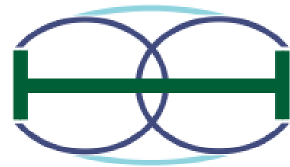
Strategic Report for Viacom, Inc.



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Innovation through Collaboration

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Executive Summary

Viacom, Inc. is one of the largest global entertainment and media corporations. It consists of two segments: Media Networks (e.g., MTV Networks, BET Networks) and Filmed Entertainment (e.g., Paramount Pictures). Viacom owns many well established brands—in addition to those mentioned above, Viacom owns Comedy Central, Nickelodeon, CMT, iFilm, and a controlling interest in DreamWorks, LLC, among others. The global media and entertainment industry is characterized by intense internal rivalry and significant threats from substitutes.

Viacom emerged in its current form following a split from the original Viacom (now CBS) in March 2005, which was intended to allow high-growth businesses (e.g., MTV and BET networks) to flourish following an infusion of new capital for future acquisitions and expansions. Trading under the ticker VIA on the NYSE, Viacom has a market capitalization of almost $26 billion.[1]

Several factors have influenced the recent performance of Viacom and the industry at large. The slowing economy has led to declining viewership and, consequently, has also negatively impacted revenue generated from advertising. Anthony Noto, an analyst from Goldman Sachs Group, Inc., predicted U.S. advertising sales will decline three to five percent in 2008, and cut profit estimates for media and entertainment companies.[2] The recently resolved writers' strike also had a significant, harmful effect on TV viewership and ratings and DVD sales. Despite these obstacles, Viacom is predicted to outperform its peers.[3]

In this report, Harkness Consulting focuses its attention on three main strategic areas. The first area is broadly encompassed by "financial opportunities". Specifically, we recommend considering a leveraged recapitalization and divestiture of underperforming business segments. The second strategic area we focus on is content distribution. We examine new content distribution opportunities and corresponding new advertising models. In this area, Harkness Consulting recommends developing a competitor to YouTube and other similar businesses in order to directly bring content to end consumers. This may be most easily accomplished

through Viacom's recent partnership with Microsoft. We also suggest continuing to explore mobile video and interactive media (i.e., participation TV), both on mobile and home platforms. The third strategic area we focus on is Viacom's international presence. We suggest Viacom continue to globalize its holdings and increase its international presence, especially in India and China, through partnerships with local content creators and new ventures similar to "NickUK" in England.

Company Background

The Business

Viacom is a global entertainment and media corporation that produces branded entertainment which it distributes through a variety of mediums. They conduct business through two primary operating segments: media networks and filmed entertainment. Media networks include cable television networks, website properties, and digital services. In its stable of media networks, Viacom has major names such as: MTV Networks, BET, CMT, VH1, Comedy Central, Urge, Logo, Harmonix, Rhapsody, Nickelodeon, Nick at Nite, Neopets.com, TurboNick, Noggin and The N, Spike TV, TV Land, iFilm, Xfire, and others. In this segment, Viacom primarily derives revenue from two sources: (1) the sale of advertising time on cable television networks and (2) receipt of affiliate fees from cable operators, DTH (Direct-to-Home) satellite operators, and other distributors. Filmed entertainment consists of Paramount Pictures Corporation, which produces, finances, and distributes features films and television programs. Paramount has produced blockbuster titles such as *Titanic, Forrest Gump, Braveheart, Indiana Jones, The Godfather, Mission: Impossible,* and *Star Trek*. Paramount's home entertainment group distributes titles such as *The Dave Chappelle Show, Dora the Explorer,* and *Laguna Beach*. The filmed entertainment division also includes a controlling interest in DreamWorks L.L.C., a leading producer of live-action motion pictures. Revenues for this segment primarily come from: (1) sales stemming from theatrical releases domestically and internationally, and (2) home entertainment which includes the sales of DVDs, (iii) and broadcast licensing fees.

Beginnings

Viacom was originally formed by Columbia Broadcasting System, Inc. (CBS) in 1970 in an effort to comply with FCC regulations prohibiting a broadcast network from owning cable assets or from syndicating their own programs. In 1971, CBS conducted a spin-off, which made Viacom a separate public corporation. At the time of the spin-off, Viacom had approximately 90,000 subscribers to its cable systems and $19.8 million in revenue. Despite access to a number of popular television programming assets via the CBS relationship, at the time, Viacom struggled to establish itself as a major player in the highly-segmented cable market. They, however, were not alone. A slew of debt-ridden cable companies across the US found it very difficult to compete with the ingrained broadcast networks as they faced onerous regulation as well as logistical and financial difficulties. Even TCI, which at its zenith was a veritable titan run by the shrewd and ruthless John Malone, stumbled in this altogether choppy business environment.

In 1976, Viacom launched Showtime movie network in an effort to compete with Home Box Office (HBO). Partnered with Warner Amex in the venture, Viacom took the daring step of transmitting the network via satellite to other cable systems and effectively displaced HBO. In the 1980's, Viacom, under the leadership of Terrence Elkes, ventured into other media assets, and, in 1981, acquired a Chicago radio station for $8 million and Video Corp. of America for $16 million. In a struggling pay-TV environment, Viacom formed a joint venture in 1983 with Warner Communications Inc. and Warner Amex Cable Communications, which resulted in the joint operation of both Showtime and The Movie Channel. In 1985, Viacom purchased 66 percent of MTV networks which included Music Television, Nickelodeon, and VH1. MTV itself was indeed the jewel in this acquisition with a very desirable young target demographic. While Nickelodeon had not met with much success up until the Viacom acquisition, Viacom reworked Nickelodeon to make it more fresh and exciting. Shortly thereafter, Viacom acquired the remaining outstanding shares of MTV.

