LEE ENTERPRISES INVESTMENT CASE STUDY

Lee Enterprises – US Newspaper Group

Lee owned 49 daily newspapers with a combined circulation of approximately 1.6 million. At the time of our investment in October 2009 Lee's senior secured debt was trading at 53% of face on a 4.2x estimated 2009 EBITDA and 5.2x free cash flow multiple. 2009 EBITDA was down 23% from 2008 and down 40% from 2007.

Lee's results were a reflection of the newspaper industry as a whole. US newspaper advertising revenue had been declining in absolute terms since 2006 at an accelerating pace reaching a 30% decline in the first half of 2009. US weekday newspaper circulation had been declining for more than two decades at a fraction of a percent up to 2004. Since 2004 the decline had accelerated reaching 7% for the six months ended March 2009.

With this backdrop of rapidly deteriorating performance the market had been applying a significant discount to newspaper securities. The general consensus was that newspapers were subject to a fundamental and potentially terminal decline caused by the rise of the internet as well as a cyclical decline. This sentiment is neatly summed up by one analyst's description of the business as, "selling buggy whips".

Our view was that a substantial portion of the decline was cyclical and therefore reversible. We accepted that newspapers were also subject to a structural decline caused by the internet. However the internet was only having a fundamental affect on certain discrete portions of newspaper revenue, in particular some categories of classified adverts which were rapidly and permanently being lost. Much of that process had already occurred. Other portions of newspaper revenue were also being affected by the internet but at a slower pace.

Applying conservative assumptions, we concluded that Lee's newspapers would be around for the medium term i.e. long enough to get our money back with considerable upside given our purchase price.

Key points relevant to our analysis.

1] Based on Audit Bureau Circulation "ABC" reports Lee's core print circulation decline never exceeded 1.5% until March 2009 when it declined by 6%. This shows that Lee's underlying structural decline in circulation prior to the recession had been modest.

2] 55% of Lee's total advertising revenue comes from non-classified retail expenditure, which is mainly local businesses. This retail revenue only began to decline in the second half of 2007 at the same time as the recession took hold. By the 1st and 2nd quarter of 2009 it was declining in the mid 20% range. This degree of decline was no different from the decline of local spot TV and local spot radio. The amount of revenue lost in these three categories of local advertising was much too big to be accounted for by the internet. This suggested that the majority of the decline in retail revenue was a cyclical and not a structural issue. Analysis of TNS data discussed below confirmed this point.

3] 30% of Lee's total advertising revenue comes from classifieds which itself is sub-divided into the four categories of Auto, Real Estate, Employment and Other. Significant portions of classified advertising have moved permanently to the internet. However, there are pockets of classified revenue that will remain in print for the medium term.

Standard industry practice classifies all auto advertising regardless of where it appears in the paper as classified. A significant proportion of the remaining auto classified revenue comes from local dealership display ads. The percentage decline in auto-classified advertising in 2009 was similar for all media types including the internet. This was driven by the collapse and bankruptcy of much of the auto industry. We expected this to bounce back. The "Other" category, which includes legal notices, had not declined at all.

4] Lee's capital structure ensures that all free cash flow is earmarked for the benefit of the senior secured debt.

5] Lee's papers are located in stand-alone markets with populations of less than 350,000 and limited competition with other papers.

The non-discounted return in this case was 49% on an investment of 3 million.

Commentary

Lee is an example of a recurring inefficiency caused by a credit moving from investment grade or high yield to the distressed space.

In these circumstances it is often the case that pre-existing sources of information which were not relevant to pricing become material. These sources of information can easily be overlooked by the majority of market participants. Where information has only recently become relevant by virtue of changed circumstances analysts will not have been looking at it historically and in all likelihood that carries through even for liquid credits with significant analyst coverage. An example is the TNS data used by us in our analysis.

The market research firm TNS maintains a database that counts and records all adverts in the newspapers it covers. For example it tells you the amount of advertising column inches placed by Macy's in a given paper on a given day. The database also provides the amount that Macy's has placed across other media types including the internet, radio and TV. TNS also provide copies of individual adverts. The TNS service is regularly used by advertisers to track competitor campaigns of specific products. We were using it for a different purpose.

The TNS data enabled us to identify the newspapers' top advertisers. We then analysed those advertisers to determine how their advertising spend had changed firstly within newspapers and secondly between newspapers and other media types including the internet. The data allowed us to identify which advertisers were shifting allocations away from newspapers and which were not. Where it was obvious that advertisers' spend had decreased for cyclical reasons the information gave us a sense for what the quantum of a bounce back could be.

The TNS data was material because it provided robust evidence to determine how much of the 25% decline in retail revenue was due to structural vs. cyclical factors (the data shows that nearly all of it was cyclical). That decline only became material in the last quarter of 2008. Prior to the end of 2008 the TNS data would have been irrelevant to pricing newspaper securities.