PALI RESEARCH

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Music Industry

US Digital Track Trends Weakening

While recent music industry news has focused on the potential of an EMI/WMG merger, as well as the strength of WMG's March quarter, we believe weakening digital download trends are concerning.

Year-to-date, digital tracks (including digital singles and digital albums converted to tracks at a 10:1 ratio) are up 98% over the same 18 week period in 2005. However, the weekly trend lines are significantly different year-over-year. **In 2005 (see Exhibit A), digital track figures increased significantly throughout the first 18 weeks of the year**, with tracks continuing to improve throughout the rest of the year (see Exhibit B which goes thru calendar Q3).

In 2006, despite the aggregate year-to-date strength in digital tracks, weekly performance continues to decline, with every week during the second quarter below the year-to-date average.

- During calendar Q2/Q3 2005, we were concerned that digital track growth was flattening out, albeit Q4 2005 showed a dramatic acceleration that continued through Q1 '06.
- **We are now concerned that digital tracks will actually be down sequentially in Q2 '06** (over the past 9 quarters since digital began, <u>growth</u> has never been less than 8% sequentially).
  - While new revenue streams that are not included in the digital track figure (OTA downloads, streaming music videos, ringtones, etc..) are offsetting the track slowdown, with physical sales down 5.4% year-to-date, the music industry needs as much growth as possible in digital tracks to achieve a flat-to-up 2006 (currently up 2.0%).

While seasonality is certainly part of the reason behind the current slowdown, <u>**we believe the weak 2006 trendline increases the likelihood that EMI will make another attempt to acquire WMG.**</u>

However, it is unclear whether EMI would offer more than \$30-\$32. Based on our view that at least 60% of a transaction will be stock-based, we remain comfortable with our NEUTRAL rating on WMG (as 15%-plus upside from current levels appears hard to achieve).

Please Read: Important disclosures and analyst's certification appear in Appendix

