

Special Situation Investing Newsletter

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Company Spotlight: Getty Images Inc. (GYI-NYSE)
Current Stock Price: \$50.43
24/7 Wall St. Price Target: \$36.00 to \$38.00; 18-month outlook
Options Strategy: De-leveraged JAN09 \$40 PUTS at \$1.95; This is not a naked short call, we are taking the put options instead.

gettyimages®

Key Statistics: Market Capitalization \$3.0 Billion; Forward EPS estimates: 2007 \$2.35; Current P/E Ratio: 23.0; Forward P/E Ratio: 19.1; Dividend \$0.00; 52-Week Trading Range \$41.21 to \$68.10; Average Daily Volume 560,000 Shares; Institutional & Insider Ownership 82%.

After looking around at the various ways of playing the online stock photo and video segment, it is easy to realize that the largest player is still Getty Images. Even with their recent transactions and attempts to broaden out their product lines, it looks like this company could face further margin erosions into the future. The company is going to survive, that we are certain of. But that doesn't mean that everything will be happy and smooth from here on out. Making a bearish call in a bull market is not always easy to do, but this is a market neutral stance and competitive pressures persist.

Getty Images (GYI-NYSE): Getty Images is the clear leader in copyright online stock photo and video for content and website publishers to go to. The problem is that the stock photo giant is already under siege from direct competitors and it really looks like any online photo storage site (even for mom and pop) could be turned on as a competitor. Throw in a YouTube, a MySpace, a Facebook, Eastman Kodak, and the like, then you have what could be almost endless potential margin compression.

Getty Images has already had stockholder issues despite beating earnings and raising estimates. The company is increasing royalty-free images

and is under fire from potentially hundreds of 'wannabe' digital image (and now video hosting) web sites.

GUIDANCE & VALUE: Just last week, Getty posted preliminary earnings of \$0.63 EPS on revenues of \$213 million, compared to First Call estimates of \$0.62 EPS and \$212.65 million revenues. It guided next quarter to \$0.66 operating EPS on \$218 million, the First Call estimates were \$0.65 and \$212.9 million. It guided 2007 to \$2.47 EPS (after \$0.17 charges, so \$2.64 non-GAAP) and revenues of \$880 million, compared to First Call estimates of \$2.63 EPS and \$848.7 million. The company will also restate a number of past quarters to reflect charges from options grants from 1998 to 2005. Cash and equivalents grew \$47 million to \$386.5 million after spending \$16.6 million in property and equipment. Foreign exchange may have helped the bottom line. Shares are not trading any higher despite a "raised guidance" press release.

The forward guidance for 2007 gives the company a 19.1 forward P/E ratio, and based on a forward P/E of the S&P 500 Index we think this one should have closer to "market multiple." This is partially how we derived the \$30's price

target but we are also not a fan of its balance sheet and think it will continue have charges from acquisitions (therefore earnings quality issues). As of the last real 'current' full balance sheet last year, Getty's entire current assets were under liabilities and the company had far too much in goodwill and intangibles on the books.

THE SECTOR: Because of the fact that the company has been the leader in global image sales for news and media, it is under fire from potentially anyone with \$20,000.00 that wants to compete. Here is a part of the underlying problem in the sector and the acquisitions: The company acquired WireImage, a creator of entertainment and event imagery. It has also acquired PunchStock, a provider of royalty-free images. It has acquired Scoopt and owns iStockPhoto.com. This sounds good, but the underlying fact is that Getty cannot just acquire everyone out there and there are just too many fledgling companies that will go to much cheaper photo sites. It would cost too much and the ease for a flood of new competitors is just too strong. So at some point the company will (if it hasn't now) draw the line in the sand and say, "We have our platform, so it's Getty Images against anyone and everyone else."

