Dichotomy Partners LP
14 Grant St
Tuckahoe, NY 10707

DICHOTOMY CAPITAL

Yellow Media(TSE:Y)

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Investment Overview

I believe Yellow Media is completely misunderstood. The recent recapitalization has left scars on both debt and equity owners. The shareholder base is confused, the sell-side is too scared to initiate coverage, and nobody is looking at the business as a going concern. In all of this chaos exists a company that is trading for 1-2X FCF.

The perception is that Yellow Media is a dying print company with a small online advertising business. I believe that is incorrect and in the next couple of years, Yellow Media will become an online advertising business with a small dying print business. The better debt profile, focused online effort, and significant cash flows leave Yellow Media dramatically undervalued and misunderstood.

The table below shows my conservative expectations based on extensive research.

(In Millions)	2012	2013	2014	2015
Print/Other	$740.44	$537.30	$376.11	$ 263.28
Online	$367.30	$385.67	$404.95	$ 425.20
EBITDA	51.5%	40%	38%	38%
EBITDA	$570.49	$369.18	$296.80	$ 261.62
Interest	$149.42	$81.00	$59.97	$ 51.29
CapEx	$40	$50	$50	$50
EBT	$381.07	$238.18	$186.83	$160.33
FCF	$228.64	$178.18	$106.83	$96.20
75% Excess Cash Sweep	--	$133.64	$80.12	$72.15

Simply put, this is a business selling for 1.2X 2013's FCF and 2X their 2014 FCF that should have no problem meeting their mandatory debt repayments. In the next three years, at conservative growth rates, online revenues should be the majority of revenues and print will no longer be the focus of investors and management.

The recent recapitalization is a safety net for investors because of the forced debt repayment and cash sweep. Although the recap improved the company’s prospects, it left behind confused sell-side analysts and equity holders who don’t know what to do with their holdings. Nobody is willing to stick their head out and declare that this is one of the least expensive businesses for sale today and significantly safer thanks to the robust cash flows.

Allow me to be the first.

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Effects of the Recapitalization

Overall the recap lowered debt by $1.5 billion. The company now has $800M senior secured notes that yield 9.25% and $107.5M of senior convertibles that yield 8% with a 12% PIK option. All together they will pay $82.6M in interest per year. The company expects EBITDA of $415-$459M in 2013 (pg10 Supplemental Disclosure Q4 2012), giving them an interest coverage ratio of 5.0X. I have modeled EBITDA of $369M in 2013, a less optimistic coverage ratio of 4.5X, factoring significantly higher attrition rates. In either scenario, the company is well covered.

Interest expense will drop due to the mandatory minimum debt repayment. As mentioned in their filings, there is a bi-annual cash sweep that will be used to pay down debt. The minimum payment is $100M in 2013, $75M in 2014, and $50M in 2015 for a minimum payment of $225M over the next three years.

Their first debt payment will take place in May of this year. The company generated $48M FCF in Q4 2012 and I expect them to generate $90-$100M in EBITDA in Q1 2013, which works out to roughly $48M in FCF. A 75% sweep of the two quarters FCF is $72M ($96M*75%). While the exact timing and amount of the repayment is unknown, the general timeline can be seen in the table below. The bottom line is that by 2015 $225M of debt should be paid off.

Table 1. Senior Secured Mandatory Minimum Payment Schedule

	2013	2014	2015
Debt	$800.0	$666.4	$574.5
Repayment	$133.6	$91.8	$78.8
Interest Exp	$82.6	$70.2	$61.7

At the end of Q4 2012 their balance sheet showed $106.8M of cash, well above the minimum $75M that the Senior notes require. As long as the company continues to generate cash flows debt will be repaid and accrue directly to the equity holders. So the real question is how much cash can the business generate?

Business Analysis

The business is divided into two segments, Print and Online. Obviously Print is not doing so well and is seeing double digit declines on an annual basis. It's tough to peg a firm number on decline rate but we can try to estimate 2013 free cash flows by compounding conservative assumptions (shamelessly stealing from Baupost).

1. In 2012 online revenues were $367.3M, up from $346.1M in 2011 or a 6% increase. Management has guided for growth of roughly 11% per year. It seems reasonable to conclude that with increased focus on the business the company can grow online revenues at least 4% and perhaps 11%.