Struggling under a massive debt load from this slew of acquisitions, Viacom was losing money on sales of nearly a billion dollars in 1986. It quickly became a takeover target and Carl Icahn

made an abortive attempt to purchase the company. A subsequent management buyout initiated by Terrence Elkes also failed. After a prolonged struggle, Sumner Redstone, Chairman and CEO of the privately-held National Amusements, Inc., purchased 83% of Viacom in March of 1986 for $3.4 billion. National Amusements was a family business that Redstone had expanded from 50 drive-in movie screens to more than 350, and he immediately set to renovate the struggling Viacom.

Viacom under Sumner Redstone

Redstone's first order of business was to install Frank Biondi, the former CEO of HBO, in the top spot at Viacom. International expansion at MTV coupled with several major successes with television assets allowed Viacom to shore up its debt structure and get the company on an upward trajectory. Additionally, Viacom sold a 50% interest in Showtime to John Malone's TCI, hoping to benefit from added visibility with TCI's enormous subscriber base. In 1989, Viacom saw sales of $1.4 billion and net income of $369 million, quite an improvement indeed. Also in that year, HBO introduced a comedy television network, and, several months later, Viacom launched its own as well. At the time, a merger of the two channels was considered, but HBO's parent company, Time Warner, would only support the initiative if Viacom settled an outstanding lawsuit with HBO. Merger possibilities collapsed, for a time. In 1992, the suit was settled out of court, and Viacom and Time Warner subsequently completed several transactions together including a merger of the two comedy channels into one: Comedy Central.

In 1994, Viacom merged with Paramount Communications Inc., a major motion picture producer, for $9.9 billion. Also that year, Viacom acquired Blockbuster. To alleviate the stress of the debt load, Viacom sold off several entities including all of its radio broadcasting assets. It also completely exited the cable provider business after consummating a deal with TCI.

In 1999, Viacom went public on the NYSE, and, in 2000, completed what would prove to be a short-lived $39.8 billion merger with CBS Corporation. CBS, under Mel Karmazin, operated in several different operating segments at the time including cable, radio, television, and

billboards. Additionally, they owned several cable programming assets including CMT and the Nashville Network. After the CBS merger, Viacom continued making acquisitions, and, in 2001, Redstone bought BET Holdings II, Inc. for $3 billion. In 2003, Viacom picked up the other half of Comedy Central for $1.2 billion.

On December 31, 2005, Viacom was split into two companies: CBS Corp. and Viacom. The new Viacom housed the cable and film assets while CBS retained control over the television broadcasting assets, Simon & Schuster publishing house, and Infinity broadcasting, a radio company. Sumner Redstone retained the chairmanship of each. The split was executed to separate out the high-growth cable and film assets from the slower growing television, publishing and radio assets. In January of 2006, the "new" Viacom acquired DreamWorks L.L.C., a live-action motion picture producer for $1.53 billion. It subsequently sold a 51% controlling interest in DW Funding LLC, the owner of the DreamWorks live-action film library to Soros Strategic Partners LP in a transaction which valued the asset at $900 million.

In 2006 and early 2007, Viacom cleaned house and ousted several senior executives. First on the firing line was Tom Freston, the former CEO of Viacom who had been promoted after the separation from CBS. Freston had been credited with turning MTV into the powerhouse that it was and had been with the company for 26 years, but was fired for the lagging performance of Viacom's stock price following the separation. Next up was Gail Berman, the then head of production at Paramount. Berman, a former TV executive, had met with great success at News Corp.'s Fox television network where she helped create the hit show "24". However, the skill set proved to be nontransferable when it came to movies, and, two years after her appointment, she was dismissed by the studio head, Brad Grey. Finally, two senior MTV executives were shown the door as Philippe Dauman, Freston's replacement for the top spot at Viacom, sought to focus more on the financial performance of the division.

In February of 2007, Viacom ordered YouTube, a subsidiary of Google, to remove all of Viacom's copyrighted material from its website. While Viacom had allowed it in the past, it no

longer believed that the increased exposure of its material justified the lost revenue. A Google executive contended that Viacom was focused more on short-term financials than long-term economics, but Viacom believed that it should have commercial licensing agreements with the companies that generated so much advertising revenue off of its content. A month after the cease and desist order, Viacom sued YouTube for $1 billion. The claim was based on the fact that 160,000 videos containing Viacom's property were viewed more than one million times on the site, generating considerable amounts of revenue for YouTube and Google, while not a cent went into Viacom's coffers.

During 2007, Viacom participated in two major transactions. The first occurred in May when Viacom agreed to sell its music publisher, Famous Music, to Sony/ATV Music Publishing for $370 million in cash. Famous Music, a top ten music label, included noted artists Eminem and Shakira and also had rights on several major motion picture soundtracks including *Titanic, Forrest Gump*, and *The Godfather*. Viacom also entered into a content sharing agreement with Microsoft in a deal valued at over $500 million over a five-year period.

