Recommendation: Long

Warner Music Group (NASDAQ: WMG)

Investment Presentation

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Investment Thesis

Warner Music Group is best positioned to capitalize on powerful digitization trends that are revolutionizing the future of music.

Powerful Industry Trends

- Streaming is **under-penetrated** today at just ~11% of total smartphone users today, and we estimate **streaming subs will >3x** over the next decade.
- DSPs (e.g. Spotify) have more **pricing power** remaining and are likely to raise prices, which flows directly through to Warner's bottom line.
- Ad-based streaming is **undermonetized** with YouTube holding ~47% of digital music consumption but **only ~6% of recorded music revenues**.

Chokepoint of Hourglass

- Shift to digital has **~20x'd the number of songs being released** annually over the last two decades, significantly enhancing label leverage over artists.
- **Increasing competition** between a **fragmented DSP competitor set** retains Warner's leverage over streaming platforms and end-customers.
- Warner sits at the **chokepoint of the hourglass** with DSPs on one side and artists on the other, and we expect LT Adj. EBITDA margins to rise **above ~20%.**

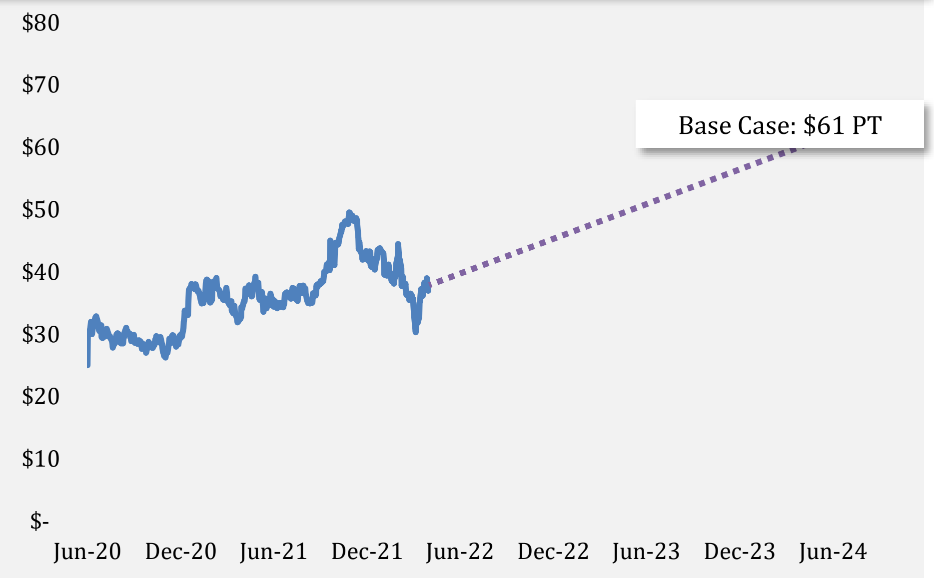
Embedded Call Options

- New emerging music opportunities in social media platforms (e.g. TikTok), connected fitness, gaming, and SVOD create **~$3B in revenue uplift** by 2025.
- Integration of music into the metaverse could expand market size by **>$4B in revenue** over the same time period.

Attractive Setup

- We expect Warner to beat consensus EBITDA estimates over the next four years, and we are **+14% vs. sell-side estimates**.
- Street sentiment is low, with **7 of the 17 analysts** on the Street **at sell or hold.**

Digitization of music is a **generational tailwind**, and WMG holds the **chokepoint of the industry.** WMG's **role will strengthen** in the music industry, **not weaken**, despite Wall Street's **overblown fears** of diminishing leverage over other ecosystem players.



Business Overview

Record labels like Warner Music Group monetize music intellectual property in a variety of ways.

