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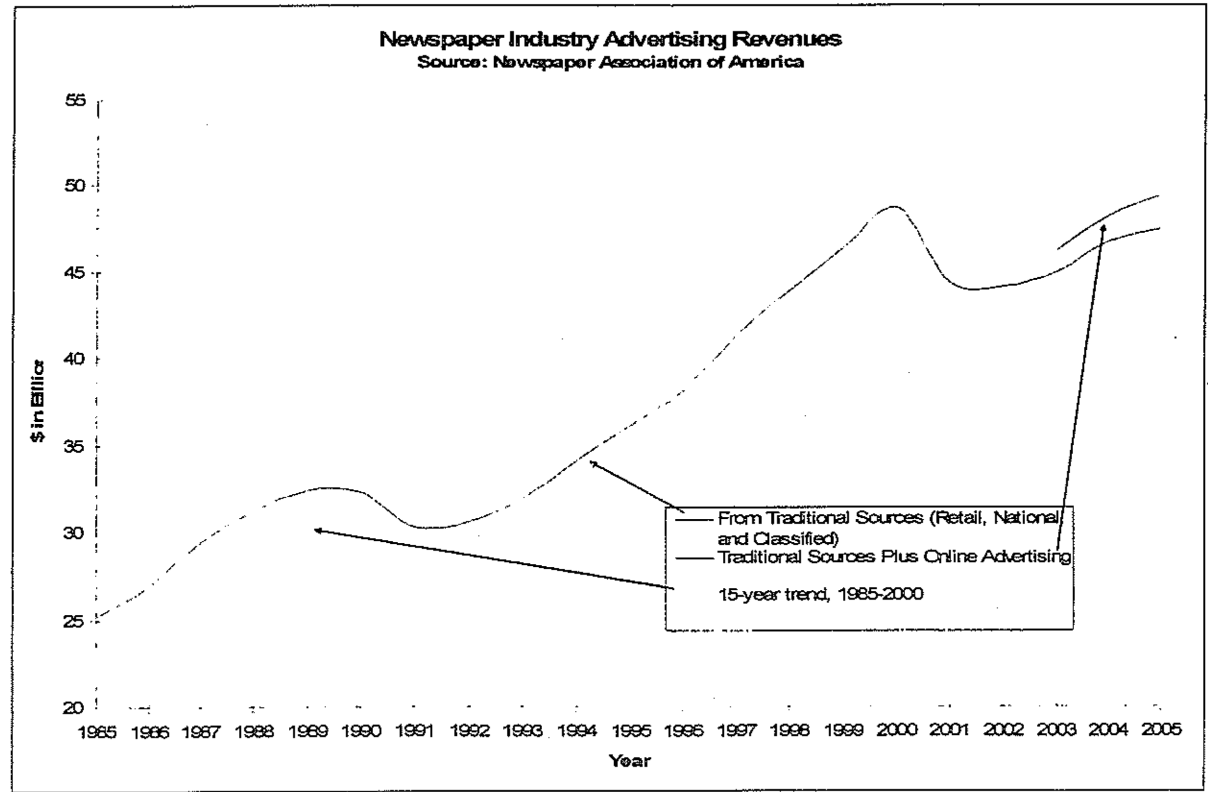
The newspaper industry is gradually adjusting to declining print circulation and the loss of advertising revenues to Internet content providers. At the same time, the Internet has presented new opportunities for renewed growth in the form of new online readers and a new source of advertising revenues. Unfortunately, the positive side of this adjustment has proceeded slowly while the negative side has been exacerbated by a sharp cyclical decline in revenues.

Advertising revenues in the industry have always been cyclical, but they also have always bounced back strongly from every decline. That is, they bounced back strongly from every decline for 50 years from 1950 to 2000. Since 2000, however, the bounce has gone out of the industry. Advertising revenues, which currently account for slightly more than 80% of the industry's total revenues, steadily increased for decades, but flattened after 2000. Some numbers from the Newspaper Association of America ("NAA") are useful to highlight this trend.

As shown in the chart below, advertising revenues rose from $25.2 billion in 1985 to $48.7 billion in 2000 and then fell sharply in 2001 to begin a deeper and longer-lasting cyclical decline than usual. Revenues recovered somewhat in 2004 and 2005, but the recovery was anemic by past standards. The recent introduction and rapid growth of advertising revenues from the online editions of newspapers -- shown in the chart as the red line -- represents a bright spot in the industry's otherwise cloudy outlook. The NAA estimates that online advertising generated $2.0 billion in 2005. When added to the $47.4 billion realized from traditional sources, revenues totaled $49.4 billion in 2005, just slightly ahead of the amount reached in 2000, but still well below a continuation of the 1985 to 2000 trend line.