Scenario 1(low): Revenue in this segment grows 4%. $367M*1.04 = $381.9M
Scenario 2(high): Revenue in this segment grows 11%. $367M*1.11 = $407.3M

2. Print. Ah print. This segment was declined considerably. In 2010 the print segment was doing $1,184M in revenue and it dropped to $740.7M of revenue in 2012. That's a drop of roughly 20% per year. Year over year I calculate that print dropped 24.5%(2011 had print revenues of $982M, this declined $241.3M). As another reference point, a decline of 20% per year is also what DEXO and SPMD forecast (Slide 13).

Scenario 1: Print declines by 35% next year(40% higher than this years decline): $740.7M *65% = $481.5M
Scenario 2: Print declines the same as it did this year (~25%). $740.7M*75%= $555.5M

So total revenue could come in at $863.4M-$962.8M.

3. EBITDA margins are right around 50% and management expects this to go down into the 40's as they transition to online. In the Q4 conference call management has opted to increase selling expenses in an attempt to slow attrition. They gave a firm number of 40% EBITDA margins in 2013.

If margins end up at 40% for the year, EBITDA will come in at $345M-$471M. This is compared to a company that has $106M of cash and we know has $800M of long-term debt and $87M of outstanding debentures. Enterprise value (assuming a market cap of ~$200M) is right around $1.0B. This implies a forward EV/EBITDA multiple of 2.8X-2.0X.

CapEx was $42.5M for 2012, and $68.8M for 2011. In the Supplemental Disclosure management breaks down CapEx. The Senior notes have covenants that prevent CapEx from going over $50M. Ultimately the real amount should be closer to the amount spent in 2012.

Interest is straightforward. They will pay up to $74M on the senior notes per year and $8.6M on the convertibles. Therefore Interest is, at most, $82.6M and will be less depending on the repayment in May and November. To be conservative the model in Table 2 assumes no debt is paid all year and the maximum amount of interest is paid.

Taxes were guided to be $60M in 2013 and $80M in 2014 in the Q4 Supplementary Disclosure. Taxes are confusing due to the recapitalization. Regardless, management has stuck to their guns and stressed that starting in 2016 they will pay 26%, or standard corporate rates. Table 2 summarizes all the assumptions.

Table 2. FCF Table for 2013

	Current	% Change	Low	% Change	High
Online	$367.30	4%	$381.90	11%	$407.30
Print	$740.70	-35%	$481.50	-25%	$555.50
Total	$1,108.00	-22%	$863.40	-13%	$962.80
EBITDA Margin	52%		40%		40%
EBITDA	$570.62	-39%	$345.36	-33%	$385.12
Interest	$82.60		$82.60		$82.60
CapEx	$50.00		$50.00		$50.00
Taxes	$60.00		$60.00		$60.00
FCF	**$378.02**	-60%	**$152.76**	-49%	**$192.52**

Nobody will argue that this is cheap for a business with a market capitalization of $200M. Table 3 below shows expected cash flows if the company sees further erosion of EBITDA margins, only grows the online business at 5% per year, and sees attrition of the print business at 30% per year. I believe this is conservative on all factors (growth of online, decline of print, further decrease of EBITDA margins).

Table 3. Cash Flows 2013-2016

	2012	2013	2014	2015
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75% EC		$133.64	$80.12	$72.15

Obviously looking several years into the future is bound to be error prone because so many things can change. I think by compounding conservative assumptions we can come to two conclusions:

1. The mandatory minimum payments have a high probability of being paid.

2. In the next couple of years the online business should be the majority of revenue. This makes the business much more sustainable.

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Print Business Examined

I think it's a good thing that online will become the majority of revenue. I would be lying if I said that I have used a phone book in the past year. In fact, the last time I used a phone book was sometime around the age of 12, when I was growing up in rural NH. My generation and all after mine equate the phonebook with a phonograph, simply a relic.

However, this is not about my biases, this is about how much cash can be extracted from the business before the inevitable demise. As a Yellow Pages Media Consultant told me "I'm not sure the print business will be around in 20 years, but it's not going anywhere soon."

The key factor that will kill the print directory business is opt-in programs. Organ donor studies have shown opt-in programs reduce prospective organ donors from 99% to 12%. Arguably (and hopefully!) phone book opt-in programs see the same rate of decline.

Opt-in programs are being implemented in San Francisco, Seattle and a few other parts of the United States. Outside of a few bloggers petitions, I am not aware of any opt-in program in Canada for yellow pages directories. As the phone book business dies I believe the backlash will too. The environmental impact will be less and less and in theory people should care less and less. I have no way to prove or verify this.

If we assume that there will be no opt-in program anytime soon, demographic data could aid in estimating the decline of print.

