predicted it was going to spark an era of consolidation and rising asset values. Radio was one of the best-performing sectors in the stock market in the 1990s. Then, at the beginning of 2005, I shifted over to investment banking and stopped having published opinions on radio stocks. As an investment banker, I was involved in transactions including the Univision and Clear Channel LBOs and the formation of Cumulus Media Partners.

Within our fund, we have a small portion of the fund invested in select traditional media companies. We like companies that are generating free cash flow and have strong underlying asset values. We like companies that are successfully building a community around their traditional media brands, have a profitable digital strategy, and perhaps are diversifying into other complementary media. Specifically regarding radio, we like its free cash flow characteristics. The key question for the industry and investors is the long-term revenue growth rate.

Larry, what are your thoughts on traditional radio?

LM: I think traditional radio is very simple to use. It's ubiquitous, with a massive number of endpoints, particularly in the car. It has a lot going for it, including great content, personalities, local engagement, and a powerful selling infrastructure. It is a double-digit billion-dollar industry. I am a listener.

If traditional radio wasn't an exciting industry, then attempting to innovate in ways that are going to change that industry would not be of interest. You have seen digitization sweep through music, publishing, video games, and these trends may eventually impact radio.

Is radio a good business right now?

LM: I will defer to Drew, as he's best qualified to answer.

DM: Our general view is that radio is in a position to gain share from print media but lose share to digital media. Most importantly, radio's free cash flow characteristics remain strong. The radio industry has been successful at deleveraging in the past couple of years after entering the recession at dangerously high levels of debt leverage. We expect the deleveraging to continue as the industry adjusts to its being a mature sector, as opposed to a growth sector.

We also think consolidation is healthy for the sector and will likely continue. We are seeing that right now with the Cumulus-Citadel merger and the Dial Global-Westwood One merger.

Is radio a buy?

DM: When we look at a sector or a company, we do deep, bottom-up research on growth trends and the impact of technological change and regulatory shifts, and we analyze private market values. Of course, we overlay valuation discipline over the analysis. Not to be coy, but a lot of the answer to your question lies in the outlook for the economy and the consumer. Obviously, the economy has grown more slowly this year than most economists predicted. At the same time, our outlook for radio growth in 2011 is lower now than at the beginning of the year. We thought radio would grow about 2 percent in 2011. We think we were right on the number, but probably wrong on the sign — it is now more likely to shrink 2 percent.

A key area of focus is automobile advertising. Most experts we talk to think inventories will return to normal in September for the first time since the Japanese tsunami catastrophe. If that is true, then radio could be positioned for a good 2012, with easy auto comps and political advertising. With regard to the longer term, we are looking at the impact of new competitors in the local advertising environment, such as Groupon.

On the regulatory front, we do not expect any further loosening of the ownership rules. The NAB will need to be on its toes to avoid performance royalty fees for terrestrial broadcasters. We expect the deal environment to pick up as the equity gap between enterprise value and debt quantum widens.

"FIVE YEARS FROM NOW, I WOULD EXPECT USERS TO HAVE SIMPLER AND MORE UBIQUITOUS ACCESS TO INTERNET RADIO AND FOR YIELD RATES FROM ADVERTISERS TO IMPROVE STRONGLY."
— *Larry Marcus*

Where do you see music licensing issues affecting the online world?

DM: I would simply say that it seems to be illogical for an Internet radio company like Pandora to be paying more than half of its revenue in performance royalties while terrestrial pays zero.

LM: I agree. The lack of royalty parity does not make sense.

Five years from now, where do you see the online radio world?

LM: The broad thesis on new media investing is that dollars follow time spent by consumers. The ones that acquire high levels of users and deep engagement ultimately have tremendous opportunity to yield dollars. In new media businesses, revenue per hour, per user, per page, per impression, or whatever the metric is, will always lag the incumbent industry. This is due to early lack of standards, tracking, selling, and buying infrastructure.

Eventually, the gap between time spent and monetization does close. Mary Meeker did some great work on this when she was at Morgan Stanley. The Internet went through this, beginning in the mid-'90s. Ultimately CPMs and yield went way up, including the introduction of new types of revenue like paid search and cost per action. Ultimately, the online advertising market picked up.

For mobile Internet, we are in a similar transition. Ad units are being established and advertisers are getting more comfortable. Mobile usage is surging and will surpass desktop. Mobile means hyperlocal, given GPS targeting.

New local players like Groupon and LivingSocial are showing the desire of local advertisers to engage in new ways. Meanwhile, the rate of adoption of smartphones by consumers is at an all-time high, over a half million activations a day. Five years from now, I would expect users to have simpler and more ubiquitous access to Internet radio and for yield rates from advertisers to improve strongly. I would expect any forward-looking radio or content companies to want to follow their users onto mobile devices and IP-based delivery.