Description

Recorded Music – Digital

- **Streaming:** Generated as cut of streaming revenues (usually monetized on a per-stream basis), split between subscription streaming and ad-based streaming services
- **Downloads & Other:** Includes revenue from downloads of recordings (e.g. purchasing of an album) and other forms of digital based music (e.g. using the recorded music in a video game)

Recorded Music – Physical

- Record label's cut of sales of physical vinyl, CDs, and DVDs
- Shrinking percentage of revenue (given adoption of streaming), and physical music remains a small revenue portion for WMG today with parts of this segment experiencing negative YoY growth

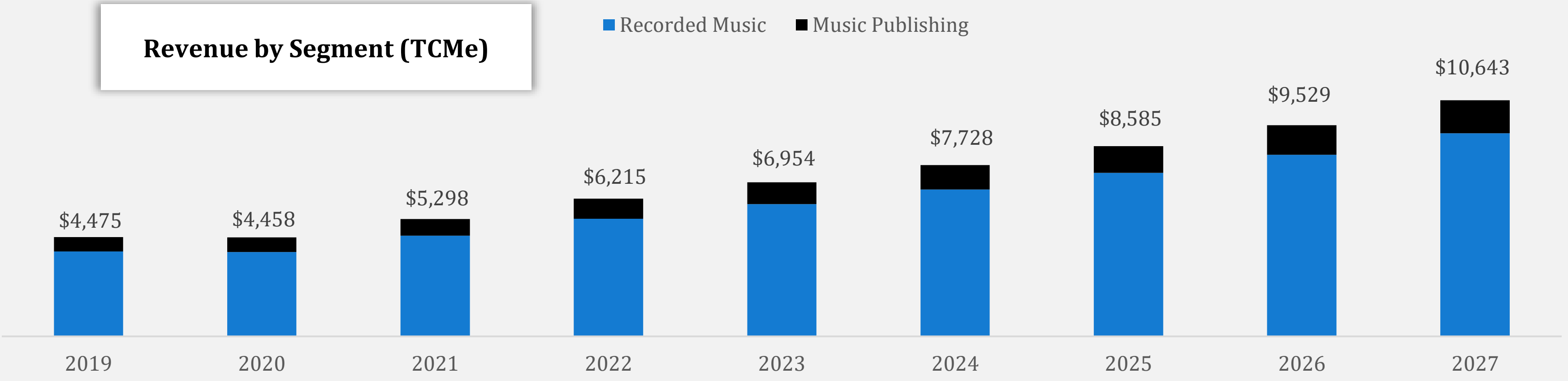
Music Publishing – Digital

- Music Publishing is sales generated from the musical composition (the melody, lyrics, etc.) rather than the original recording. This could include covers of the original recording or other forms of alterations to the original
- Includes revenues generated from streaming services, download services, digital performances, and other digital music services that may use the musical composition that WMG has rights over

Music Publishing – Non-Digital

- Non-digital music publishing includes revenues generated from use of the musical composition in various venues that are not digital, such as physical performances or mechanical royalties (from DVDs/CDs)
- Hit hard during pandemic but has relatively recovered as performances have come back online

Revenue by Segment (TCMe)



Company History

1967: Emerged as a result of consolidation of multiple media players.

2005: Taken public by consortium of PE owners.

2011: LBO'd by Access, who oversaw the transition towards digital revenue streams.

2011-2020: Transitioned towards streaming and digital revenue streams faster than peers.

2020: IPO'd in mid-2020.

Source: Internal Estimates, Company Filings

Competitive Landscape

Warner Music Group was one of the first to capitalize on digital streaming and has been early to new emerging music use cases.

Majors

Market Dynamics

- Functional oligopoly among three players (Warner, Universal, and Sony) who compose around 2/3 of the overall market of recorded music & publishing.
- The number of songs released has ~20x'd over the last two decades, which has intensified competition between artists and increased leverage for labels.
- Majors as a group has seen slightly declining overall share as independents have launched in a digital-first music industry.
- Recent investment cycle by the majors due to cash raised during IPOs by UMG/WMG.

Competitive Dynamics

Warner (~16% market share):

- Has higher market share in digital than physical (~17% vs. ~10%) which should support market share gains as industry mix shifts towards digital.
- First label to have majority of revenue coming from digital, and early to new emerging digital music use cases (

Universal (~32% market share):

- Largest player in the space with 1/3 of the overall industry.
- Weaker presence abroad (compared to WMG) should result in slight share losses over time for Universal over time.

Sony (~20% market share):

- Sony has been the fastest growing record label and is likely to capture small share gains over the next few years.
- Relatively core asset to Sony's larger business, but the only non-pureplay post-UMG spinoff.

Independents

Market Dynamics

- Independents have been capturing slight share over the last few years driven by digital-first record labels.
- Typically significantly smaller or localized to a given geography or genre.

Competitive Dynamics

- Generally provides more flexibility and rights to artists at the expense of fewer marketing resources and limited support.
- Some new innovative independent labels (e.g. Kobalt) have captured market share by offering more data analytics and "disruptive" offerings.