The majority of Yellow Page print users are 50 years or older according to media consultants at Yellow Media. According to a report done by Yellow Media in 2010, 63% of all Canadians use print directories during the year and of those, 40-50% are 50+ years old. Table 4 shows the population distribution for Montreal, Vancouver, Toronto, and Canada from Statcan.

Table 4. Population Data for Canada

	Montreal	Vancouver	Toronto	Canada
Age				
Under 50	2,601,807	1,639,549	4,077,558	22,498,943
50-59	554,762	351,624	812,242	5,131,726
60-69	401,420	242,859	534,053	3,708,143
70-79	239,291	136,108	308,606	2,114,739
80+	160,435	93,507	209,029	1,426,940
Total	3,957,715	2,463,647	5,941,488	34,880,491
% of Pop >50y old	**34%**	**33%**	**31%**	**35%**

Source: Statcan

I have not verified the data from Yellow Media independently but the basic takeaway is that people over the age of 50 are the main users of the print directories. I sincerely doubt this group will be switching exclusively to Google anytime soon.

Simple actuarial death rates can be applied to the age groups above to get a more accurate picture of how many people over the age of 50 will be alive in two or three years. It should be fairly obvious that this group of people will still make up about 1/3 of Canada's population. I think that this population distribution means that the transition to online can continue and the cash cow that is print directories can be milked.

Online Business

The online business is essential to Yellow Media's long-term survival and prosperity. Unfortunately, right now revenues decline as each customer switches from print to online. Management is reluctant to provide any detail on the price decline for making the switch.

Luckily for us, again, media consultants at Yellow Media will give quotes for any city in Canada. A few of the quotes I received can be seen below.

Table 5. Advertising Rates for Yellow Pages. Per month rates

	Montreal	Vancouver
1/4 Column Ad	$146.00	$226.10
Full Page Ad	$2,996	$3,159.30
Guaranteed Sponsor Placement	$1,366.00	$1,308.00
Mobile Sponsored Placement	$79.20	$79.20

It's pretty clear why management doesn't tout the figures above. Every time a customer switches from print based ads to online ads the company loses at least 60% of their revenue.

Even with that large revenue cliff only 35% of their customers were using online placement as of Q4 2012(Supplemental Disclosure). There were 309,000 total customers in Q4 2012, thus ~108,000 were using online placement. This is compared to Q4 2011 where out of the 340,000 customers, only 64,000 were using online placement(19%). This year over year growth of 68% will not replace print but it will go a long ways towards creating a sustainable business.

Management is investing heavily this year to ensure the success of the online business. The drop in EBITDA margins is directly correlated to increased SG&A spend to slow customer attrition and build out online products.

How well this will work remains to be seen. Investors are told to look at how many customers leave each quarter. Even if we don't see positive customer numbers, I believe online revenues should overtake print revenues in either 2013 or 2014. This clear inflection point should ease fears of the very confused shareholder base.

Who Owns Yellow Media?

Following the recapitalization the old note holders and debenture holders ended up owning over 80% of the new common. These owners were primarily income seeking funds. Interviews with some of the funds indicate they don't want to own the common outright. While it is unknown at what price they are selling (our lowball bid 10% above market prices got rejected) it was made very clear that they don't want to own the common or warrants for an indefinite period of time.

The sell-side is definitely perplexed and outwardly admits to be confused. This probably explains the lack of coverage, the last research report found was done in the beginning of December. Two months later the analyst had not put out a new report.

He was very confused about the company and when asked if he thought they were cheap after the recapitalization he said he thought so. So why not publish a piece?

"Uhh... yeah. I don't know what's going on. I'm afraid to initiate on this because I might be missing something that makes me look stupid but I can't figure out what it is."

These interviews were not done to confirm what I believe. They were done to examine the mood and the sentiment. I am led to believe those interested in Yellow Media, either as a shareholder or as an analyst, are very confused. While I would be lying if I said knew the whole story and don't have lingering questions, I believe my research paints a much clearer picture than simple EBITDA metrics.

