

Sirius Satellite Radio, Inc.*

The nascent satellite radio industry got its start in 1997 when Sirius Satellite Radio and XM Radio were the winning bidders for two FCC licenses to operate a satellite radio service. It wasn't until the spring of 2001 that XM finally shot its two geostationary satellites (aptly named "rock" and "role") into orbit. By fall of that year, XM subscribers could already tune in to 100 digital channels from coast to coast. Plagued by missteps, Sirius got off to a slower start. By the time that Sirius started nationwide service in the summer of 2002, XM already had well over 100,000 subscribers.

Building a large subscriber base is the crucial element of a successful business model in satellite broadcasting. Fixed costs, including FCC license, satellites, repeater network, content and marketing, run into the billions of dollars. Since consumers can tune into traditional AM/FM radio for free, pricing power is also limited in the satellite broadcasting business. In early 2006, both Sirius and XM were charging a \$12.95 monthly subscription fee. Large numbers of subscribers are therefore the only way to get the economics to work.

By the end of 2005, Sirius had grown its subscriber base to over 3 million, while XM satellite radio had grown to over 6 million. Both companies were still reporting significant losses, but despite Sirius's lagging subscriber numbers, its market capitalization had overtaken that of XM, topping \$7 billion. There were two key reasons for Wall Street's enthusiasm. First, well known "shock jock" Howard Stern had recently made a well-publicized move to Sirius. Stern was lured by a \$500 million compensation package and the ability to peddle smut unimpeded by FCC decency rules governing the public airwaves. Second, Sirius had recently hired radio industry veteran Mel Karmazin to be its CEO. Karmazin's career included stints as CEO at Viacom, CBS and Infinity Broadcasting (which he built from virtually scratch). He was regarded as one of America's most aggressive and creative executives and Wall Street saw him as the perfect figure to accelerate subscriber growth and turn Sirius to profitability.

A key factor in the growth strategies of both Sirius and XM were strategic partnerships with automakers. Sirius had partnered with Ford and DaimlerChrysler, while XM had partnered with GM and Honda. Under these partnerships, the automakers typically agreed to factory install satellite radios, with Sirius and XM subsidizing the cost of the radios and the initial subscription fees. The idea was that drivers would get hooked on their new radios and continue to pay subscription fees when the free trial ended. During 2005, over a quarter of Sirius's sales were derived from these partnerships.

By the middle of 2006, automaker production cuts were hampering Sirius's ability to meet its subscriber growth targets. With this background, Sirius's stock price dropped from \$6 in early 2006 to \$4 by mid 2006. Several Wall Street analysts saw this drop as a buying opportunity. A representative analyst made the case as follows:¹

* This case was prepared by Professor Richard Sloan as the basis for class discussion, rather than to illustrate either effective or ineffective handling of a business situation. Copyright ©2007 by Richard Sloan.

¹ This analyst quote represents the case-writer's personal synthesis of the published views of the numerous analysts that were bullish on the stock in 2006.

We continue to be bullish on Sirius based on a strong secular growth outlook for satellite radio, attractive long-term economics and a favorable risk/reward ratio. Based on our scenario analysis we believe that Sirius has little downside risk from current levels (25% in the bear case) yet significant upside potential in the bull case (150%). Our expected value for Sirius is \$6, with our base case forecast implying 70% upside.

Detailed information on Sirius's business strategy, financial situation and expansion plans are provided in its Form 10-K for the year ended December 31, 2005. For comparative purposes, similar information is also provided for Citadel Broadcasting Corporation in its Form 10-K for the corresponding period. Citadel is a traditional radio broadcasting company. Finally, we provide a representative example of a sell-side analyst model that was used to justify the analyst quote provided above. These documents are available as online exhibits at:

<http://webuser.bus.umich.edu/Lundholm/mywebs/eValcases/index.htm>

QUESTIONS:

Business Strategy Analysis

1. Identify Sirius' source(s) of competitive advantage in the radio business relative to traditional AM/FM broadcast radio stations.
2. Identify two key risks associated with Sirius' business model relative to traditional broadcast radio stations.
3. Sirius uses automakers as a major distribution channel. Briefly evaluate Sirius' ability to generate and sustain competitive advantage through this distribution channel.