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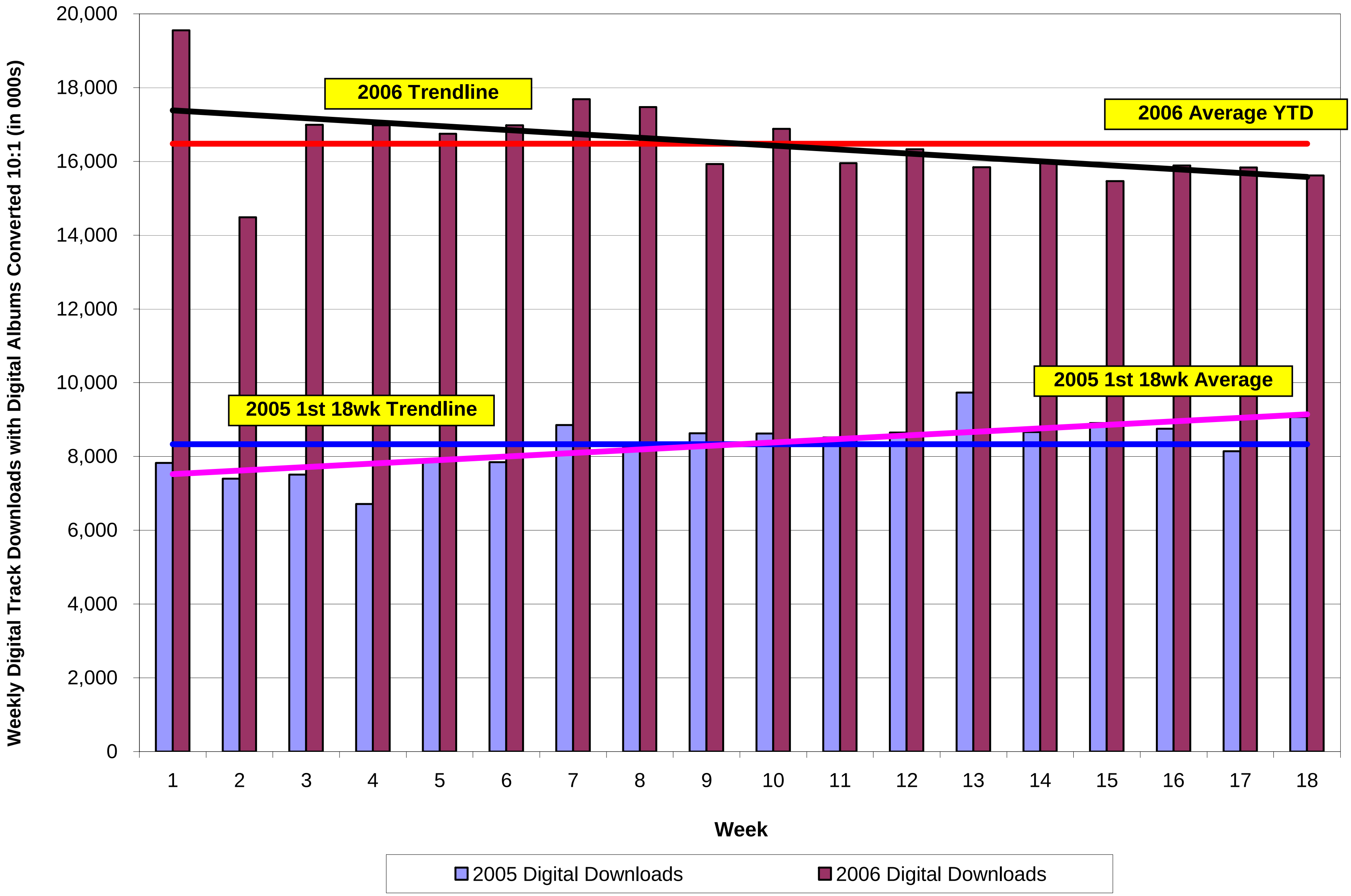
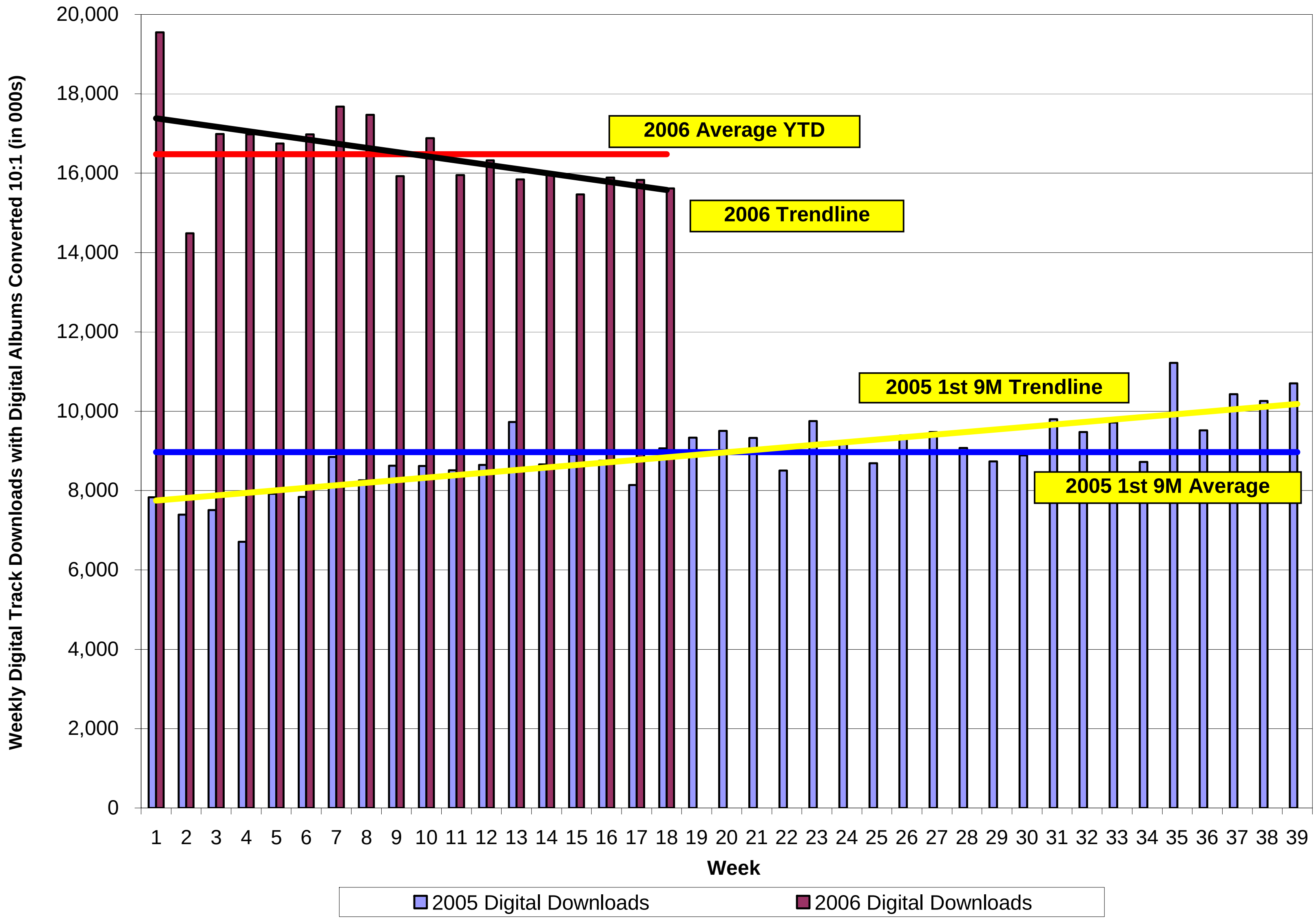
Exhibit A. Weekly Digital Track Trends during the First 18 Weeks of 2006 vs. 2005 (digital albums converted 10:1)



Source: Nielsen/Soundscan data via Billboard.com.

Exhibit B. Weekly Digital Track Trends during the First 9M of 2005 vs. 2006 YTD (digital albums converted 10:1)



Source: Nielsen/Soundscan data via Billboard.com.

APPENDIX

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OTHER DISCLOSURES

Other Companies Mentioned:

- Warner Music (WMG, $28.49, NYSE, NEUTRAL)
- EMI Group (EMI, LSE, £2.73, Not Rated)

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