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Sirius Unfairly Hit by XM's Issues

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4/28/2006 2:01 PM EDT
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Sirius (SIRI:Nasdaq)	BULLISH
Price: $4.82 | 52-Week Range: $4.36-$7.98	

- As XM's share price has fallen, it has pulled Sirius down with it.
- Howard Stern drove Sirius' subscriber growth into the lead.
- Sirius CEO Mel Karmazin controls costs and drives advertising growth.

Position: **Long**

Since 2006 began, **Sirius** (SIRI:Nasdaq - commentary - research - Cramer's Take) has labored under the shadow of issues at its duopoly competitor **XM Satellite Radio** (XMSR:Nasdaq - commentary - research - Cramer's Take).

A few months ago, XM lost one of its directors, former investment banker Pierce "Jack" Roberts, who not only quit but did so in a very flamboyant manner. He insisted at the time that if XM didn't mend its ways, it faced a "significant chance of a crisis on the horizon." XM traded off significantly and fell to a recent low of $19.66 from its latest high of $40.89 in December 2004.

It pulled down Sirius with it -- unfairly. And if you can wait out the temporary gyrations as this volatile new industry gets its legs, Sirius could be a solid pick long-term pick for your portfolio.

Despite detractors who say it will never be commercially viable as a business, satellite radio has gone from having no subscribers to a combined total between the two providers of more than 10.5 million subscribers, who are willing to pay, on average, about $10 per month to receive the service.

Those who get it love it. I am among them, and so are my kids, who now have satellite radio in their homes, not just their cars. Ratings data show that the average in-car radio listener plays his radio about 40% of the time, while satellite radio users listen about 85% of the time. The cost is about 30 cents per day. Compare that with a $3 daily latte at **Starbucks** and tell me which is the better value.

The three major costs for this industry are:

1. Launching the satellites. The satellites are clearly in the sky and operating. Eventually they will need replacement, but not anytime soon.
2. Buying programming to lure listeners. Both companies spent a lot of money securing exclusive programming, but that, too, is winding down. XM offers every major league baseball game in the U.S., and Sirius offers football.
3. Marketing, which at the moment includes subsidizing the receiver you install in your car or your home. Marketing is the last high-cost front. And as the price of the units declines with volume, the size of that hurdle is also on the downswing. These numbers show up in the companies' financial statements as SAC, subscriber acquisition costs. They have been dropping dramatically for Sirius: $177 in '04, $139 in '05 and $113 in the fourth quarter of 2005. XM's have been more volatile.

Just for some background, Sirius went public in 1994 and hoped to be first to market. XM didn't go public until 1999. The two systems are of different design, and the Sirius technology took longer to make operative. So despite being first to concept, it was not first to market. Because it has been selling units longer, XM now has 6,502,000 subscribers after adding 569,000 in the first quarter of 2006. It was outselling Sirius until the fourth quarter of 2005, when Sirius leaped into the lead in new subscribers for the quarter on the back of the arrival of Howard Stern. Sirius also beat XM in the first quarter as well. As we already know, Sirius added more than 700,000 new subscribers through mid-March, when it announced it had passed the 4 million mark.

What dramatically turned this tide is that on Oct. 6, 2004, Howard Stern decided to jump ship from CBS radio, formerly Infinity Broadcasting, to Sirius. However, CBS would not release him from his contract, and Stern could not go live on Sirius until January 2006. Stern was guaranteed a revenue stream of $80 million per year for providing programming, at his own expense, for two complete cable channels operating 24 hours a day. In addition, he was given a "signing bonus" worth $100 million in stock when the deal was announced.

At that time, Sirius was trading at $3.46 per share. His bonus was contingent on his driving a certain number of undisclosed new subscribers to Sirius. The $200 million number recently bandied about in the press arose from the fact that in December 2005, when Stern's bill came due, Sirius was selling for twice that price.

Prior to the Stern deal, Sirius trailed XM by 10 percentage points in brand recognition. Now Sirius leads XM by 10 percentage points. If you were **Procter & Gamble** introducing a new brand, you would spend similarly to get it launched.

When he quit with a splash, former XM director Pierce was probably on the money about XM's balance sheet. Just this month, XM has refinanced $800 million with lower interest rates through unsecured debt at 9.75% and by issuing new shares. These refinancings did lower the ongoing borrowing costs, but Thursday's quarterly release does not rule out the need for further financings.

Sirius is insistent that it will not need to raise another dollar of public funds, and hopefully management will say so loud and clear on the earnings conference call next week. XM also announced Thursday that the Federal Trade Commission is looking into some of its marketing practices, and the Federal Communications Commission has expressed concern about the emissions from some of the Delphi SkyFi2 receivers that are soon expected to be phased out of production.

Last but not least among Sirius' attractions is the presence of Mel Karmazin. Karmazin launched Stern's career when he ran Infinity Broadcasting, which owned WFAN, Stern's home in New York. As Karmazin likes to brag, he has made $20 million per year for the last 20 years. He doesn't need to work. But once Stern jumped to Sirius, Karmazin did, too.

Karmazin knows more about radio than anyone in the U.S. He is salivating at the opportunity to sell commercials on the company's talk channels, while vowing that Sirius will keep its music channels free of commercials. Many analysts are ignoring this source of revenue, but that is a mistake. One of the knocks on Sirius in the past was its profligate spending ways. It should also be noted that nobody runs a tighter ship with regard to expenses than Karmazin does, so those days are over!

My firm has owned Sirius since Karmazin arrived. We haven't made money yet on our first lot of shares, and we bought more in March at $4.51. We are *very* patient long-term investors. I don't know how soon the Street will figure out the value here, but eventually it will.

This isn't a trade, something I don't know how to do. It's an idea for those who are patient and willing to wait. Sirius has stated that it expects to be cash-flow positive in the fourth quarter of this year and for all of 2007. Earnings should follow thereafter. This is a great business model, because, as with the magazine business, most people pay in advance, so you collect their cash first and deliver the service later. Sounds good to me.

At the time of publication, Lappin was long Sirius, although holdings can change at any time.
Joan Lappin, CFA, is chairman and chief investment officer of Gramercy Capital Management Corp., a registered investment advisor based in New York City, which she founded in 1986.