Family Matters

A tense family rivalry has muddied the waters at Viacom as of late. In early 2006, the Redstone family began to see the first signs of tension when Brent Redstone, then 55 years old, sued his father's privately-held National Amusements, Inc., seeking dissolution of the company in order to realize the value of his 17% holding. Claiming that he had been cut out of major corporate decisions, the younger Redstone wanted to sell off his portion of the company, but was only allowed to do so at book value, a steep discount to the estimated market value, by shareholder agreements. It was widely commented at the time that a major motivation for the lawsuit was the success with which his younger sister, Shari, had met. She had been designated the heir apparent to the media empire, serving as President of National Amusements as well as non-executive Vice Chairman of both CBS and Viacom. The suit was quickly settled and the elder Redstone bought out his son. However, this was only to be the beginning of the family's strife. In July 2007, it became apparent that Sumner and his daughter Shari were having a falling out

that might displace her from being Sumner's successor. After the settlement with Brent Redstone in 2006, Shari was left with 20% of the holding company, National Amusements. It seemed that Shari was willing to be bought out, but only at the fair value of the assets which she pegged at $1.6 billion. Since word of the falling out in July, there has been no news as to whether or not the family has come to an arrangement.

Competitive Analysis

Viacom Inc. is a leading global entertainment content group and operates in a number of different industries, including film production, broadcasting, and cable television. While many of the entertainment-related industries in which Viacom operates in also contain other media conglomerates, Viacom's competitors often vary within each specific industry. Viacom operates through two main reporting segments: Filmed Entertainment and Media Networks. The Filmed Entertainment segment, which includes Paramount Pictures, produces, finances, and distributes motion pictures and other entertainment content, faces competition from media companies such as Disney, Fox, Sony Pictures, Universal, and Warner Bros., as well as other independent film producers. The Media Networks segment, which includes MTV Networks, BET Networks, and Nickelodeon, focuses on providing content that appeals to advertisers across multiple distribution platforms, and faces competition from other cable channels and internet sites.

Internal Rivalry

The industry in which Viacom's Filmed Entertainment segment operates is characterized by a small group of media production conglomerates and other independent producers. The value chain in this market is initiated through the creation of the actual product, which is the writing and production of the motion picture. Independent writers, including those who are affiliated with certain production companies, introduce the content to the producers, such as Viacom's Paramount Pictures, which in turn produce the film. The next stage of the value chain is the distribution of the content, which is also controlled by the film producers. The production companies distribute their films to theater-chains and home entertainment stores such as Blockbuster. The companies also sell the rights to the content to videogame producers and toy

companies. According to the Viacom 10-K, revenues in this industry are primarily generated from (1) the theatrical release of motion pictures in domestic and international markets, (2) home entertainment, which includes sales of DVDs and other products related to motion pictures, (3) license fees paid worldwide by third parties for exhibition rights. Each player in the film production industry must aim to create a carefully balanced film portfolio that represents a variety of genres and levels of investment. The goal is to create the maximum appeal for niche and mass-market audiences. Each motion picture is characterized as a distinct product and the profitability of the product is directly related to public response. Not only do theatrical sales improve revenue for the particular motion product, but the success of the film also directly determines subsequent home entertainment sales and licensing fees.

The cable-television industry, in which Viacom's Media Entertainment segment operates, is similarly defined by a handful of media conglomerates that own multiple television channels. According to the 10-K, revenues in the cable-television industry are derived from three sources: (1) sale of advertising time on cable-television networks and digital properties and services, (2) receipt of affiliate fees from cable-television operators, and (3) home entertainment sales of television programming and licensing of brands for consumer products, including video games and other interactive products. Each player in this industry aims to target certain niche markets that are defined by age groups, genders, and entertainment preferences. The success of a cable-television network is driven by audience viewership, as most revenues are driven by advertising space on the networks. The cable-network is able to negotiate better terms with the advertisers if ratings are higher for their television programming. Competitive position in the industry primarily depends on the ability to dominate niche markets, distribution and marketing success, and public response. Viacom also states that industry position in the cable-television market is also threatened by further consolidation among cable operators and increased vertical integration of such distributors into the cable or broadcast television business. Such consolidation and integration could adversely affect a company's ability to negotiate favorable terms for distribution of services. The switch to digital formats could also increase competition in the market, especially if "must carry" regulations are extended to channels

beyond primary channels. More television options could increase competition and lower negotiating terms with advertisers.

Viacom's Media Networks segment also operates in the Interactive and Online Media business. One of the industries in which Viacom competes is the video game industry. The video game industry is characterized by intense competition from several media companies. Success in the industry is primarily driven through the popularity of the video game and the game's ability to generate licensing revenues through other channels of distribution. The online content industry is also filled with increasing competition from online content distributors. Similar to success in the cable-television industry, success in this industry is driven through advertising revenues, which are proportional to user hits on websites.

While Viacom operates in several media-related industries, participants in these industries face increasing competition for viewers, advertising, and distribution. Such competition comes from broadcast television, specialty cable networks, online properties, movie studios, and independent film producers and distributors. Competitors in most of these industries include market players with interest in multiple media businesses and vertical integration is common. The success of a media conglomerate depends on a number of factors, including the ability to provide high quality entertainment and adapt to new technologies and distribution platforms.

Piracy is a major factor that is threatening many of the industries in which Viacom operates, and which is changing the landscape of the entertainment industry. The success of all media companies, especially those that operate in the film and cable-television businesses, depends on their ability to cope with the growing infringement of intellectual property rights of entertainment content. Piracy of brands, motion pictures, television programs, and DVDs has the potential to significantly affect profits by reducing revenues that companies could potentially receive from legitimate sale and distribution of content.

Entry

Both the film production and cable-television industries are mature markets, and both markets have already experienced considerable consolidation and vertical integration. This has made entry into the industry extremely difficult. Most of the media-related industries which are controlled by conglomerates require significant amounts of capital to build platforms on which content is launched. In the film production and cable-television market, capital expenditures are crucial given the scale of many films and television programs. Films such as Spiderman require millions of dollars, which other smaller production studios would be unable to finance. A new entrant into any of the major media businesses would have to offer the same quality of entertainment product while also enduring significant start-up costs given that many of these industries are relatively capital-intensive. The companies that already dominate the industry are large and enjoy significant economies of scale with respect to production, marketing, distribution, and advertising. These economies of scale limit a potential entry's entry into the market.

