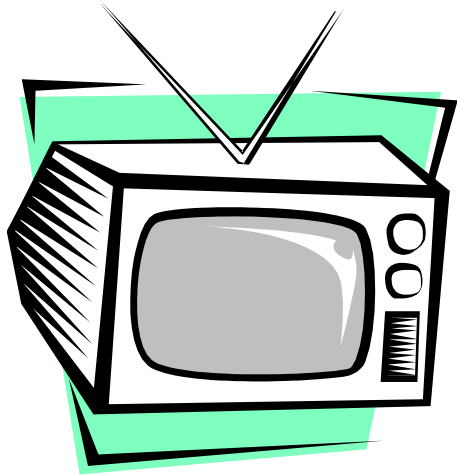


Deregulation and Consolidation

Broadcasting & Publishing

Media Consolidation?



+



“Round up the usual suspects!”

Acme Communications	(ACME - \$6.11)	McClatchy	(MNI - \$71.35)
Gannett	(GCI - \$83.95)	Media General	(MEG - \$58.65)
Gray TV	(GTN'A - \$12.14)	Nexstar Broadcasting	(NXST - \$7.75)
Hearst-Argyle	(HTV - \$ 25.77)	Pulitzer	(PTZ - \$54.05)
Journal Communications	(JRN - \$16.91)	E.W. Scripps	(SSP - \$47.88)
Knight-Ridder	(KRI - \$70.75)	Sinclair Broadcasting	(SBGI - \$6.81)
Liberty Corp.	(LC - \$41.10)	Viacom	(VIA'B - \$36.01)
LIN TV	(TVL - \$18.03)	Young Broadcasting	(YBTVA - \$11.83)

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Media Consolidation, or Lack Thereof

Earlier this year, the Third Circuit of the Federal Court of Appeals (Philadelphia) effectively halted the FCC's march toward further relaxation of media ownership when it first stayed the Commission's 2003 initiatives and then subsequently remanded the rules back to the FCC. The recent Bush White House victory and expansion of the Republican Party's majority in the House and Senate bode well for further deregulation *over time*. In the nearer term, media ownership is still likely to be the province of the courts. Nevertheless, the political victory noted above also has implications for a more conservative Supreme Court, as President Bush will likely have the opportunity to appoint one or more justices.

In view of improved prospects for consolidation, we favor owning a basket of media companies that are potential participants, as merger and acquisition activity is likely to accelerate. Importantly, there are sound reasons owning buyers as well as sellers. As acquiring companies get larger, they have an ability to reduce and effectively spread costs across a larger station base, and to control advertising inventory and its pricing.

A Dearth of Deals

The paucity of media transactions in 2004 ran counter to earlier expectations. The Third Circuit put the brakes on looser ownership rules promulgated by the FCC. The Commission's new rules would have relaxed cross-ownership restrictions allowing the combination of newspapers and television broadcasters in the same markets. In addition, the proposed rules would have eased duopoly regulations. This would have facilitated greater in-market concentration. In light of a lack of regulatory clarity, managements hesitated to do deals, preferring instead to wait for the dust to settle.

Realistically, buyers could have stepped to the plate to do deals anyway. However, a less robust advertising recovery along with continued high expectations on the part of sellers had a chilling affect on transactions. Further, the anxiety created by the war in Iraq coupled with rising oil prices all combined to have a stultifying affect on merger activity. Moreover, we sensed a general public uneasiness that may have been amplified by the uncivil tone of political discourse during the race for the White House. Now, we believe that several factors are in place that could change the environment over the near to intermediate term.

Table 1 **Liquidity and Buying Power**

Company	Symbol	Recent Price	Est 2004 CF (\$ mils)	Est YE Debt (\$ mils)	Est. YE Leverage	Added Turns of Leverage	Total Leverage	Buying Power (\$ mils)
Hearst-Argyle	HTV	\$ 25.72	\$ 334.5	\$ 950	2.84	2.40	5.24	\$ 803
Tribune	TRB	43.71	1,513.4	2,165	1.43	2.30	3.73	3,481
Gannett	GCI	83.39	2,425.2	4,200	1.73	2.50	4.23	6,063
EW Scripps (1)	SSP	48.71	593.9	500	0.84	3.00	3.84	1,782
Belo	BLC	24.31	414.0	1,200	2.90	1.10	4.00	455
Media General (2)	MEG	58.64	212.2	550	2.59	1.50	4.09	318
Journal Commun. (3)	JRN	17.01	110.0	70	0.64	2.40	3.04	264

(1) SSP debt excl. minority interest in *TV Food Network*

(2) MEG could be a buyer or a seller of media assets

(3) JRN reflects 100% of debt and media cash flow only

Source: Company reports, Gabelli & Co. estimates

Aggregate buying power \$ 13,166

What's Changed?