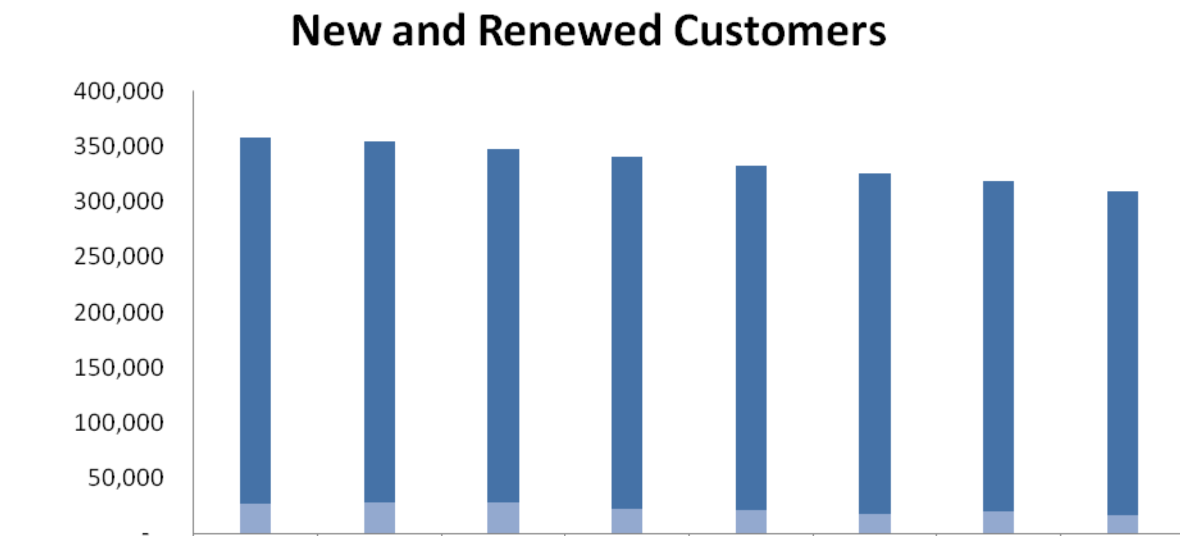
Confusion could be a value investor’s best friend here.

Customers of Yellow Media

Ultimately the success of Yellow Media will hinge on their ability to slow customer attrition and keep milking the print business for as long as possible. Happy customers will go a long ways towards achieving that goal. The chart below shows the number of advertisers and how many new customers are signing up over the trailing 12-month period.

While many customers are leaving many more are staying and a few are joining. Customer interviews lead me to believe that while customer attrition will continue there is a very sticky base that plans to stay. One creative director, representing 75 companies, used all advertising mediums, did not have any success with Google and is looking to further expand her commitment to Yellow Media.

Chart 1. New vs. Renewed Customers Source: Authors Calculations from Supplemental Disclosures in 2012, 2011, and 2010



	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012
Lost Customers	331,760	326,480	320,160	317,550	311,460	307,980	299,280	292,400
New Customers	26,240	27,520	27,840	22,450	21,540	18,020	19,720	16,600

Several law firms indicated that the print business was a very successful medium for them and they would continue to use it until print was discontinued. While Google is an attractive medium for most advertisers, there is still a market for print advertisers.

Obviously advertisers are leaving so interviews are simply evidence that the overall business is not destined for zero.

I do not believe that Google will overtake Yellow Media. The reason is two-fold. According to interviews with Yellow Media consultants and SEO consultants Google will often buy information about local business from companies like Yellow Media. This creates some small information edge for Yellow Media.

Even with that information customers of Yellow Media like the idea that they can get guaranteed placement and are not simply part of the pool. This could help explain why Yellow Media's retention rates are significantly higher than Google's.

Valuation Considerations

Given the high leverage currently associated with Yellow Media, the mandatory debt repayment should help us estimate a fair value for the company. Taking the cash sweep from Table 3 I have estimated the value of the equity if the enterprise value stays stagnant at $1.001B ($800M senior notes, 107.5M Debentures, 106M cash and $200M market capitalization).

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Table 6. Valuation of Yellow Media at Constant Enterprise Value(EV) In Millions

End of Year	EV	EBITDA	EV/EBITDA	Value of Equity	Debt w/75% Sweep
2012	$1,001	$554	1.81	$200	$907.5
2013	$1,001	$369	2.72	$332	$774.5
2014	$1,001	$312	3.20	$406	$701.7
2015	$1,001	$275	3.64	$473	$634.9

Getting an exact calculation of fair value is difficult; there are too many variables. I think at the very least if one believes that the online business will be the driving force in a couple of years(all indications point to that being the case), a 6-10X FCF multiple can be applied since the business is growing and likely sustainable.

Conclusion

There is no denying that the print phone book business is dying but even dying businesses have value. The belief is that Yellow Media will not be able to make the shift to an online advertiser. Over 108,000 companies have already voted with their wallet and believe that Yellow Media offers true value.

The margin of safety comes from forced repayment of debt and ample free cash flows. The opportunity is here because the shareholder base is confused and scared by what just happened. While I can't peg a firm value I believe that over time the cash flows will be used to pay off debt and enhance shareholder value.