

SMH CAPITAL

Research Report

SMH Capital
Institutional Equity Research
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CBS Corporation (CBS/NYSE): Shares a Bargain at Current Levels; Reiterating Buy Rating

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Industry: Media & Entertainment

January 22, 2008
Recommendation: Buy

Price: \$23.09 Mkt. Cap: \$15.6B Price Target: \$37 Estimate Change

Estimates: (Dec.)	2006A		2007E		2008E		Est. 3-Yr. Growth Rate
	Curr	Prior	Curr	Prior	Curr	Prior	
EPS (Diluted)	\$1.62		\$1.83	\$1.83	\$2.06	\$2.05	10% – 13%
RPE/G	1.01x		1.25x		0.87x		
ROIC	6.7%		6.9%		7.2%		

Please refer to <http://www.smhou.com/disc/CBS.pdf> and the last page of this report for important SMH Capital disclosures.

Reasons for Report

- Ahead of CBS's Q4 earnings call on February 26, we are fine-tuning our Q4 '07 and 2008 financial projections. For the December quarter, we are removing \$142.3 million in TV-related revenues and \$71.1 million in TV-related EBITDA from our projections to account for syndication activity that, while healthy, likely did not clock in with the numbers we had originally anticipated.
- With the shares down measurably over the November/December timeframe against broader market turmoil and now a screaming bargain, in our view, we believe CBS was particularly aggressive in buying back stock. We are therefore modeling 675 million shares, versus our previous projection of 715 million shares.
- The two moves on the income statement offset each other and result in no change in our Q4 core EPS assumption of \$0.53, still in line with consensus.
- The WGA strike has extended three weeks beyond our projection, and with CBS easily the most exposed, we are recalibrating our 2008 estimates to account for less scripted programming, though more reality programming and more one-off "specials," which command a lower CPM for advertisers but are far less expensive to produce.

Company Update

For Q4 2007, we are removing \$142.3 million in TV-related revenues and \$71.1 million in TV-related EBITDA from our projections to account for syndication activity that, while still healthy, likely did not clock in with the numbers we had originally anticipated. That is due, at least in our opinion, to lower per-episode fees for network series "NCIS" relative to our previous projections. It is also due to a tough comp versus last year, in which CBS's syndicate pipeline included international sales of "CSI" plus the second-cycle sale of "Star Trek Voyager," bought by Viacom. With the shares down measurably over the November/December timeframe and now a screaming bargain, in our view, we believe CBS was particularly aggressive in buying back stock. We are therefore modeling 675 million shares, versus our previous projection of 715 million. The two moves on the income statement offset each other and result in no change in our Q4 core EPS assumption of \$0.53, still in line with consensus.

The WGA strike has extended three weeks beyond our projection, and with CBS easily the most exposed media company to the vagaries of this strike, we are now recalibrating – albeit slightly – our 2008 projections to account for less primetime scripted original programming, though more reality programming and more one-off "specials," which command a lower CPM for advertisers but are far less expensive to produce. As a result, our 2008 revenue projection moves from \$14.6 billion to \$14.4 billion, though our 2008 EBITDA projection declines by only \$75 million, from \$3.34 billion to \$3.27 billion. Again, with pronounced pro-activity in shrinking the equity, our 2008 EPS projection improves, from \$2.05 to \$2.06, now \$0.04 ahead of the Street.

CBS is rated Buy for value-oriented investors who have a bias toward cumulative return. While the stock continues to face a myriad of headwinds, including the WGA strike, mixed success with new radio formats, and the prospect of an advertising recession, we believe investors should take a step back and make note of the following:

- **CBS is most-watched:** The moniker of CBS being the “most-watched” network is no lie. In terms of total viewers, CBS is the most-watched English-language broadcast network of the six currently measured by Nielsen, providing viewers with some of the nation’s highest-quality entertainment, news, and sports programming.
- **Game theory works:** CBS takes an efficient game theory approach to primetime programming, meaning a balanced mix of company-owned shows (e.g., “CSI”), licensed shows (e.g., “Two and a Half Men”), and shows that are sold to other networks (e.g., “Medium”). Placing too many company-owned shows on a primetime schedule can be very risky and can amount to substantial losses if the shows are canceled.
- **Political works on TV:** With 40 television stations and 9 duopoly platforms, CBS has guaranteed local television distribution in the Top 40 markets and, besides NWS, is the only large-cap, vertically integrated media company to own so many owned and operated (O&O) television stations. That will be a distinct advantage in the second half of 2008, which will see both Presidential and Congressional elections.
- **Little secular threat to Outdoor:** Unlike its peers, CBS derives substantial revenues and cash flow from an envious asset base of domestic and international Outdoor signage. Unless a technology arises that makes automobiles obsolete, the case for the validity of Outdoor advertising is a strong one, in our opinion.
- **Showtime could yield upside:** Though he has not expressly said so, we believe Mr. Moonves will make it a priority over the next 12 months to fix Showtime, which has gotten decimated in the ratings by HBO. Should that happen, it could lead to a theoretical earnings event not currently being anticipated by the Street.

Valuation & Recommendation

We value CBS using a 10-year discounted cash flow analysis with a discount rate derived from the capital asset pricing model, which by our calculations is 9.87% and supports a fair value per share of \$38. Our terminal cash flow growth rate of 6.5% correlates to an implied EBITDA exit multiple of 14.0 times, which represents somewhat of a premium compared to exit multiples afforded established broadcast entities, although this is one of a very few that has a broadcast network operation, which usually commands a premium terminal multiple anyway. In addition, given a healthy dividend yield, plus the prospect of rising dividends at what we feel will be 10% per year, we have added to our analysis the dividend discount model, which leads us to a fair value of \$34 per share. However, we are now assigning a 9.0 times exit multiple to CBS’s core television operation, inclusive of the O&Os; an 11.5 times exit multiple to CBS’s solidly run Outdoor operations; a 10.0 times exit multiple to EBITDA generated by the CBS Radio Group; a 5.5 times exit multiple to the Simon & Schuster publishing operation; and a 14.0 times exit multiple to Showtime. That leads us a valuation of \$37.21 per share based on anticipated 2008 EBITDA. We therefore blend the three methodologies to promote a 12-month price target of \$37.