Advertising revenues have flattened in recent years primarily because the Internet has been draining advertising dollars from the newspaper industry. New Internet-based companies such as Monster, HotJobs, and Craig's List, for example, are taking classified advertising dollars that would otherwise go to newspapers. Newspaper publishers were slow to respond to the competitive threat from the Internet, and slow to realize the potential of the Internet as a new source of readers and advertising revenues, but they appear to be making a greater effort now to maximize this new source of revenues. The Wall Street Journal, for example, which charges for its online edition, is now including its online readers in its audited circulation base.

While revenues have flattened, costs have continued to rise. The result has been downward pressure on profit margins and falling stock prices. Average profit margins for the 12 largest publicly traded newspaper companies (measured as total net income as a percent of total revenues), were at 12.4% of revenues in 2000, fell to 6.5% in 2001 and then recovered to 12.7% in 2004, only to fall again to 9.8% in 2005.[1] Despite this decline in margins, the industry overall is still profitable. A 9.8% margin on total revenues means that about 10 cents out of every dollar in revenues falls to the bottom line as net income. For 2005, a relatively good year for corporate profits throughout the economy, net income for these 12 companies totaled $3.3 billion, down almost 20% from $4.1 billion in 2004.[2]

Newspaper managers responded to this most recent decline in profit margins with renewed cost-cutting efforts. Despite these efforts, an index of input costs for the industry has risen steadily in recent years; climbing from 106.3 in 2000 to 122.9 in 2005 (on an index based at 1992 equals 100).[3] This means that total input costs rose by 6.3% in the eight years from 1992 to 2000 and by 15.6% in the five years from 2000 to 2005.

One of the elements in this steady rise of costs, for example, has been the recent rise in the cost of newsprint, which has been beyond managements' control. The cost of newsprint rose from $565 a metric ton in 2000 to $606 per ton in 2005, a 7.3% increase.[4] Over the same five years, the NAA reports that the circulation of morning newspapers remained relatively flat while the circulation of evening and Sunday papers fell by 1.9% and 4.2%, respectively. Thus, the demand for newsprint, which is directly related to the number of newspapers printed each day, would have been flat in the daily paper market and slightly down in the evening and Sunday paper markets over the past five years. The rise in the cost of newsprint, therefore, has to be related to conditions on the supply side of the newsprint market -- conditions outside of the control of newspaper managers. Other costs have also increased. Total operating expenses for the 12 largest public companies, for example, increased from $23.3 billion in 2000 to $25.3 billion in 2005.[5]

In the face of these adverse financial conditions, stock prices for many of the major newspaper companies have fallen and Wall Street analysts that follow the industry closely have sounded alarm bells. Lauren Rich Fine, an analyst with Merrill Lynch, for example, said in a report on the industry released May 26, 2006, "[W]e are now concluding that the fundamental outlook for newspapers is even more challenging than we had previously thought; in essence profits generated

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[1] Moody's Economy.com Industry Reports, Consumer & Health Services Sector, Newspaper Section, p. 43, May 2006.
[2] *Ibid.*
[3] *Ibid.*
[4] *Ibid.* Price quoted is for east coast delivery.
[5] *Ibid.*

from an almost monopolistic position within classifieds is being eliminated as the core listings business could become a loss leader for other online classified models." Fine's concern stems from the $2.3 billion decline in classified revenues, as reported by the NAA, from $19.6 billion in 2000 to $17.3 billion in 2005. The classified category fell from 40% of total advertising revenues in 2000 to 35% in 2005. Fine goes on to say that although the classified category is causing the most concern, the industry faces other problems as well.

In a research note released April 24, 2006, Peter Appert, an analyst with Goldman Sachs, said, "[I]n our view, valuations have not yet reached the level where investors are 'paid to wait' for a cyclical bounce in industry growth." The note went on to say that in view of "the ever-increasing fragmentation in the local media marketplace, we believe we are experiencing a permanent downward shift in valuation levels." In a research report released June 9, 2006, Appert downgraded both The New York Times Co. and Dow Jones to "underperform" from "in-line" saying, "[W]hile we believe both companies have attractive franchise properties and management teams that are aggressively addressing industry challenges, in the context of our relative rating system, these stocks rank at the lower end of our valuation matrix." In the same report, Appert upgraded the Tribune Co.'s rating to "in-line" from "underperform" on the expectation of a major restructuring or a breakup of the company, not on the expectation of improved operating performance.