Source: Company Filings, Tegus, Internal Estimates

Generational Music Tailwinds

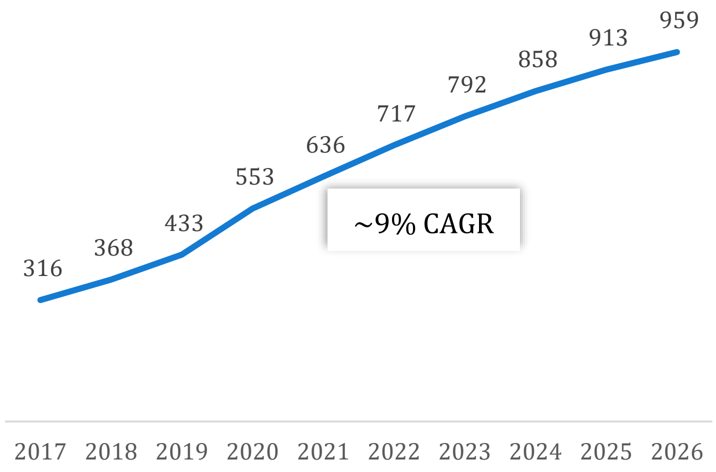
Warner Music Group benefits from powerful secular trends propelling the music industry.

Penetration of streaming remains low…

Country	% Penetration 2021	2026e
Largest:		
USA	27.0%	41.5%
Japan	10.5%	15.8%
UK	27.5%	38.1%
Germany	25.1%	31.9%
France	12.3%	16.2%
South Korea	20.6%	28.0%
China	12.2%	19.1%
Early:		
Sweden	49.0%	--
Norway	60.0%	--

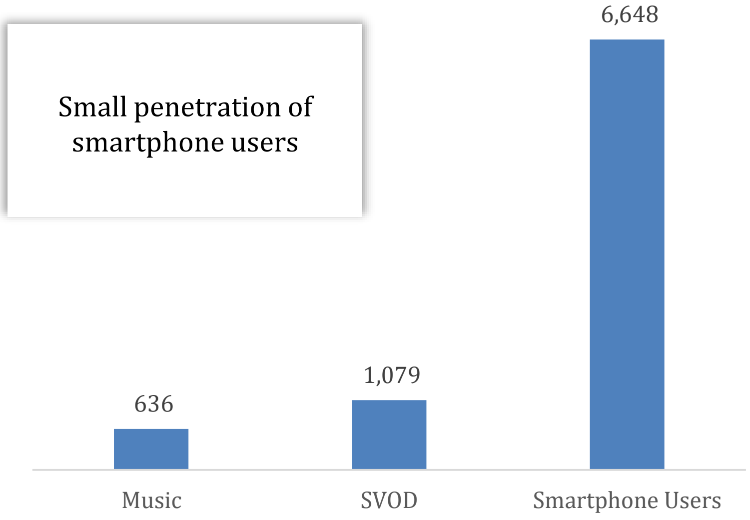
Large developed markets still underpenetrated relative to early adopters

… and users (in mm) will increase dramatically



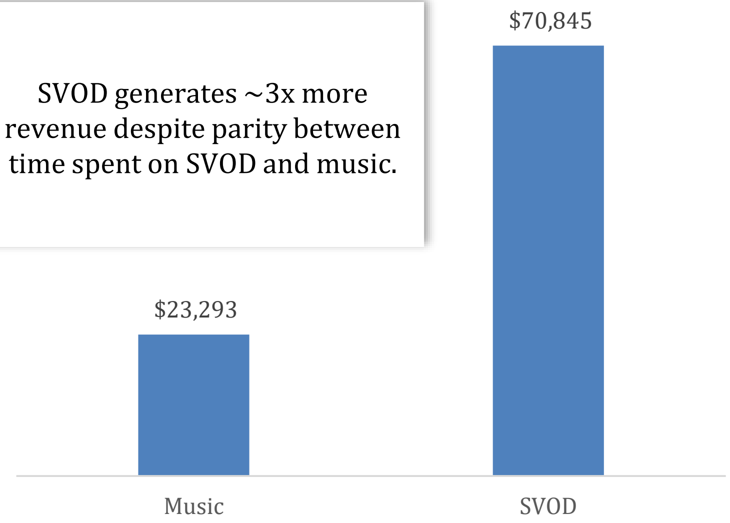
… but the opportunity is still larger (2021 MAUs)

Small penetration of smartphone users



Music is extremely undermonetized… (2021 Revs)

SVOD generates ~3x more revenue despite parity between time spent on SVOD and music.