Accounting Analysis

4. Briefly describe how Sirius currently accounts for its subscriber acquisition costs.
5. Assume that instead of using its current accounting practices for its subscriber acquisition costs, Sirius instead capitalized all of its subscriber acquisition costs in the fiscal year that these costs are incurred and then amortizes them using the straight-line method over the subsequent two fiscal years. Estimate the Loss from operations that Sirius would have reported for the fiscal year ended December 31, 2005.
6. Which of the above two methods of accounting for subscriber acquisition costs do you think better reflects the underlying economics of the business?
7. Briefly explain how Sirius accounts for its subscriber revenue.
8. Assume that instead of using its current accounting practices for subscriber revenue, Sirius instead recognized subscriber revenue upon the receipt of subscriber payments. Estimate the Loss from operations that Sirius would have reported for the year ended December 31, 2005.

9. Briefly describe how Sirius accounts for its FCC license. Do you think that Sirius' current application of this accounting method is appropriate? Explain your answer.

Ratio Analysis

10. Compute Property & Equipment turnover ratios for Sirius and Citadel Broadcasting Corp. for fiscal year 2005.
11. Briefly identify the major reason(s) for the difference between the turnover ratios that you computed above.
12. Compute operating margin ratios for Sirius and Citadel for fiscal year 2005.
13. Briefly identify the major reason(s) for the difference between the margins that you computed above.
14. Sirius' 'Net loss' has been more negative than its free cash flow for fiscal years 2003, 2004 and 2005. Identify the major reason(s) why 'Net loss' has been more negative than free cash flow during these years.

Forecasting Analysis

15. The sell-side analyst model provided with this case presents a 'Base Case' model (see Exhibit 1 of the model) in which Sirius' total subscribers are forecast to grow to 17.3 million by the end of 2010. Briefly evaluate the plausibility of this forecasting assumption.
16. The sell-side analyst model provides a 'Revised Model' (see Exhibit 2 of the model) in which Sirius' depreciation and amortization expense is forecast to grow at a much lower rate than its total revenues through 2010. Do you think that this lower growth rate for depreciation and amortization expense is justified? Explain your answer.
17. Load Sirius into eVal and provide a set of forecasting assumptions that yield similar sales growth and EPS assumptions to those in the 'Revised Model' (see Exhibit 2 of the model). (note that Sirius data can be loaded from the eVal 'Data Center' sheet by typing SIRI in the white box at the top of this sheet and clicking the adjacent 'Go' button).
18. Evaluate the plausibility of the forecasting scenario you provided in answer to the preceding question.
19. The 'Revised Model' (see Exhibit 2 of the model) assumes that the diluted weighted average number of common stock outstanding will remain constant at 1,628.3 million between 2006 and 2010. Compare these numbers to the number of shares outstanding in your own eVal forecasting model and explain any differences.

Valuation Analysis

20. Load the Sirius data into eVal², set the valuation date to June 1, 2006 and critically evaluate the default valuation provided by eVal (note that Sirius data can be loaded from the eVal 'Data Center' sheet by typing SIRI in the white box at the top of this sheet and clicking the adjacent 'Go' button).
21. In mid 2006, Sirius was trading at around \$4.50/share. Using eVal, provide a set of forecasting assumptions that approximates this price. Use a cost of equity capital of 10% and a valuation date of June 1, 2006. Do you think that these forecasting assumptions are plausible?
22. Based on your analysis above, evaluate the plausibility of the \$5.79 price target proposed in the sell-side analyst model (see Exhibit 1 of the model).

² The data file is available at <http://webuser.bus.umich.edu/Lundholm/mywebs/eValcases/index.htm>.

To load the data file in to eVal, open eVal and click "Input Historical Data", then click "Import Data from a Saved File", then select "Data from Thompson Research" then locate and open the data file.