The Election

The reelection of President Bush and expanded Republican control of Congress (and important committee chairs) can contribute to further deregulation. The President has been a champion of fewer governmental controls and we would anticipate an expanded deregulatory agenda during the President's final term in office, as he attempts to put his stamp on the presidency.

The reelection also means that the chairman of the Federal Communications Commission will continue to be a Republican. Whether or not the current chairman, Michael Powell, remains in that post is an open issue. Speculation suggests that he may return to his alma mater to serve as president of William and Mary. Nevertheless, the chairman can now start afresh on deregulation, especially since last year's most contentious issue, the broadcast ownership cap, was modestly expanded by Congress and enacted into law.

The Republican victory also means that the current Commission could be more receptive to taking up the Philadelphia Court's remand. In the midst of the fractious and close presidential race, it was unlikely that the FCC would act at all. Now, however, the Commission could be more responsive, although action may have to await expected changes in the FCC's composition.

In the absence of regulatory action by the FCC, we believe that at least two companies (Tribune and Media General) are prepared to petition the Supreme Court on the cross-ownership issue. In particular, MEG's case is somewhat more pressing with a cross-ownership issue at stake related to renewal of an expiring broadcast license in Florence SC. Tribune's license renewals are further out.

Recent disclosures about the seriousness of Chief Justice William Renquist's illness also bring election results into sharper focus. It is possible that President Bush could appoint several justices to the Supreme Court over the next several years. It is probable that any such justice appointed would approach media ownership rules in a fashion that could favor less governmental intervention and more media consolidation.

Two other election outcomes are noteworthy. Senator Fritz Hollings (D-SC) did not stand for reelection. Hollings was a frequent critic of media consolidation, and will be replaced in the Senate by Republican Jim DeMint (although Hollings' replacement on the Commerce committee may be equally opposed to media consolidation). In addition, Minority Leader Tom Daschle (D-SD) was defeated in his reelection bid by Republican John Thune. Although not involved in the election, John McCain (R-AZ) will give up his chairmanship of the Commerce Committee, the principal legislative media oversight body.

In summary, the FCC loosened the rules on cross-ownership and duopolies. The Philadelphia Court remanded the rules back to the FCC. Generally, the Third Circuit objected more to the Commission's methodology than to the underlying rule changes. We believe that the stage is now set for relaxing restrictions with the potential for earlier action on cross-ownership, especially in large markets. Accordingly, we believe that we will soon see a catalyst for merger and acquisition activity materialize.

That said we believe other trends could also foster consolidation.

Improving Liquidity, Growing Financial Firepower

On a recent conference call, Hearst-Argyle Television management noted that its leverage (debt/EBITDA) was down to 3.2 times. Earlier acquisitions had pushed Argyle's leverage above 5 times, and HTV said that it would be comfortable at the higher level, in anticipation of rapid debt reduction. HTV's parent, privately held Hearst Corp., a large newspaper publisher, has a vested interest in the removal of newspaper-television cross-ownership restrictions. Improving liquidity at Argyle can help fulfill Hearst's Corp.'s agenda. The reduction in HTV's leverage (despite repurchasing stock) affords the company the prospect of more than \$800 million of purchases, without giving effect to acquired cash flow.

Other companies are similarly liquid (see Table 1). Tribune's debt is just over 1 times cash flow. Gannett's debt is under 2 times cash flow. Adding 2.5 turns of leverage for those two companies combined is equal to roughly to \$9.5 billion of buying power. Belo's leverage is now below 3 times cash flow. Although Belo may feel constrained about another large deal after being punished by the market for its earlier purchase of Providence Journal Co., a 1x increase in leverage is equal to \$400-500 million of buying power. And while much smaller, Journal Communications' relatively unlevered balance sheet could support \$200-300 million of media purchases.