While there are significant barriers to entry with respect to enormous capital expenditures in the film and cable-television industry, the one media-related industry which is easier for a potential entrant to penetrate is the interactive online media industry. Low capital is required for entry into this market and even those online media providers that are significant players struggle to maintain a technological advantage over other providers. With the online technological landscape changing so quickly, consumers are less inclined to follow brand name, but rather will view those media outlets that provide them with the most enticing content.

Another strong barrier to entry is the relationships many media conglomerates have with distributors and advertisers. These relationships have been built over years of negotiation and partnership. In the film production market, a film studio's success is formed through its bargaining power with theater retailers and home entertainment suppliers. Cable-television networks also have significant relationships with cable-television operators and companies in certain sectors of the economy that wish to advertise on their networks. A potential entrant

would need to build relationships with distributors and operators, which could take significant time to develop. Moreover, the contracts that emerge from these relationships are almost always multi-year, which prevents entrants from gaining market share. Moreover, retailers are hesitant to switch content-providers because of the lucrative nature of these long-term contracts.

The brand name of the media companies that operate in the entertainment industry is also a significant barrier for potential entrants. Paramount, Sony, Warner Bros., Disney, and Fox are all household names and attract consumers worldwide. A potential entrant would have to compete with these mega-players on quality of product because a lack of initial capital would prevent them from huge capital expenditures on advertising and marketing. The development of a strong of a brand name usually requires years of offering high quality and diverse entertainment.

The impact of piracy also has the potential to limit the amount of entrants into the media industries, especially film production. Billions of dollars are lost by entertainment companies through their inability to restrict unauthorized reproduction, distribution, and display of their contents over the Internet, through downloading, and the sale of DVDs. A potential entrant would need to have enough capital to withstand the loss of profits that would accompany the growth of piracy. A potential entrant would also need sufficient capital to pay for legal costs associated with defending patents, copyrights, and trademarks to protect its intellectual property.

Substitutes and Complements

The threat of substitutes is significant in the media industry. As mentioned earlier, the success of a production studio and cable-television network rely primarily on popularity and appeal across varying demographics. Switching costs are zero for consumers in the media industries and profits are driven by quality of product. A studio or television network must provide differentiated and appealing content to the consumers in order to maintain success. While box office sales have been increasing, there are numerous substitutes for a production studio's films

in theaters, hence increasing the significance of providing a quality product. The threat of substitutes in the film industry is less significant in the high-budget film market as there are a limited number of studios that can afford the high capital expenditures and launching platforms required for such films. In the cable-television industry, other substitutes are simply different programming channels available to consumers through their cable providers. Changes in policy that require addition channels to be available to households and a consumer shift towards satellite television can increase the threat of substitutes in this market. In order for a company to maintain its market share and not be affected by substitutes, it must provide high-quality content to niche markets. In order to generate revenues in this industry, a cable network must be able to garner enough viewership to attract company advertising on their programming. High spending advertisers will quickly shift their advertising expenditures to other networks if ratings decline for particular programming. The threat of substitutes can also come in the form of piracy. Pirated material of a production studio's own content can also cannibalize sales as consumers can spend significantly less on viewing content through illegal sources.

The second main substitute that presents a threat to success in the media industries is the changing landscape of consumer preferences. Many of the products offered by the entertainment industry are price elastic and any shift in price could adversely affect the popularity of the product, especially given the increasing number of entertainment options offered to consumers. While there are no perfect substitutes, any other form of entertainment can be considered a substitute for the products offered by media content providers. With technology and innovation constantly improving, other forms of entertainment, such as video games, could blossom and lead consumers to substitute movie-watching and television-watching for less expensive and more dynamic forms of entertainment. While many of the media companies are attempting to diversify their portfolio by venturing into the online media and video-gaming industry, such industries are much more difficult to dominate and hold much less brand appeal than the film production and cable-television industries.

The demand for products offered by Viacom and other media conglomerates relies more on general economic conditions and personal incomes rather than on complementary goods. The income elasticity of the products offered by the entertainment industry, especially in the film market, results in the success of media companies primarily tied to the financial well-being of its consumers. While many entertainment industries enjoy success even during economic troubles, consumers still have zero switching costs to switch their consumption towards other more inelastic goods.

Supplier Power

Viacom and its competitors in the film production and cable-television industries own the back-end of the value chain as they are the content creators as well as distributors. The major suppliers to production companies such as Viacom are the writers, actors, and other specialists required for the development of the film. Many of the production inputs are not concentrated and hence suppliers to Viacom and other media companies do not have much bargaining power. The inputs that result in the creation of a film or television program are not very differentiated as there are a plethora of writers, directors, and specialists in each genre meaning that the heavy presence of substitute inputs reduces the negotiating power held by the suppliers. The only instance in which these writers hold supplier power is in the upper echelon films that are directed and written by superstars. In these cases, Paramount and other studios must bid for writers and directors, for example, in order to develop the box-office blockbuster they are aiming for. Switching costs are minimal with respect to suppliers' unless there is a contract in place, choosing one production studio over another does not require additional capital. These superstars can drive up the price of their scripts and ideas to the mega producers like Viacom. The increased cost of these ideas from the production point of view can have a significant effect on profits.