Not all analysts are as pessimistic on the newspaper industry as Fine and Appert. Thyra Zerhusen, manager of the Chicago-based ABM Amro Mid-Cap Fund, for example, said on June 2, 2006, in an interview reported by the Dow Jones Newswire that a number of newspaper stocks are currently "undervalued." She specifically mentioned The New York Times Co., Washington Post Co., Gannett, and the Tribune Co. as being undervalued. Zerhusen said she is encouraged by a statistic issued last month by Nielsen/Net Ratings. The research firm said that newspaper Web sites averaged 56 million users during the first quarter of 2006. Zerhusen said that newspaper companies "need to do a better job of explaining how quickly online readership and online ad revenues are growing." She said, "[T]here is a misperception in the marketplace, and I think that's going to change." Once online ad revenues reach "critical mass," she added, investors' opinions will change.

As might be expected, the NAA is also optimistic about newspaper companies' progress in mobilizing the Internet as a new source of revenues. In an apparent effort to do exactly what Zerhusen urged, John F. Strum, President and CEO of the NAA, in a press release reporting on first quarter online revenues for the industry dated June 2, 2006, said, newspaper publishers are "winning on the Web" and "their efforts to attract visitors, build leading Internet properties and monetize their online investments are being recognized by advertisers and consumers -- as shown by a full two years worth of outstanding consecutive [quarterly] gains." Strum reported that online newspaper advertising revenues increased by 35% in the first quarter of 2006 compared with the same quarter a year ago, rising to $613 million for the quarter.

To underscore a point made by both Fine and Appert, however, newspapers no longer have a near-monopoly in local advertising, particularly local classified advertising. As Appert said, local advertising markets have become 'increasingly fragmented' in recent years. As recently as a decade ago, the main competitors to newspapers for local advertising dollars were the local TV and radio broadcast stations, and they were not very effective competitors for the classified category of advertising, which newspapers had pretty much to themselves. Today, there are many more players in local advertising markets than there were even a decade ago. Also, most readers now have many more choices for news than they had as recently as a decade ago. Most readers, for example, now

have easy access to the online editions of all major TV networks, including the online editions of the 24-hour news networks, as well as the online editions of many newspapers, not just their local newspaper.

Newspaper publishers are pursuing several strategies to improve shareholder value and, generally, to cope with the operating challenges they face. In addition to pursuing aggressive cost-cutting efforts, as mentioned above, these strategies include moving more aggressively now to improve their newspaper's online presence, as well as pursuing share buybacks, shedding non-core assets, and exploring merger and other consolidation opportunities.

Most newspapers now have a growing presence on the Internet. Moreover, even though online advertising still accounts for only about 4% of total advertising revenues, recent reports from the NAA, as mentioned above, indicate that this new source of revenue is now growing very rapidly. For many newspapers, the decline in print circulation corresponds closely with the increase in online readership. Readers, particularly younger readers, are simply trading one format for the other.

One prominent example of the ongoing trend toward consolidation in the industry is the recent acquisition of Knight Ridder (and its 32 daily newspapers) by McClatchy, which was announced on March 13, 2006. The deal, estimated at a value of $6.5 billion, is expected to close this summer and create the second largest newspaper chain in the country. McClatchy immediately put 12 of the newspapers it was acquiring up for re-sale and within weeks had firm offers for 11 of these papers, including an offer of $562 million ($515 million in cash and the assumption of $47 million in liabilities) for two of them -- the Philadelphia Inquirer and the Philadelphia Daily News (along with philly.com, the Internet presence for both newspapers) -- from a group of local investors. The buyers said they hope to reverse recent circulation declines by emphasizing local news and being more aggressive with the Internet.

The McClatchy/Knight Ridder transaction indicates that potential buyers and investors still place a high value on quality newspaper properties. In fact, as the Wall Street Journal said on June 9, 2006, in an article dealing with the possible breakup of the Tribune Co., which owns such marquee newspapers as the Los Angeles Times, the Chicago Tribune, Long Island's Newsday and the Baltimore Sun, "there are plenty of investors interested in acquiring newspapers -- despite the industry's much publicized problems."

In conclusion, although exceptional newspaper properties remain highly valued and command high prices on sale, the newspaper industry overall, although still profitable, continues to face serious downward pressure on that profitability from rising costs and slow-growing revenues. Most Wall Street analysts continue to express long-term concern about the negative impact on newspaper profits from other information sources, particularly from the Internet, but also to some extent from personal communications devices, which are rapidly becoming very sophisticated information sources. Some analysts speculate that this adverse trend will only worsen as a new generation of potential newspaper readers turns more readily to the Internet and to their personal communications devices for their news. Newspapers are making progress toward capturing advertising revenues from the Internet, but they have a long way to go before realizing the full potential of this new source of revenues. The bottom line is old issues about monopolistic ownership in single-newspaper markets are no longer as valid as they once were due to the Internet and its widespread use as a source of news and information.