DM: Looking forward, clearly a big trend will be the ease of use and the power of mobile Internet. You will have ubiquitous deployment of smartphones, and the wireless networks will be able to handle a lot of capacity at high speeds. The consumers will be in a position to have many different choices in the way they listen to music and get audio information. I think the winners will be the companies that provide the best product. Who is the best at delivering your music library? Who is the best at music discovery? Who is the best at delivering news and information?

In the world of radio, there is always the yin and yang between the programming guys and the sales guys. Obviously, the sales guys' favorite format would be "all commercials, all the time." The programming guys want no commercials. The balance between the two, while it's always been important, will be even more important going into the future as consumers will have more listening choices with various levels of commercial loads and subscription fees.

LM: Drew highlighted something that is really important. We will have true mobile broadband. Right now, connectivity is relatively slow or nonexistent. When at-home broadband first came to market in the late '90s, its users had nearly 10 times the time spent versus dialup. Suddenly, the Internet felt fast and easy. Combine mobile broadband with these powerful smartphone devices, and don't be at all surprised when mobile Internet consumption dramatically overtakes desktop consumption.

How do you feel about how traditional radio is innovating?

LM: There is a lot of technology innovation going on in the marketplace. There are other exciting examples of music apps that are breaking out in my own portfolio. SoundHound has a music-search product that can identify music you hear or music you sing. Many users begin their interactive experience with their local radio station through SoundHound. Once a song is tagged, they can sing along with the lyrics that may actually scroll in real time to the music they hear, they can bookmark the song, share it on Facebook or Twitter or e-mail, see it on YouTube, or even start a Pandora station from it.

With SoundHound, you just say the name of a song or artist. For example, you can say, "Baby I Love Your Way," by Peter Frampton, and it will bring that song up. In the last couple of years their apps have gone from tens of thousands to tens of millions of users. Music search is a great vertical category, particularly on mobile. Something like this is a great opportunity for radio to tie in to the digital consumer.

Another company I'm involved with has a product called BandPage, helping bands make the move to Facebook because that's where their fans are. In a little over a year, over 200,000 bands have signed up and active monthly users hit 30 million. Fans want to connect directly with the artists who make the music they love. Shouldn't radio be thinking more about social and tie-ins with third-party apps?

From your answer, I take it that radio is coming on a little slower?

LM: I would look at R&D budgets and head count and ask how important strategically they think digital is. Any business, particularly a media business, should be looking at the technologies that affect them and attempt to adapt as smartly as possible. The companies that can do that well can persist with their users.

DM: The traditional radio guys have been experimenting in digital, but there has been no mass monetization. Larry's point about R&D budgets is a good one. Most radio companies were fully levered and thus were more focused on right-sizing their balance sheets than they were on experimenting with new technologies. So far we haven't seen any big successes with digital strategies, but there have been a number of small success stories. We are likely going to see consolidation, which should provide bigger platforms for innovation.

Clear Channel continues to try to innovate with iHeartRadio. CBS Radio has done a great job on the programming side. The new Cumulus-Citadel combination, with the resulting right-sizing of Cumulus' balance sheet and national footprint, gives it more resources to experiment. Salem and Radio One are also building digital business around their niches. We will see what happens going forward. Right now, the scorecard shows Pandora's getting more than 50 percent of online listening. That number speaks for itself.

LM: There are some strong-performing apps related to terrestrial radio. In addition to single-station apps, there is Clear Channel's iHeartRadio, which aggregates and rebroadcasts terrestrial stations. There is another product called TuneIn, which is also an aggregator and rebroadcaster. Millions of people are listening to their favorite broadcast stations through TuneIn, even if that broadcaster doesn't have its own app. Both iHeartRadio and TuneIn are very popular apps on the iPhone and Android devices.

Do you think iHeartRadio will be real competition for Pandora?

LM: Absolutely. Clear Channel has a lot of promotion muscle and is pushing iHeartRadio across its stations. Competition is a very healthy dynamic in a market and benefits consumers. The corporate commitment to iHeartRadio is certainly an indication that they believe consumers are interested in this form of radio. Consumers will have an opportunity to try it and make their choices.

Where do you think Pandora will be in five years?

LM: More ubiquitous, more compelling, easier to access, more evolved from a business model perspective.

If you had the ear of a radio board, what kind of advice would you give them?

DM: I would advise them to be realistic about revenue growth. I would assume that the core, traditional advertising stream is one that will be stable going forward, but not rapidly growing. I would right-size your sales force, sales incentives, and cost structure accordingly. I would right-size your balance sheet to proper debt leverage ratios. I would build up an R&D budget to find new ways to build a social community around your listeners, which will result in a more valuable digital strategy.

Finally, I would continue to look for consolidation opportunities. In some cases, I would look for divestiture opportunities to unlock value and accelerate free cash flow growth. Deep down, Wall Street loves radio's free cash flow, as demonstrated by its historic premium valuations to other media sectors. However, the underperformance of the stocks in the past few years is due to disappointing revenue trends, the emergence of new competitors, and concerns about debt leverage. If the industry can return to healthy free cash flow growth, then its premium valuation should return. INK