More often a buyer of cable networks than television stations or newspapers, E.W. Scripps is also conservatively financed with debt roughly equal to cash flow. We believe increasing leverage to 3.8 times would generate roughly \$1.8 billion of firepower. The above-mentioned companies would have roughly \$13.2 billion of liquidity without giving affect to any purchased cash flow. Layering purchased cash flow at a 5-multiple would produce an incremental \$5 billion of liquidity (assuming purchase prices at 13x cash flow). In aggregate, these companies could have a total of \$18 billion of buying power.

Some changes in the ownership cap would likely be required to really bring Viacom and News Corp. into the mix. Nevertheless, each of those two companies is generating substantial free cash flow, with VIA recently authorizing an \$8 billion share repurchase program. Notably, both companies could purchase additional stations in order to create duopolies in existing markets without going over existing ownership limits. Finally, Disney has not been a buyer of television stations. However, recent ratings gains at the *ABC Network* underscore the advantage of controlling more distribution. Levered at less than 2 times, Disney would add another \$6 billion in surplus liquidity.

Table 2 The Usual Suspects

(\$ millions except share prices)

Company (Symbol)	Price	Shares	Equity Value	Net Debt and other assets	TEV
Acme (ACME)	\$ 6.11	16.8	\$ 103	\$ 31	\$ 134
Gray TV (GTN)	13.10	49.0	642	590	1,232
Knight-Ridder (KRI)	70.95	80.0	5,676	1539	7,215
Liberty Corp (LC)	42.02	18.8	790	0	790
LIN TV (TVL)	18.26	50.3	918	500	1,418
McClatchy (MNI)	71.68	46.2	3,312	393	3,705
Media Genl (MEG)	58.64	23.7	1,390	416	1,806
Pulitzer (PTZ)	54.80	21.6	1,184	130	1,314
Sinclair (SBGI)	6.81	85.4	582	1860	2,442
Young (YBTVA)	11.89	20.0	238	643	881
			Total		\$ 20,935

Source: Company reports, Gabelli & Co. estimates.

The Usual Suspects

Table 2 is a list of so-called “usual suspects.” The oft-mentioned names in media consolidation, both broadcasters and publishers, includes Liberty Corp., Sinclair Broadcasting, LIN TV, Young Broadcasting, Media General, Pulitzer and Knight-Ridder. A change in cross-ownership rule would be needed to flush out certain buyers and sellers. And, some companies appear on both lists.

Combining the enterprise values of the ten frequently mentioned companies equates to approximately \$21 billion (at current market). As noted above, if Disney, News Corp. and or Viacom joined the fray, liquidity would far surpass the aggregate of the enterprise values. While not quantifiable, there is also substantial private equity money on the sidelines. Industry rumblings abound with some potential near-term deal at or around historical cash flow multiples by financial players, not strategic buyers.

These comments are not meant to indicate that any one company is an imminent target or buyer. Some companies could be either buyers or sellers. We merely want to point out that the strong balance sheets of the potential buyers provide ample liquidity for meaningful merger and acquisition activity.

Scale Economies

In examining the pure play broadcasters, differences in corporate expense are interesting. Admittedly, companies address corporate general and administrative costs in different fashions. Table 3 lists seven broadcasters along with annual corporate spending levels. On average, these companies spend almost 5% of revenues on general and administrative expenses. The companies vary by total revenues and number of stations operated. Combining the four smallest revenue companies (Gray, Liberty, Nexstar and Young) would put 101 stations under one roof.

Our take is that if Sinclair Broadcasting can run 62 television stations consuming \$20 million of corporate expense, it should not require \$53 million to oversee 100 stations. Looking at some of the more frugal operators (who spend less than 4% of revenues on corporate) would suggest that at most, \$1.0 billion revenues should consume no more that \$40 million of corporate costs.

Many companies, large and small, have noted increased costs related to Sarbanes-Oxley compliance. Combining a number of entities into a single company would also spread this particular expense.