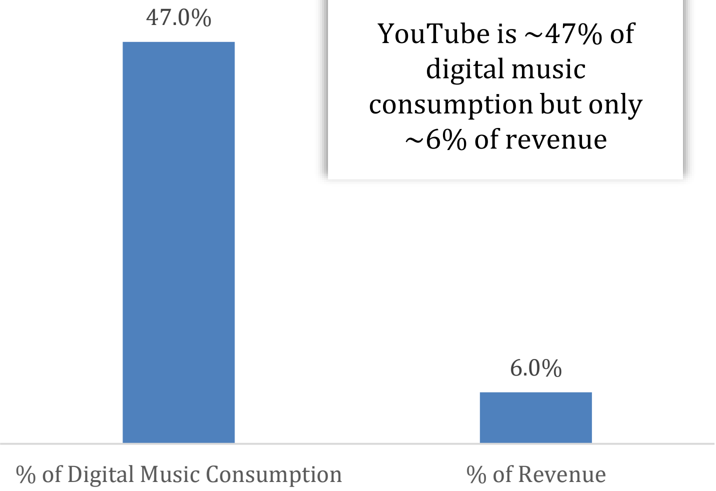


… which supports pricing increases

Country	Normal	Family
US	$ 9.99	$ 14.99
Mexico	5.14	7.74
Germany	11.06	16.60
UK	12.87	19.31
France	11.06	16.60
Spain	11.06	16.60
Sweden	10.30	15.50
Netherlands	11.06	16.60
Japan	9.01	13.61
Poland	5.17	7.75

Spotify Prices

… and better monetization of ad-based music



YouTube is ~47% of digital music consumption but only ~6% of revenue

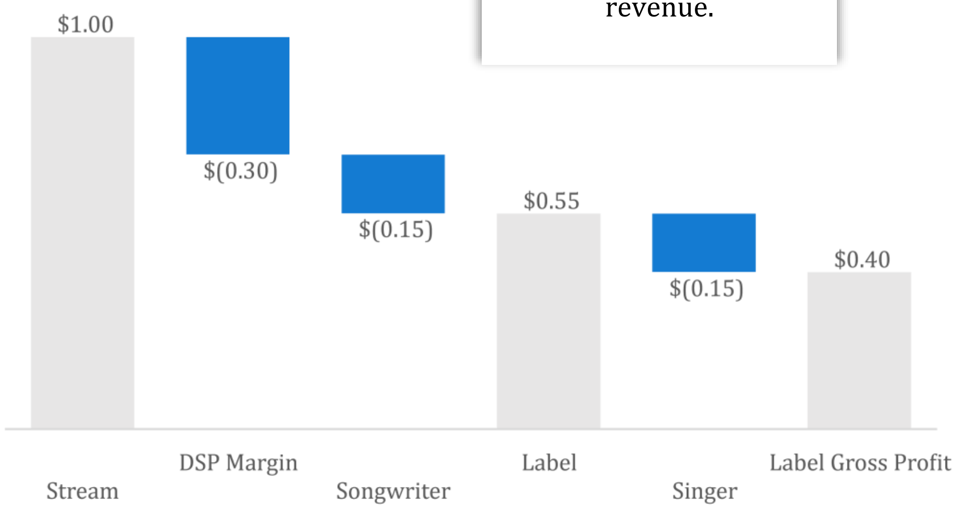
Chokepoint of the Industry Hourglass

Warner Music Group is situated at the chokepoint in the industry, controlling the economics for both artists and DSPs.

DSPs

- Significant fragmentation among DSPs (Apple, Spotify, etc.) maintains Warner's leverage over DSPs.
- Intensification of competition on the DSP side likely enhances Warner's positioning.
- Catalog is >60% of streams and Warner's catalog comprises of ~1.4 million songs (including world-famous artists like the Rolling Stones), and it is mission-critical for DSPs to have these catalogs on their platform.

Labels receive significant share of streaming revenue.



