

## Blu-ray Wins, But Does Anyone Care?

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On Feb. 18 Atsutoshi Nishida, president of Japan's largest chipmaker, Toshiba, waved the white flag in the multi-billion-dollar high-definition DVD format war. The winner: Sony's Blu-ray; the loser, Toshiba's HD-DVD. Of course, this was more formality than revelation; the real war ended nearly two months prior when Warner Bros., the only Hollywood studio continuing to support both technologies, cut ties with Toshiba, provoking Microsoft to follow suit two days later. After five-plus years, the war — with surprisingly few losers despite the money involved — was over.

“I don't think Toshiba is doing that badly, other than a loss of potential,” says Scott Berry, a Connecticut-based analyst and consultant to technology and investment companies and former VP at wealth-management firm SMH Capital. No one cares to venture a guess on what that loss of potential amounts to because Blu-ray is “still in its infancy.” And besides, adds Berry, “Any company — Toshiba included — still has time to get on board and make money from it, assuming the technology takes off.”

According to Japanese business daily *Nikkei*, Toshiba lost US\$986 million as a direct result of its defeat, a move that temporarily depressed the company's stock. However, it's small change beside net sales (primarily from semiconductors and nuclear equipment) which

reached US\$76.7 billion in 2007, up 12% from 2006. Likewise, the company is forecasting 30% growth over the next three years. That's an "achievable target," commented Fumiyuki Nakasishi, equity analyst at SMBC Friend Securities Co. in Tokyo, after Toshiba released its year-end report on April 25.

The same goes for Microsoft (Nasdaq: MSFT), the format's other major backer. The software giant "only had one piece of technology incorporated into HD-DVD, plus some marketing dollars," says Alan Davis, equity analyst at D.A. Davidson & Co. in Lake Oswego, Oregon. Microsoft declines to say how much it spent on marketing and developing the HD format, but even if it's in the millions, says Davis, "it's minor compared to the billions they're spending on Internet search efforts," including its US\$44.6 billion attempt to buy Yahoo. Like Toshiba, there were "no long term stock affects."

So if the losers aren't doing too badly, how are the winners faring? "Sony will benefit from royalty revenue — pennies per disc but overall, it will be a lucrative amount once Blu-ray takes off," says Irena Logovinsky, equity analyst at Morningstar. While Sony (NYSE: SNE) won't comment on future strategy, Logovinsky doesn't see "anything changing in the near future." But, she adds, "ask me again in January" after sales from holiday promotions and an expected price drop on Blu-ray players to \$199.

Echoing most analysts, Logovinsky rates Sony a Buy, especially after the company released several new HD televisions and other portable devices at the 2008 Consumer Electronics Show in Las Vegas. To benefit from the DVD battle, Sony first needs to convince consumers to invest in HD TVs, which take best advantage of Blu-ray technology. According to a report from Informa Telecoms & Media, more than 47 million households in North America will have an HDTV by 2009, up from 17.8 million in 2007; 6.7 million in western Europe, up from 1.3 million in 2007; and 14.3 million in Asia Pacific, up from 5.3 million in 2007.

But according to a recent report from consumer market research firm NPD Group, sales of Blu-ray players, excluding PlayStation 3 game consoles, dropped 40% in February, recovering a mere 2% in March. The Blu-ray Disc Association blames lack of supply for the drop in sales, NPD consumer electronics analyst Ross Rubin blames the decline on lack of consumer interest; people are generally happy with standard DVD and won't invest in a new player until prices drop.

The NPD figures don't include sales of Sony's PS3 game console, which has a built-in Blu-ray player. ABI Research estimates PS3s account for more than 85% of Blu-ray players in use, and that the number of stand-alone players won't surpass the PS3 until 2013. However, the PS3's install base is expected to double this year — the strongest growth rate of any video game console — according to data released by research firm iSuppli. Worldwide PS3 sales could reach 10

million units in 2008, compared with 12.2 million units for Nintendo's Wii and 7.5 million units for Microsoft's Xbox 360.