Table 3 Corporate Overhead Comparisons

Company	No. of TV Stations	Est. 2005 TV Revenues	Approx. Corp. G&A Expense	G&A Exp as a % of Revs
Gray TV	30	\$ 280	\$ 11	3.9%
Hearst-Argyle	25	730	25	3.4
Liberty Corp.	15	200	15	7.5
LIN TV	23	380	20	5.3
Nexstar	45	235	10	4.3
Sinclair	62	700	20	2.9
Young Broadcasting	11	240	17	7.1
			Average	4.3%

Source: Company reports, Gabelli & Co., Inc. estimates.

We believe that there are other important economies of scale. Programming is one of the more expensive line items in television broadcasting. Combining stations into larger groups would provide the consolidated company additional buying power when negotiating with the producers of syndicated programming. In addition, a larger broadcasting group could spread expensive news production costs over a larger base of properties. News programming is an important differentiating factor in competitive markets. The ability to produce more and better news would be a plus.

Other Speed Bumps

As noted earlier, we do not expect an immediate rush to consolidation. The advertising environment is not robust, and potential acquirers would prefer more economic clarity. At the same time, the absence of political spending in 2005 will put pressure on television company income statements. In addition, interest rates are likely to increase at some point, raising the cost of acquisitions. We judge these issues to be speed bumps and not permanent impediments to further consolidation. There is a certain amount of herd mentality in the merger market place. Deals haven't taken place because deals haven't taken place. Indeed, since the announced sale of Young Broadcasting's Rockford IL ABC affiliate, we sense that broker activity may have already increased.



Company Reports:

Belo Corp

“Leveraged to a Recovery – Buy” – On 09-03-03, recommended to buy BLC at \$23.44 per share

“Gathering Strength – Buy” - On 03/03/04, we recommended to buy BLC at \$28.09 per share

“A Case Study – Buy”, On 08/13/04, we recommended to buy BLC at \$21.57 per share

Company Reports:

Tribune

“Major Market Opportunities - - Buy” – On 11-03-03, recommended to buy TRB at \$48.52 per share

“The Good, The Bad, The Better – Buy” – On 08/06/04, we recommended to buy BLC at \$41.40 per share

Company Reports:

Journal Communications

"New Kid On the Media Block" - On 01/15/04, we recommended to buy JRN at \$18.35 per share

"Midterm Report Card" - On 07/15/04, we recommended to buy JRN at \$18.44 per share

Nexstar Broadcasting Group

"Buy - Virtually Attractive" - On 04-06-04, we recommended to buy NXST at \$11.88 per share

"Busted IPO - Buy" - On 09-01-04, we recommended to buy NXST at \$8.30 per share

Companies Mentioned

Acme Communications	(ACME - \$5.71 - NASD)	McClatchy	(MNI - \$71.01 - NYSE)
Belo Corporation	(BLC - \$24.35 - NYSE)	Media General	(MEG - \$57.75 - NYSE)
Disney	(DIS - \$26.43 - NYSE)	News Corp	(NWSI - \$18.20 - NYSE)
Gannett	(GCI - \$84.86 - NYSE)	Nexstar Broadcasting	(NXST - \$7.15 - NYSE)
Gray TV	(GTN - \$13.16 - NYSE)	Pulitzer Inc.	(PTZ - \$53.95 - NYSE)
Hearst-Argyle Television	(HTV - \$26.05 - NYSE)	E. W. Scripps Co.	(SSP - \$47.97 - NYSE)
Journal Communications	(JRN - \$17.05 - NYSE)	Sinclair Broadcasting	(SBGI - \$6.88 - NASD)
Knight-Ridder	(KRI - \$70.64 - NYSE)	Viacom	(VIA'B - \$36.49 - NYSE)
Liberty Corp	(LC - \$40.88 - NYSE)	Young Broadcasting	(YBTVA - \$12.25 - NASD)
LIN TV	(TVL - \$18.20 - NYSE)		

I, **Barry Lucas**, the Research Analyst who prepared this report, hereby certify that the views expressed in this report accurately reflect the analyst's personal views about the subject companies and their securities. The Research Analyst has not been, is not and will not be receiving direct or indirect compensation for expressing the specific recommendation or view in this report.

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