Artists

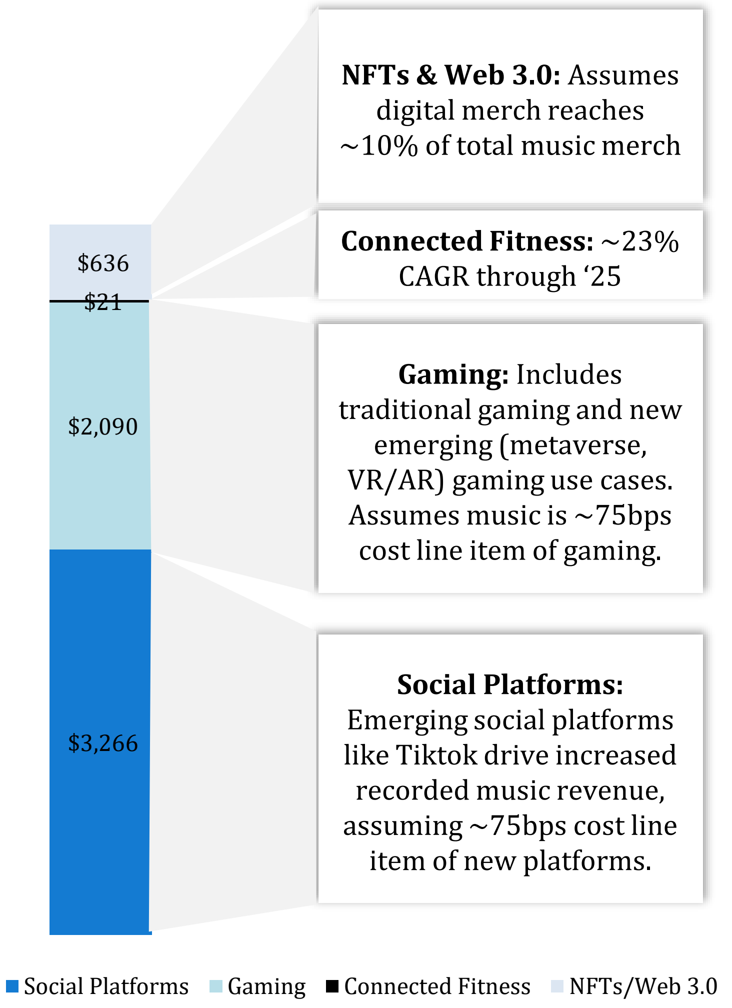
- The number of songs released annually has ~20x'd over the last two decades, making it significantly harder for artists to get noticed.
- The top three artists combined typically make up <2-3% of all streams, leaving artists with limited negotiating leverage.
- Streaming is seen as top-of-funnel for artists, who monetize primarily via performances and other engagement types with fans.
- Three majors make up >90% of the Billboard 100 despite noise about artist leverage.

Source: Company Filings, Internal Estimates

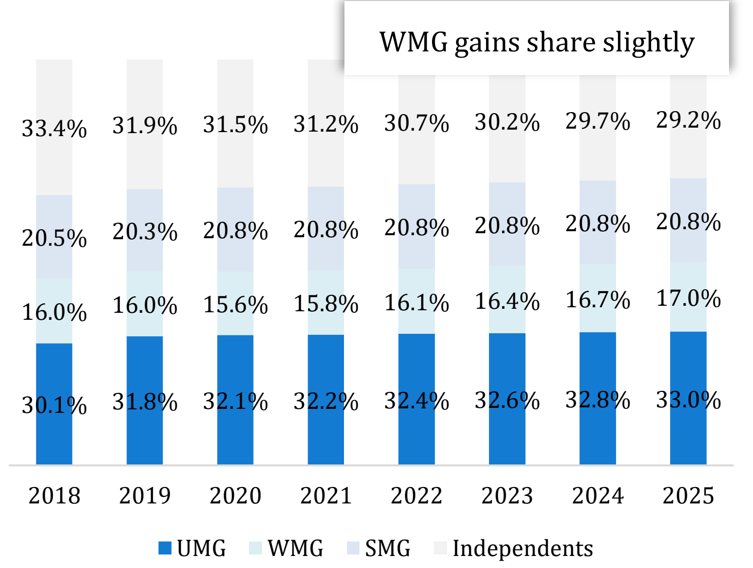
Emerging Streaming Platforms

Warner Music Group is more levered to emerging streaming platforms and digital opportunities than peers.