Also, because of the enormous scale of many of the businesses operated by Viacom in the media industry, they can drive down prices offered by suppliers in a similar way that Wal-Mart owns the bargaining power with its retail suppliers. Therefore, Viacom and its competitors can

maintain relatively constant margins over time. Furthermore, supplier power in the industry can further be minimized through contract negotiations with certain writers and directors. This would disable those behind the ideas from shopping their idea among several big-name production studios.

In the cable-television industry, supplier power is even less of an issue, as content is directly created within the cable-television network. Networks such as MTV, BET, and Nickelodeon have in-house writers and directors. Viacom and other networks own the back-end of the value chain in this industry. By creating and then distributing their own content they are able to also maintain healthy margins within the business. Supplier power in the online interactive and video-gaming industry are also not significant issues, as content is also created in-house and other third-party companies are not significant players in the distribution of their content to consumers.

Buyer Power

The end-consumers of the products offered by Viacom's businesses vary across the industries in which Viacom primarily operates in. Hence, the buyer power of Viacom's segments is not concentrated within a few main players. In the filmed entertainment business, theater retailers such as AMC and Loewe's are the buyers of their films. The buyer power held by these theater chains is limited due to the enormous and lucrative nature of the films produced by big-name studios in the film industry. If a theater-chain refuses to accept the terms set forth by a studio such as Paramount Pictures, it could prove costly for them when other high budget and highly advertised films come to market and Paramount refuses to sell the rights to their film to the theater-chain. The power held by the buyers in the industry is more significant with respect to independent studios, which do not have the negotiation power or brand name held by the mega-players.

Another set of consumers is the people who watch Viacom's films. While theater-chains do not hold much buyer power in the industry, the power of end-consumers is significant. Consumers

have zero switching costs and can easily choose to consume the plethora of other films and entertainment substitutes that are available to them. The method in which production studios are able to hedge the threat of consumer buyer power is through a differentiation of their film products to minimize buyer concentration within a certain niche. Viacom's filmed entertainment business also licenses the rights to its intellectual property to retailers of consumer products such as toys and videogames. The buyer power of these retailers is also not a significant force as Viacom is able to switch to other toy-makers and video-game creators without much transition cost, unless a contract is in place. Production studios also enter into agreements with cable-television networks, in which the cable networks buy the rights to a television-show for the particular movie. In such cases, buyer power is relatively low as well, as multiple networks bid for the rights, especially if the movie produced is well-received by the public.

In the cable-television business, the buyer power rests in the hands of companies that wish to advertise on the cable-television's networks. The buyer power in this industry is directly correlated with the success of the programming. If Viacom's networks are able to enjoy high ratings for their programming, they can pressure advertising companies into more favorable terms given the success and popularity of their shows. Buyer power in the industry is further minimized by offering niche market programming. Viacom, for example, dominates children programming through its Nickelodeon channels. If a company whose product appeals to children wishes to advertise, it must do so on the limited number of children programming options available. Because Viacom dominates children programming, advertising companies have little to no bargaining power. Buyers in this industry are not able to extract a significant amount of firm and industry profits. The buyers of Viacom's television content have been expanding into the mobile phone industry as well. Mobile network providers such as Verizon, AT&T, and Sprint are beginning to offer cable channels as part of plans consumers can buy. This offers another unique way in which Viacom and other cable-network companies can gain additional revenues. While buyers in this market may have more power, it provides extra revenue for Viacom without much cost associated in the distribution of their content.

Buyer power in the online interactive media business is much more of an issue for Viacom. Because of the numerous online options available to consumers, it is much more difficult to dominate a niche market within the online industry. Because revenues are driven by advertising associated with online content, advertisers can easily and without cost switch to advertising on other sites. Hence, buyer power is much more significant and can only be minimized through the creation of highly differentiated and popular online content.

The only case in which Viacom and its competitors face the growing threat of buyer power is through the retailing of their own content in stores such as Wal-Mart. Wal-Mart and other mega retailers are able to control prices of the goods they purchase from distributors. For example, if media companies such as Viacom are unwilling to negotiate on the terms set forth by Wal-Mart, Wal-Mart can threaten to pull their products from their shelves. While the "Wal-Mart effect" is a growing threat to suppliers such as Viacom, Viacom's DVD and videogame sales are not significant enough for this to be a serious threat to the overall profitability of Viacom's businesses.

SWOT Analysis

Strengths

- Dominant individual sub-brands in their respective markets (e.g., MTV, BET, Nickelodeon);
- Large amount of capital on hand gives flexibility to create new content, acquire third-party content, invest in businesses, acquire businesses, and repurchase shares, as well as pay interest and taxes;
- Multi-year affiliation deals create reasonably stable sources of affiliate fee revenues; and
- Investment grade credit rating provides adequate access to capital markets given expected cash needs.

Weaknesses

- Problems with succession lead to questionable future—conflict within the Redstone family raises continuity issues;
- Redstone's continued trouble with top managers (e.g., fired Tom Freston, the long-time head of MTV);
- Success is dependent on audience acceptance of content, which is difficult to predict;
- Must respond to rapid changes in consumer preferences and behavior resulting from changes in technology and distribution platforms; and
- Revenues, expenses, and operating results vary based on the timing, mix, number, and availability of programming and motion pictures.

Opportunities

- Partnership with Microsoft to distribute content online;
- New entry into interactive media;
- Expanding presence internationally to focus on regions and demographics that offer the greatest growth opportunities; and
- Alternatives for pricing, structure, and volume of advertising spots and commercial segments to reflect new ratings methodology effective beginning in 2008.