Risk Analysis

- **Deep exposure to ad cycle:** CBS is essentially an equity carve-out from the old Viacom. The old conglomerate structure derived 55% of its revenue from advertising. Most of those businesses are now housed inside of CBS. Therefore, should the U.S. experience another economic downturn similar to that of the second half of 2001, CBS is a lot more exposed to potential downside than the “new” Viacom.
- **It ain’t friendly for radio:** Whether real or perceived, the market remains hostile to free, over-the-air terrestrial radio. While we do believe that terrestrial radio in its current form can survive and even thrive, CBS’s radio assets are mostly located in “yuppie” markets, or markets where satellite radio/iPod penetration is high relative to smaller markets.
- **Re-transmission a tough sell:** Most cable MSOs “re-transmit” a broadcast network’s signal for free in exchange for access to that company’s suite of cable networks, which is why consumers opt for analog and/or digital cable access in the first place. Without any of the cable networks to use as a nugget of leverage, CEO Les Moonves may have trouble persuading MSOs to pay for the CBS signal. In our opinion, that is why CBS has acquired CSTV, and more cable acquisitions could follow.
- **Terrorism affects Outdoor operations:** CBS’s Outdoor advertising operation is heavily exposed to human traffic deltas as a result of terrorism through its 90% ownership of all ad space in the London tube. While many

London residents have not shifted their commuting patterns, just the concern that Tube traffic might be negatively affected has already threatened CBS's Outdoor CPM in that region.

Year-End: Dec.	2006A		2007E		2008E		Investment Profile	9/30/07
<i>\$mm except EPS & %</i>	<u>Curr</u>	<u>Prior</u>	<u>Curr</u>	<u>Prior</u>	<u>Curr</u>	<u>Prior</u>		
Revenues	14,326		14,097	14,321	14,428	14,616	Share Base (mm)	675
% change	-0.2%		-0.98%		2.3%		Market Value (mm)	\$15,585
EBIT	2,589.4		2,631.8	2,671.8	2,761.8	2,834.6	Insider Ownership	13.1%
% change	-7.1%		1.7%		4.9%		Institutional Ownership	58.7%
EBITDA	3,109.2		3,086.2	3,157.3	3,270.8	3,345.6	Total Cash (mm)	\$1,226
% change	2.0%		-0.9%		5.9%		LT Debt (mm)	\$7,035
Net Inc.	1,248.3		1,271.0	1,295.0	1,387.3	1,442.2	Enterprise Value	\$21,395
% change	2.5%		1.8%		9.1%		Total Debt/Cap	45.1%
EPS (Diluted)	1.62		1.83	1.83	2.06	2.05	Daily Trading Vol.	1,446,476
% change	5.6%		12.9%		12.5%		Price Range (52-week)	22.93-35.75
ROIC	6.7%		6.9%		7.1%		Dividend (\$)	\$1.00
% change	12.3%		2.9%		2.9%		Dividend Yield (%)	4.33%
							Earnings Yield (F2008)	8.92%
EPS (Diluted)	<u>2006A</u>	<u>Prior</u>	<u>2007E</u>	<u>Prior</u>	<u>2008E</u>	<u>Prior</u>		
Q1	0.30		0.28A		0.36	0.34		
Q2	0.47		0.54A		0.58	0.58		
Q3	0.42		0.48A		0.51	0.51		
Q4	0.43		0.53E	0.53E	0.61	0.62		
Revenue (\$mm)	<u>2007A</u>	<u>Prior</u>	<u>2007E</u>	<u>Prior</u>	<u>2008E</u>	<u>Prior</u>		
Q1	3,581.8		3,657.8		3,617.8	3,706.8		
Q2	3,483.1		3,374.9		3,462.6	3,502.6		
Q3	3,378.8		3,281.4		3,417.8	3,477.8		
Q4	3,882.9		3,783.4	3,925.7	3,930.7	4,039.2		

Public Companies Mentioned

News Corp. (NWS/NYSE-\$19.35); Not Rated

Viacom, Inc. (VIA'b/NYSE-\$38.18); Rated: Sell; <http://www.smhou.com/disc/VIAB.pdf>

On January 8, 2008, SMH made the following revision to its ratings system: The "Short" rating was eliminated. On November 27, 2007, the "Not Rated" category was added. The definition for "Not Rated" is as follows: "SMH Capital is not carrying a rating on this stock for the time being. The rating, price target (if applicable), and estimates are under review." SMH's previous definitions (enacted on July 20, 2007) for its Buy, Sell, and Neutral ratings remain in place and are defined as follows: Buy: The analyst expects the stock to outperform its relevant benchmark (S&P 500, R2000, etc.) and its peer group. Sell: The analyst expects the stock to underperform its relevant benchmark and its peer group. Neutral: The analyst sees no compelling rationale for a Buy or Sell recommendation. Prior to January 8, 2008, the definition for the now-defunct Short rating was: The analyst expects the stock to underperform its relevant benchmark and its peer group, and sees significant potential for a decline in the price of the stock. Prior to July 20, 2007, SMH Capital's ratings included Buy/Outperform, Neutral, and Sell/Underperform.

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The methods used by SMH Capital to determine the price target for this security, along with the risks, are detailed within this report.

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