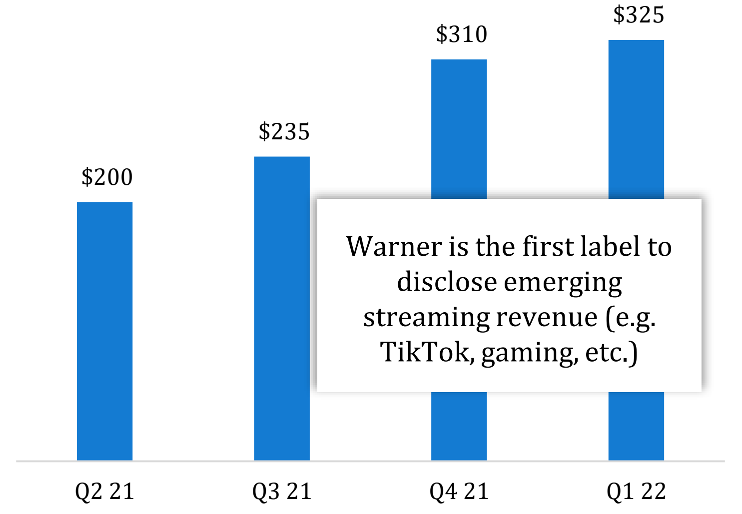
New opportunities expand market TAM…



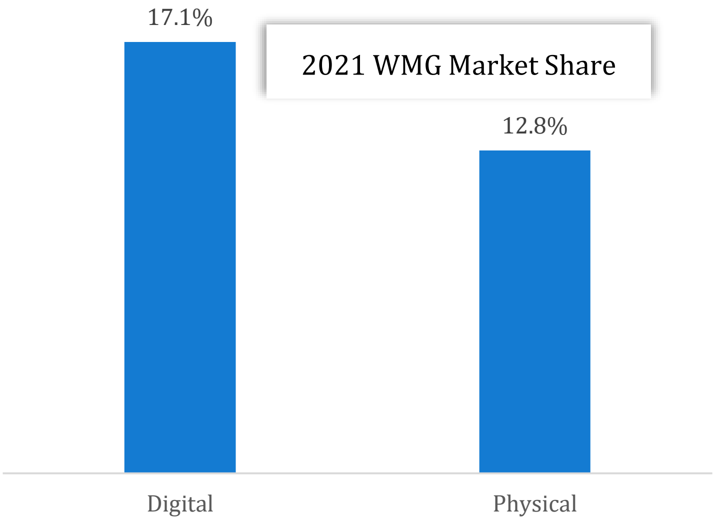
… and WMG will gain market share



… and WMG has significant revenue ($M) traction



… with higher digital market share than physical



… and forward-looking investments

2019

2021

Source: Company Filings, Tegus, Internal Estimates, Flywire Web Scrape

Financial Summary + Valuation

Imminent beats to earnings should support multiple and drive outperformance vs. market indices.

CAPITALIZATION	Book 12/31/21
Cash	$ 450
Debt	3,846
Net Cash	$ (3,396)
Share Price	$ 37
FD Sharecount	518
Market Capitalizati	**$ 19,169**
Minority Interest	19
Enterprise Value	**$ 22,584**