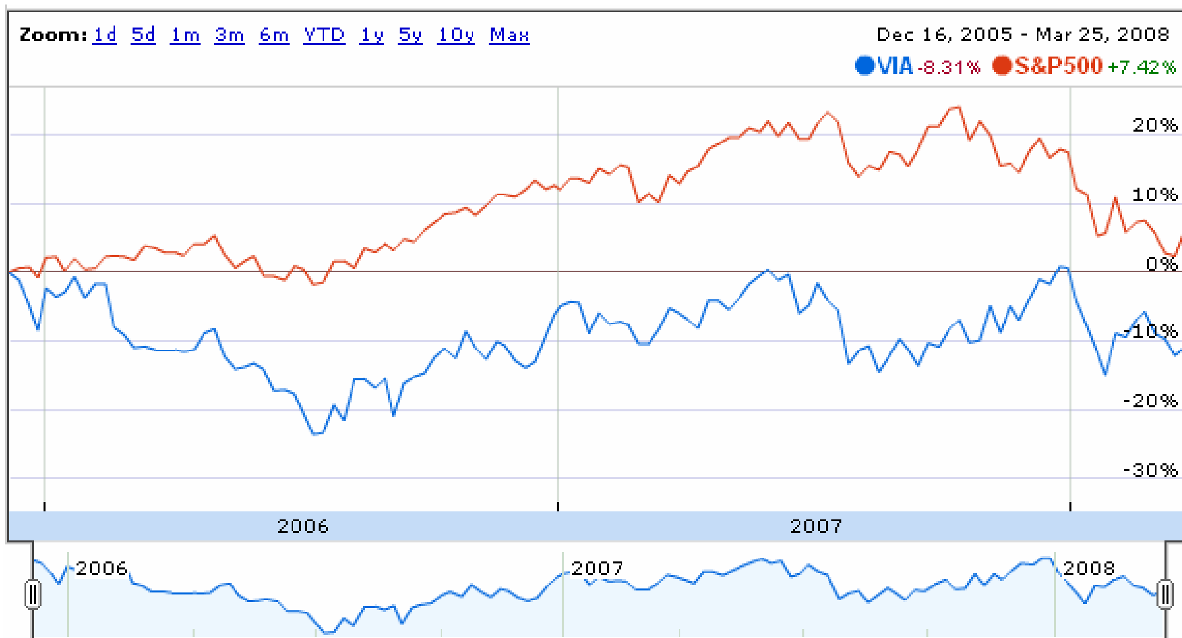
Threats

- Piracy of brands, motion pictures, television programs, and DVDs;
- Entry into interactive space highly contested: a number of new entrants have emerged;
- Increased costs for programming, motion pictures, and other content;
- Loss of affiliation agreements with content distributors could cause revenues to decline in any given period or in specific markets;
- Loss of key talent could disrupt business and negatively affect revenues;
- Failure or destruction of satellites and facilities could negatively affect ability to distribute content.

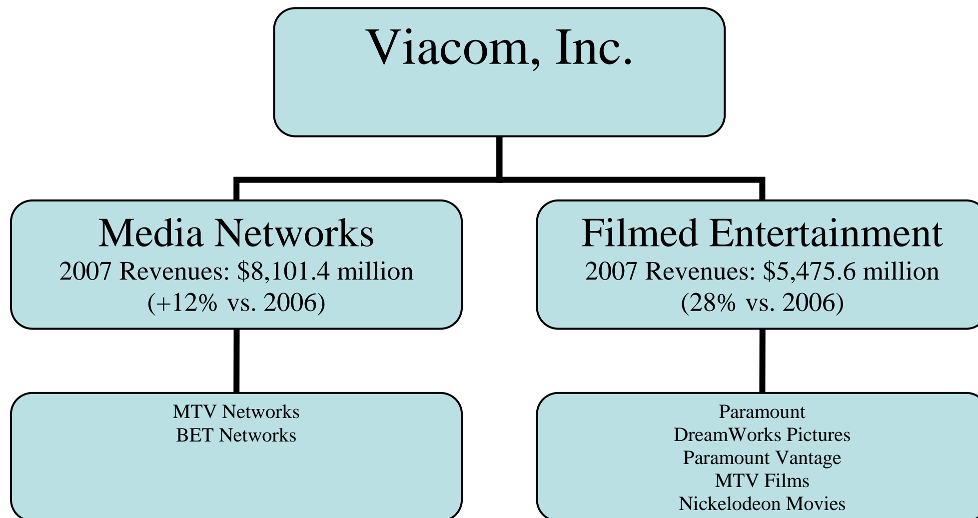
- Obligations related to guarantees and litigation could adversely impact financial condition;
- Changes in U.S. or foreign communications laws or other regulations could adversely affect business;
- Changes in advertising markets could cause revenues and operating results to decline significantly in any given period or in specific markets; and
- Strikes and union activity could adversely affect business.

Financial Analysis

Viacom is currently trading at 8.31% below its spin-off price from the previous Viacom (now CBS) in 2005. Viacom has underperformed the S&P500 during the entirety of this period (the S&P500 is up 7.42% over the same time horizon).



In order to better understand Viacom's value, however, it is helpful to break the company down into its separate businesses. The chart below shows Viacom's 2007 operating income by business segment (and the percent change from 2006), and illustrates where its various subsidiary business fit into the larger corporation.



In 2007, revenues from Media Networks and Filmed Entertainment accounted for 60 and 41 percent of total revenue, respectively (elimination of intercompany revenues were 1 percent). Approximately 27 percent of total revenue was generated from international operations (primarily in Europe, which generated 63 percent international revenues).