If you look through the list of competitors, it just goes on and on. If you include what could be the photo storage and printing sites in this as a competitor in a year, then the competitors grow astronomically. Here is a sample: PhotoBucket, Corbis, Shutterfly, Flickr, Adobe Stock Photos Dreamstime.com, Photos.com, StockedPhotos.com, StockVault.net, BigStockPhoto.com, Stockphotos.com, Clipart.com, TSSPhoto.com, Shutterpoint.com, FreeStockPhotos.com, Fotosearch.com, Freeimages.co.uk. If there is truth to the News Corp tie-up with PhotoBucket, you can bet Rupert and crew are smart enough to realize this.

There is no way to know how many of these there will be in 6 months, but to prove the point type in "stock photos" on a Google search. Getty Images is there in the sponsored search list but the alternative go on and on. Kodak's EasyShare Gallery website and Shutterfly could even get customers to offer this for "credits" against payment. That may be a stretch, but not if you believe in a user-generated content world. Keep in mind that the "user generated content" world hasn't expanded to photo hosting and storage sites, but this can quite easily happen.

Go read the book "Wikinomics" and you can see how easy this sector would be to flatten out.

GETTY'S PART IN THE SECTOR: Getty does have royalty-free imagery and offers discounted images with the recent transactions and offers more affordable subscription services. It is no longer just a stodgy high-priced hold-out. It also now can offer "copyright for sale" video that is above and beyond what many others could offer, but with the opening up of the world user-generated content this too can and will likely change. After speaking with a sales rep at the company to confirm pricing, some of these can be had for as little as \$60.00 all the way up to subscriptions at \$1,600.00.

It also feels that the newer royalty-free model and the failed Jupiter Media (JUPM-NASDAQ) could amount to an admission that stock photos in a user-generated world just aren't worth what they were in recent years. Jupiterimages would have added over 20 different niche stock photo websites and the failed buyout may have boiled down to an issue inside Jupiter or with Mr. Meckler. This looks more plausible that Getty itself was smart enough to realize they might be purchasing assets with a decreasing present and future value. This analogy is far easier to draw than say YouTube ripping off vast amounts of television and video that would strip away income. The barriers to entry are close to nothing and literally a small mass of a few dozen people hired on contract in major cities around the world could have a brand new competitor up overnight.

The Getty Investment group itself owns 14% of the company and they can certainly hold out without needing to sell stock. They would also be able to round up "votes of support" if things get too bad. They could even do a "bear bluff" by sending a signal that if the stock gets too bad they would look to take the company private. The mere hint of that would at least have a shot of creating a floor, even if there was no truth to it. Analysts are mixed on the stock and the chart is very non-directional near-term.

Once the company becomes current in its filings it will be able to start repurchasing shares and may be able to take on more shareholder friendly initiatives. So we are looking at the safest de-leveraged bet against the company as the JAN09 \$40 PUTS. The options are still too pricey to buy at the money calls out to JAN-08 and are far

too pricey for JAN-09. The premium for the JAN-09 \$40 PUT premium is \$1.95. The same \$40 Strike in JAN-08 only costs \$1.00, but it doesn't really give enough time for a longer-term call like this. We also expect that the company will do fairly well compared to estimates in the next two quarters and that the newer-model business pressures will not come to pass until late 2007 or early 2008.

The fact that media and news platform mergers are being proposed on two massive scales with a News Corp tie-up with Dow Jones and a Thomson tie-up with Reuters adds even more risk longer-term, which is actually just a recent and newer risk that was not present when we first started researching this in much more depth. Fewer and larger key customers can make for larger risks and puts more power in the hands of customers.

How would the current \$50.00 stock handles of the stock compare to the past? The 52-week trading range is \$41.21 to \$68.10, so a lot of this downside may already have been taken. At the end of 2005, this was up to \$90.00+ (partly because of the media needing to buy war photos from hot zones). The stock climbed from under \$20 since 2002 and was a huge beneficiary of the Iraq and Afghan war zone photo needs of major media in 2002 to 2004. So you can see the stock has been all over the place.

Once again, this one is too costly to bet against with major conviction of a true short-sell because of the cost of the call options. Using a tiny fraction on a de-leveraged basis to maintain the same downside risks would give an implied 4.0% downside (once again de-leveraged, so only 1 contract purchase per 100 shares you would normally trade) out to JAN-09. Instead of shorting 1,000 shares for the full amount we are merely saying to own 10 put contracts, so this is much lower nominal investment than normal.