SUMMARY FINANCIALS	FYE September 30,								
	2019	2020	2021	2022	2023	2024	2025	2026	2027
Recorded Music	$ 3,840	$ 3,810	$ 4,544	$ 5,320	$ 5,970	$ 6,640	$ 7,382	$ 8,197	$ 9,167
Music Publishing	643	657	761	903	993	1,098	1,214	1,344	1,489
Intersegment Eliminations	(8)	(9)	(7)	(8)	(9)	(10)	(11)	(13)	(14)
Revenue	**$ 4,475**	**$ 4,458**	**$ 5,298**	**$ 6,215**	**$ 6,954**	**$ 7,728**	**$ 8,585**	**$ 9,529**	**#####**
% growth		*(0.4%)*	*18.8%*	*17.3%*	*11.9%*	*11.1%*	*11.1%*	*11.0%*	*11.7%*
Gross Profit	**$ 2,074**	**$ 2,130**	**$ 2,559**	**$ 3,016**	**$ 3,392**	**$ 3,789**	**$ 4,230**	**$ 4,719**	**$ 5,297**
% margin	*46.3%*	*47.8%*	*48.3%*	*48.5%*	*48.8%*	*49.0%*	*49.3%*	*49.5%*	*49.8%*
% growth		*2.7%*	*20.1%*	*17.8%*	*12.5%*	*11.7%*	*11.7%*	*11.6%*	*12.3%*
Adj. EBITDA	**$ 664**	**$ 790**	**$ 1,018**	**$ 1,270**	**$ 1,490**	**$ 1,733**	**$ 2,012**	**$ 2,328**	**$ 2,707**
% margin	*14.8%*	*17.7%*	*19.2%*	*20.4%*	*21.4%*	*22.4%*	*23.4%*	*24.4%*	*25.4%*
% growth		*19.0%*	*28.9%*	*24.7%*	*17.4%*	*16.3%*	*16.0%*	*15.7%*	*16.3%*
FCF	**$ 296**	**$ 378**	**$ 545**	**$ 1,243**	**$ 1,248**	**$ 1,430**	**$ 1,653**	**$ 1,904**	**$ 2,229**
% margin	*6.6%*	*8.5%*	*10.3%*	*20.0%*	*18.0%*	*18.5%*	*19.2%*	*20.0%*	*20.9%*
% growth		*27.7%*	*44.2%*	*128.0%*	*0.4%*	*14.5%*	*15.6%*	*15.2%*	*17.0%*
Consensus									
Revenue				**$ 5,993**	**$ 6,603**	**$ 7,286**	**$ 7,842**		
% growth (YoY)				*13.1%*	*10.2%*	*10.3%*	*7.6%*		
% Delta				*3.7%*	*5.3%*	*6.1%*	*9.5%*		
EBITDA				**$ 1,202**	**$ 1,403**	**$ 1,617**	**$ 1,764**		
% margin				*20.1%*	*21.2%*	*22.2%*	*22.5%*		
% Delta				*5.6%*	*6.2%*	*7.2%*	*14.0%*		

RETURNS	Valuation at Date,				
	9/30/22	9/30/23	9/30/24	9/30/25	9/30/26
Fwd. EBITDA	$ 1,490	$ 1,733	$ 2,012	$ 2,328	$ 2,707
Multiple	18.4x	17.3x	16.4x	15.7x	15.0x
Enterprise Value	$ 27,402	$ 30,028	$ 33,065	$ 36,564	$ 40,599
Net Cash	(2,104)	(856)	574	2,226	4,131
Equity Value	$ 25,298	$ 29,172	$ 33,639	$ 38,790	$ 44,730
FD Shares	526	539	553	567	581
PT	**$ 48**	**$ 54**	**$ 61**	**$ 68**	**$ 77**
Returns	*30.0%*	*46.2%*	*64.5%*	*85.1%*	*108.2%*
IRR	*42.4%*	*24.4%*	*19.9%*	*17.9%*	*16.7%*
Discount rate	*12.5%*				
Implied EV/Sales	3.9x	3.9x	3.9x	3.8x	3.8x
Implied FCF Yield	*4.9%*	*4.9%*	*4.9%*	*4.9%*	*5.0%*

CURRENT VALUATION MULTIPLES	FYE September 30,				
	2022	2023	2024	2025	2026
EV/EBITDA (TCM)	17.8x	15.2x	13.0x	11.2x	9.7x
EV/Sales (TCM)	3.6x	3.2x	2.9x	2.6x	2.4x
EV/EBITDA (Street)	18.8x	16.1x	14.0x	12.8x	
EV/Sales (Street)	3.8x	3.4x	3.1x	2.9x	

Source: Internal Estimates, Bloomberg

Publicly Traded Comps

Warner trades at a discount to DSP players with lower margin profiles, worse leverage in the ecosystem, and slower revenue growth.