At the end of 2007, Viacom held roughly $920 million in cash and cash equivalents, which is about a 30 percent increase from year-end 2006. This seems to bode well for Viacom if it is to continue its recent trend of acquiring small online media and distribution companies. Compared to competitors, however, Viacom may not actually have that much cash on hand. For example Liberty Media Corporation (Capital), another huge media conglomerate, held $3.1 billion on hand at the end of 2007. This difference is even more significant given the relative market caps of the two companies: Viacom's is $25.6 billion to Liberty Media Corporation's (Capital) $2.03 billion. It is important to note, however, that such comparisons may be misleading given the nature of conglomerates and difficulties in separating consolidated financial data from broken-down data.

The two companies also have dramatically different debt/EBITDA ratios. In 2007, Viacom's was 2.035, whereas Liberty Media Corporation's was 10.614, about 5.2 times greater. In part, this reflects strategic differences between the two companies. Liberty Media Corporation's relatively high debt/EBIDTA ratio affords it several advantages. It can write off almost all of its taxes. It is

also able to acquire aggressively because it is more focused on generating cash to service debt than generating profits in the traditional sense (i.e., revenues-expenses). Liberty's management has always emphasized minimizing taxes and increasing the value of the asset base as opposed to generating bottom line results, an approach that stems from their days at TCI; Redstone operates an altogether different strategy. Whether Liberty's model is a good one is certainly up for debate, but given the extreme discrepancy between Viacom's and Liberty Media Corporation's debt/EBITDA ratios, it is something worth considering for Viacom going forward. Even if Viacom does not wish to take Liberty Media Corporation's approach from a strategic point of view, it may nonetheless be beneficial for Viacom to increase its debt/EBITDA ratio for the above-mentioned tax benefits.

Given that Liberty's business does differ somewhat from Viacom's in that Liberty owns so many cable systems, it is valuable to look at several addition comparison companies and metrics. The table below contains comparisons against MGM Sale, Virgin Media, Time Warner, and Disney.

Financial/Valuation Comps for Viacom against Peers (2007)					
	EV/Revenue	EV/EBITDA	P/E	Div. (Yield)	Diluted EPS
Viacom	2.42	9.778566	14.46	-	2.72
Virgin Media	1.89	9.917596	-	0.04 (1.29)	-2.82
Time Warner	1.96	10.9965	12.25	0.06 (1.75)	1.08
Disney	4.53	6.432246	14.58	0.35 (1.16)	2.25

As these metrics show, Viacom's financials are generally in line with its peers. This suggests that Viacom is fairly valued in the market place.

Strategic Issues and Recommendations

The strategic issues Viacom faces fall into three categories: (1) financial, (2) content distribution (and related advertising issues), and (3) continued international expansion. With regard to the first category, financial issues, Harkness Consulting recommends Viacom consider a leveraged recapitalization over the next several years. Although credit markets are currently rather dry, comparison with Liberty Media suggests Viacom could nonetheless take on significantly more

debt than it currently holds (see Financial Analysis section for a more detailed comparison of Viacom's and Liberty Media's debt holdings). If they chose to go ahead with a recapitalization at some point in the future, they could use the cash to do one of two things. First, they could implement a share repurchase plan. At 14x earnings, investing in the company itself may prove to have an IRR that surpasses their internal hurdle rate. Additionally, they could more aggressively pursue acquisition targets, specifically in digital media. Of course, all of this depends on spreads closing once again, which, given current markets, does not seem likely to occur for at least another 6 to 12 months.

Harkness Consulting also recommends Viacom split up in order to focus on its fastest growing business segments. We recommend Viacom look into a possible spin off of its Filmed Entertainment division. The main reason to spin off the filmed entertainment division would be to allow investors to recognize and appropriately value the main divisions of the company. Filmed entertainment is an altogether different business than media networks and investors may desire the ability to choose which kind of business they want to own. Furthermore, "revenues from the Media Networks segment accounted for 60%, 64% and 71% of [Viacom's] revenues for 2007, 2006 and 2005, respectively, and revenues from the Filmed Entertainment segment accounted for 41%, 37% and 31% of [Viacom's] revenues for those periods, respectively, with elimination of intercompany revenues being (1)%, (1)% and (2)%, respectively."[4] Although the percentage of revenues from Media Networks has fallen over the past three years, it remains the key source of revenue for Viacom.

We also believe Filmed Entertainment is too much of a hits-driven business to provide a stable source of revenue. Even though Paramount was ranked the number one motion picture studio based on domestic box office revenues in 2007, we still think Filmed Entertainment's risks outweigh the potential benefits. Moreover, looking forward, Viacom is far better positioned to capitalize on new opportunities in the mobile and digital spheres for its Media Networks businesses than its Filmed Entertainment ones. Barring unforeseen developments in digital distribution of Viacom's Filmed Entertainment content, we cannot see this segment maintaining

its success in the future. It faces many of the same problems as the music industry, and, as evidenced by Viacom's sale of Famous Music to Sony/ATV Music Publishing for $351.7 million in July 2007, it may be best to divest of Filmed Entertainment now, while its subsidiaries still retain the majority of their value.

Furthermore, Viacom has failed to capture many of the potential synergies between its two divisions, Media Networks and Filmed Entertainment, so a breakup makes sense. We believe this is and will continue to be the case because, although cross-over potential exists for Viacom's different distribution channels (i.e., film, TV, internet), Viacom's brands target such a wide array of audiences that it is too difficult to take advantage of such opportunities. Filmed Entertainment has been hit harder than Media Networks by piracy, and this trend seems set to continue. Also, selling the Filmed Entertainment division and the extensive libraries Viacom owns and has rights to, namely Paramount's and DreamWorks', would provide a huge inflow of cash to finance continued growth in its Media Networks division through investments and acquisitions.