The company will survive and we do not expect the situation to implode overnight. They will continue to have major news ties with most of the larger and smaller news agencies. Getty will still sell photos (and video now). It is very unlikely to die. Even in the years ahead, it will still have many big media clients. A key issue against it is that it will have to continue acquiring companies. Unfortunately it cannot acquire them all and it cannot stop a rising tide of wannabies that want to get in the space.

TRADE CONCLUSION The JAN09 (January, 2009) \$40 PUT options offer the safest position as a "bet against the company," but we are addressing this only on a de-leveraged basis. Buying options is a 100% risk to capital, so we are treating this only with the return based capital expectations. On a de-leveraged basis, you would look only at one contract per 100 shares you would buy/sell in the underlying stock.

Why not just short the stock and hedge with call options? For starters it is just too expensive for our taste. We look for at least a 2-1 perceived upside to downside matrix and shorting the stock with a hedged "Call" just adds too much premium. The option pricing indicates a higher propensity for this one to rise (which we disagree with), because if you model for a gain you'll see that the JAN09 \$60 CALL options cost \$5.00. So you'd be taking 20% risk to the rise in the stock price, plus the 10% for the premium if the option expired worthless, plus roughly 6% for the cost of borrowing the stock. We like to look for special situations where we feel we can limit downside on any single trade to roughly 10%. So taking on 30% or more downside is something we feel is foolish.

So in short, if you were considering shorting 1,000 shares of the stock then you would only want to purchase 10 contracts of the JAN09 \$40 PUTS. Any change to this strategy is one we would not endorse whatsoever. If a buyer stepped in or if the cautious opinion proves to be too much then this limits your downside to what would be limited to a rough equivalent of 4% based on the \$1.95 premium.

If we are wrong and the stock rises 10% or 20% we still think that roughly 1/3 of the premium would be left as time value for the stock options and the 4% downside risk would actually be able to be closed out at a slightly lower loss than that.

If this stock begins to feel more pressure than we think the event risk is and longer-term time value could take these put options to a value of closer to \$6.00 or a tad higher based on current option pricing.

RISKS TO THE POSITION For starters, this is a market neutral call or based on a non-directional market. The key risk in being negative is that in a true bull market many shares

rise despite cautionary news. We have been in the midst of a huge market rise and that may continue.

Getty is in no way one that we expect to die or even come close. Getty will be here because they have all the legal issues worked out with the actual live events and that could be a serious growth engine down the road. The long and short of it is that this is going to boil down to sheer margin compression in its core photo licensing operations feeling competitive pressure.

Newspapers and online news sites and television networks are going to use this company because of old long-term business relationships and larger sites can easily afford the Getty packages if they go to a subscriber model.

Expectations are set at what we feel is rather low and that is why the company was able to raise guidance. It is possible that the company was also being conservative in an attempt to beat earnings expectations. It is also possible that just because there are no barriers from others entering the business it would not create a profitable environment for the "me-too" businesses.

Private equity firms or management may take an interest if this gets cheap enough. The private equity buyers are leaving no stone unturned right now but it is logical that even though there has been some interest there in the name at current and slightly lower levels. Getty himself could also probably go out and raise the cash to take it private. Because of this we would probably not want to stick around forever on the negative bias.

Another issue is the delinquent filing and the stock options backdating issue. That won't last forever and companies are traditionally seeing the stocks recover as these situations get rectified and as they amount to not much more than a slap on the wrist.

It is also easy to look at the chart and ask why this call was not made back in early 2006. The shares have only made it down to \$41.00+ during the last pullback and looking at \$38.00 would take the stock back to 2003 levels. Based on what we think is happening to the cost structure of "website photo and video" it is hard to see how Getty can escape what will end up

being a margin trap and they cannot acquire everyone in the sector.

5-YEAR CHART



Chart supplied by AOL Money & Finance

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