There is speculation that Microsoft will add Blu-ray capability to the 360 (replacing the now discontinued HD-DVD add-on), but the company refuses to confirm it.

“I doubt they will pursue this strategy,” says Edward S. Williams, interactive entertainment analyst at New York-based BMO Capital Markets. “Microsoft is more interested in pursuing downloadable content than investing in a piece of hardware that plays physical discs.”

Film might not sell games, but the film industry remains the gold standard when it comes to entertainment dollars. And yet, the HD battle — ultimately decided by studio support — did not significantly affect the fortunes of Hollywood companies.

Time Warner's about-face on Blu-ray revved up the blogosphere rumour mill; Sony paid Warner as much as US\$500 million, claimed nameless sources. After all, both sides were offering incentives to studios; Paramount received US\$29 million from Toshiba. Officially, Warner cited “consumer demand” as reason enough for ditching Toshiba even though there was never a clear market leader among the two HD standards. Neither company will speak to this rumoured

payoff, and if Sony did in fact pay to play, it's an expense that doesn't show up in its quarterly reports.

“Sony is constantly restructuring, so there are no steady benchmarks to judge whether a payout like this was made,” says Logovinsky.

Similarly, Time Warner's financial statements offer no clues. But, says Larry Witt, equity analyst at Morningstar, “It's possible behind closed doors Sony offered them money.”

Remaining loyal to the loser didn't affect Paramount or its sister companies, such as Dreamworks (NYSE:DWA). “Everyone had a get-out clause,” says Witt, and besides, compared to the money made and spent on company-owned newspapers, cable TV networks and theme parks, actual funds invested in either format “is small business for these companies.” None of Witt's stocks were negatively affected by the battle's ending.

In fact, Paramount's parent, Viacom, reported 33% revenue growth in its first quarter (ending March 31) thanks to increased advertising sales on its cable TV networks and strong sales of its *Rock Band* video game. Movie studio revenue rose 12%, reaching US\$1.5 billion.

Some other companies are going to see a direct post-war gain. “Dolby is poised to do well,” says Davis. Since Dolby is standard on Blu-ray discs and players, the company will collect about \$1 in royalty fees per

sale and “at 95% margins — it’s a great business model.” Dolby Laboratories (NYSE: DLB) reported total revenue of US\$172.6 million for its fiscal Q2 2008, a 34% increase over last year.

Another sound company, DTS Inc. (Nasdaq: DTSI), will also benefit from Blu-ray. “This company has the most upside in terms of pure play benefit from the Blu-ray decision,” says Davis. While DTS’s technology was optional on regular DVDs, “it’s now standard on Blu-ray.” Like Dolby, DTS will earn high-margin payout on all Blu-ray sales.

Davis has rated DTS a Buy since last year, long before the format war was over, but since the Sony win he has raised the target price, especially after DTS sold off its money-losing professional business selling systems in theatres. The company now focuses solely on consumer royalties.

DTS' CEO and president, Jon Kirchner, attributes the company’s growth — 21%, with US\$15.2 million in revenue for Q1 2008 — to “revenue related to high definition products,” which accounted for 21% of all sales in the quarter, and “increasing momentum in Blu-ray.”

Another company poised to profit should Blu-ray take off is Macrovision, which owns encryption technology that prevents the disc from being copied. Macrosoft only gets royalties based on players

that have the technology but, unlike the music business, Hollywood is still crazy for digital rights management.

Blu-ray's challenge is that it has yet to capture widespread public interest and it's unclear whether that will ever happen. DVD sales are shrinking which suggests Blu-ray is unlikely to reach the same level of popularity as DVDs did back in the early 1990s.

For Sony to succeed, it needs to “push people toward Blu-ray,” says Scott Berry. “With VHS it was an easy change because the video tapes degraded with each viewing, but DVDs stay the same, so most people don’t think it’s worth it to upgrade.”

Berry gives a best-case scenario of 5 to 10 years before Blu-ray takes off, “and by then, digital downloads might be more popular.” If that happens, Sony's shiny new technology may find itself occupying the same place consumers keep their LaserDiscs.