If this suggestion is unacceptable to the Viacom board, Harkness Consulting recommends Viacom significantly reduce its stake in film production by seeking increased film financing from outside investors. This would allow Viacom to maintain the small synergies that do exist between its business segments, while minimizing the risk of not having enough hit films in a given year. We also believe that if Viacom chooses not to spin off its Filmed Entertainment division, Viacom should reduce the quantity of films produced, and focus on making fewer, higher-margin, films.

With regard to the second strategic area, content distribution, Harkness Consulting recommends Viacom continue to expand content distribution through mobile and digital platforms. Along these lines, we believe many of Viacom's current ventures and acquisitions are a step in the right direction. Among others, these include:

- MTV Networks and RealNetworks, Inc. creating Rhapsody America (which offers a single, integrated digital music experience that consumers can access via their PC, portable music device, or mobile phone);
- Viacom's long-term, exclusive partnership with Verizon Wireless;
- Viacom's strategic alliance with Microsoft under which "Microsoft will license certain programs and motion pictures from [Viacom] on a non-exclusive basis for use on Microsoft properties such as MSN and Xbox, provide [Viacom] with its proprietary online advertising serving solution, Atlas AdManager, and purchase certain specified amounts and types of advertising from [Viacom];" and
- Viacom's arrangements in place with download-to-own services, including Apple's iTunes, Amazon, BitTorrent, Wal-Mart and Microsoft's Xbox 360, to make various MTV, MTV2, VH1, CMT, Logo, Nickelodeon, Nick Jr., Nick at Nite, The N, Comedy Central, Spike TV, TV Land and BET programs available for purchase online.[5]

Although these initiatives are an important step toward mobile and digital content distribution and finding new ways to generate advertising revenue in these areas, Harkness Consulting believes Viacom can take several additional steps to improve its success in these initiatives and overall.

Generally, we suggest Viacom work to consolidate its online presence. Currently, Viacom streams content online on numerous websites and has six "virtual worlds" for its MTV brand alone. Harkness Consulting suggests Viacom consolidate its online presence in order to create a more unified brand, thereby enabling more cross-over between its different segments. Specifically, we recommend Viacom create its own "YouTube" with all of Viacom's current content and library materials available for streaming. Viacom has the cash on hand to undertake such an initiative, and, going forward, it could be supported by advertising, as evidenced by the success of Viacom's existing online ventures. This initiative has the additional benefits of allowing Viacom to maintain distribution rights for its content and reduce the likelihood of piracy. We suggest Viacom take advantage of its existing partnerships with Microsoft, Yahoo, and others to develop such an online portal. Harkness Consulting also recommends Viacom

consolidate its online presence by divesting itself of existing ventures that stray from its core business, such as Neopets.com, AtomFilms.com (a broadband service for original short films and online video clips), AddictingClips.com (which houses entertaining original and user-generated video clips) and GameTrailers.com (which produces broadcast quality video content for video games).

In addition, Harkness Consulting suggests Viacom continue to increase its interactive platforms. Mobile and online content distribution naturally lend themselves to this, and doing so affords potentially significant new streams of advertising revenues. The viability of such initiatives is evidenced by the current popularity (based on internal measures of page views and visits) of Viacom's various virtual worlds and social-media platforms. Best practice examples to draw on for future initiatives include: BET Mobile, mtvU, and *Nicktropolis*. On-air programming drives traffic to these digital properties and vice versa, producing convergent advertising sales, which are increasingly important to Viacom's business.[6] Moreover, these virtual communities (especially *Nicktropolis*) are beginning to yield their own revenues. As it is such a new market/product, we believe there is significant opportunity for growth in this area.

Finally, Harkness Consulting recommends Viacom continue to expand into the international market. International revenues make up an increasing portion of Viacom's total revenues every year (27%, 24%, and 22% in 2007, 2006, and 2005, respectively), and we believe competition in international markets will continue to increase, making it vital for Viacom to achieve market share now.[7]

In particular, Harkness Consulting suggests doing so through joint ventures with local companies. We commend the joint venture called Viacom 18 that Viacom established with Network18, a leading Indian media and entertainment company, in 2007. Viacom 18 includes TV, film, and digital media content across multiple brands and consumer products, and is expected to become India's largest multi-platform entertainment company. Other initiatives that should serve as best practice examples going forward include COMEDY CENTRAL

Germany, MTV Arabia, and Nickelodeon Arabia. We think such joint ventures are an excellent approach, and believe Viacom should continue to seek new ones out by concentrating resources in the regions and on the demographics that offer greatest growth potential—Viacom has identified these to by Germany, Japan, and the United Kingdom; Harkness Consulting recommends also considering China and Latin America.[8]

Harkness Consulting believes international markets afford a way not only to increase total revenue, but also to hedge against domestic slowdowns. Consequently, we suggest Viacom seek to expand its international operations as quickly as the required due diligence and negotiations allow. We caution, however, against trying to "go it alone" in international markets; in most cases, Harkness Consulting does not believe Viacom (or any other similar corporation) has the necessary knowledge of local culture to maximize the popularity of its content and, consequently, potential advertising revenues. Instead, we suggest Viacom continue to pursue its current approach of forming joint ventures in international markets. This approach not only gives Viacom access to local content and cultural knowledge, but also enables Viacom to share some of the unique risks international markets pose, while maintaining most of the benefits they afford.

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[1] Reuters.
[2] Bloomberg, January, 9 2008.
[3] Reuters.
[4] Viacom 10-K (2008)
[5] Viacom 10-K (2008)
[6] Viacom 10-K (2008)
[7] Viacom 10-K (2008)
[8] Viacom 10-K (2008).