Comparable Public Companies (in $)															
	Price	% 52 Wk	Market		CY Revenue			TEV/2022			Forward Rev CAGR		2022 Margin		
Company	4/4/2022	High	Cap	TEV	2022	NTM	2023	Revs	GP	EBITDA	CY23	CY21-23	GM	EBITDA	Rule of 40
Warner Music Group	**$ 36.98**	**64%**	**$ 19,169**	**$ 22,584**	**$ 6,215**	**--**	**$ 6,954**	**3.2x**	**6.7x**	**17.8x**	***12%***	***15%***	***49%***	***20%***	***32%***
Record Labels															
Universal Music Group	€ 23.71	85%	$ 47,431	$ 50,189	$ 10,505	$ 9,737	$ 11,437	4.4x	--	19.7x	*9%*	*24%*	--	*22%*	*31%*
Sony Group	$ 10.35	19%	1,719	1,322	611	658	792	1.7x	2.8x	(41.3x)	*30%*	*76%*	*59%*	*(4%)*	*26%*
Average:		**52%**	**$ 24,575**	**$ 25,756**	**$ 5,558**	**$ 5,197**	**$ 6,114**	**3.0x**	**2.8x**	**(10.8x)**	***19%***	***50%***	***59%***	***9%***	***28%***
DSPs															
Spotify	$ 153.70	50%	$ 29,612	$ 25,163	$ 11,575	$ 12,065	$ 13,483	1.9x	6.8x	33.7x	*16%*	*31%*	*28%*	*6%*	*22%*
SiriusXM	$ 6.59	94%	26,017	35,069	8,981	9,079	9,363	3.7x	6.5x	20.7x	*4%*	*8%*	*58%*	*18%*	*22%*
iHeartMedia	$ 18.92	67%	2,727	8,949	4,103	4,133	4,219	2.1x	3.3x	17.2x	*3%*	*20%*	*64%*	*12%*	*15%*
Tencent Music	$ 5.00	24%	8,463	35,216	29,690	30,269	31,947	1.1x	3.6x	7.3x	*8%*	*5%*	*31%*	*15%*	*23%*
Average:		**59%**	**$ 16,705**	**$ 26,099**	**$ 13,587**	**$ 13,887**	**$ 14,753**	**2.2x**	**5.0x**	**19.7x**	***8%***	***16%***	***45%***	***13%***	***21%***
Content (Digitization)															
New York Times	$ 46.05	82%	$ 7,712	$ 6,713	$ 2,334	$ 2,371	$ 2,478	2.7x	--	24.5x	*6%*	*18%*	--	*11%*	*17%*
Discovery	$ 25.02	55%	16,757	30,292	12,609	12,666	12,833	2.4x	3.7x	11.8x	*2%*	*10%*	*64%*	*20%*	*22%*
Netflix	$ 373.47	53%	165,807	177,896	33,424	34,496	37,600	4.7x	11.1x	94.6x	*12%*	*23%*	*43%*	*5%*	*17%*
Average:		**63%**	**$ 63,425**	**$ 71,633**	**$ 16,122**	**$ 16,511**	**$ 17,637**	**3.3x**	**7.4x**	**43.6x**	***7%***	***17%***	***53%***	***12%***	***19%***

Key Insight: Warner has room to re-rate higher as ensuing earnings revision cycle occurs, supporting faster revenue growth and better margin profile than peers.

Source: Internal Estimates, Bloomberg

Risks

Warner Music Group faces tangible risks to its market position, though we believe much is baked into the current share price.

		Description	Mitigants
1	**Streaming Customer Concentration**	? Spotify and Apple Music make up a joint ~27% of Warner Music Group's revenue. ? Increasing leverage of DSPs could result in negotiated rates paid to record labels decreasing during future negotiations. ? DSPs have attempted to work directly with artists to cut out labels	✓ Artist agreements with the DSPs (such as Beyonce) have mostly fallen apart, with artists realizing that signing direct with a streaming platform is worse for their overall economics than a label. ✓ Spotify had to shut down its feature allowing artists to upload music to the platform directly in 2019 due to lack of traction.
2	**Increasing Artist Leverage**	? A&R costs as a percentage of revenue has ticked up over the last few years (~29% in 2015 to ~33% in 2020), especially as important artists negotiate better rates for themselves. ? WMG skews more towards newer music content, and streaming has shifted more towards catalog at the expense of WMG.	✓ Record labels will see increasing operating margins due to declining costs of distributions and packaging under a streaming-led regime. ✓ Streaming growth should drive operating leverage on the gross margin side, which should offset rising A&R costs. ✓ Mix shift towards international for WMG should support higher gross margins given lower negotiating power of artists.
3	**Overindexed to "Trendy" Music Genres**	? WMG overindexes to genres like to hip-hop and urban music, which exposes it to risks from streaming platforms who often curate specific playlists (e.g. Rap Caviar) that increase their negotiating leverage.	✓ Overindexing to new music has resulted in acceleration of growth rates relative to peerset as hip-hop and urban music have taken share of music streams

Q&A