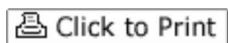




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Mel Karmazin fights to rescue Sirius

A lifeline from Liberty Media pulled his satellite radio company back from the brink. Now the CEO has to prove that the business model can still work.

By [Jon Birger](#), senior writer

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(Fortune Magazine) -- "I really don't mind everybody second-guessing," Sirius XM CEO Mel Karmazin tells me, though his tone screams otherwise.

Karmazin and I are chatting at Sirius XM's Midtown Manhattan headquarters, in a conference room just up the stairs from the studio where Howard Stern broadcasts his daily radio show for Sirius. The topic is the eleventh-hour deal Karmazin has just struck with Liberty Media ([LINTA](#)) to keep Sirius XM - the progeny of last year's ballyhooed satellite-radio merger - on the air and out of bankruptcy court. During the interview, Karmazin's mood swings from frustration (with some of the shots he's taken in the financial press) to relief (at being able to refinance at all) to optimism (about a company whose future seemed extremely shaky just weeks ago).

This is Karmazin's first interview since the Liberty deal provided Sirius XM ([SIRI](#)) with a \$530 million lifeline, albeit an expensive one. Back when he was running the show at Infinity Broadcasting and later at CBS ([CBS](#), [Fortune 500](#)) - and even when he was sparring with Sumner Redstone as the No. 2 at Viacom ([VIA](#)) - Karmazin was always a Wall Street favorite. But his reputation has taken some hits during his four-plus years as CEO of Sirius and now Sirius XM. He has presided over a 98% decline in Sirius XM's stock price (now 20 a share). Even more damning to some, he entered 2009 with \$995 million in maturing debt and no way to repay it.

The Wall Street Journal, for example, scolded him for not refinancing Sirius XM's debt last summer when he had the chance - while the high-yield bond market was still functioning. Asked about that, Karmazin retrieves from his office a stack of presentations from five different banks with which he was discussing new debt deals. "We'd started the process," Karmazin says, noting that there was nothing he could do before the merger closed on July 28. "But once Sept. 15 happened" - a reference to the failure of Lehman Brothers and the chaos that ensued - "the markets just froze."

The griping continued even after the Liberty deal was unveiled. Karmazin was criticized for giving up too much - Liberty snagged 40% of Sirius's stock, as well as a 15% interest rate on \$530 million in secured loans (the real rate is closer to 16% after factoring in the \$30 million restructuring fee Sirius XM is paying Liberty). He was accused of giving short shrift to an alternative offer from satellite-TV mogul Charlie Ergen, CEO of EchoStar ([SATS](#)) and Dish Network. For instance, Henry Blodget, the disgraced dotcom analyst turned financial pundit, questioned whether Karmazin had stiff-armed Ergen just to settle an old score or to keep his own job. "I thought that was really cool," Karmazin now says, his sarcasm overflowing.

For the record, while Karmazin and Ergen have tangled in the past - specifically over how much EchoStar and Dish would pay for Viacom cable channels such as MTV and Nickelodeon - both men insist that there was nothing personal about their negotiations. Still, Karmazin admits that he wasn't exactly thrilled when EchoStar bought up \$170 million in Sirius XM debt maturing in February just as Sirius XM was nearing an agreement with bondholders on an extension.

Sirius XM would hardly be the first troubled company to get a financial lifeline and still wind up in Chapter 11. And based on the company's 20-cent stock price, Wall Street isn't betting on a happy outcome. "Sirius was like a patient that was having a massive heart attack," says David Bank, a media industry analyst with RBC Capital Markets. "This got its heart restarted, though it's not yet out of the danger zone."

The market's skepticism is understandable. Over the years Sirius and XM have been absolute horror shows for investors. The duo rang up \$3 billion in debt, tallied cumulative operating losses in excess of nearly \$10 billion, and since 2004 lost shareholders a combined \$15 billion in stock market capitalization. As recently as March 2 - before all the i's were dotted on the Liberty deal - Sirius XM issued an ominous warning. Explaining the reasons it would be late filing its 2008 annual report, the company said it had not yet completed "its evaluation as to whether substantial doubt exists relative to the company's ability to continue as a going concern."

In spite of all that doom and gloom, Karmazin insists that having averted its credit crisis, the company is actually on the verge of living up to its early promise of doing for radio what satellite TV did for television. (Besides the Liberty deal, Sirius XM reached extension agreements on some \$400 million of debt coming due in 2009.)

"This is a company with very high fixed costs," Karmazin explains. "Before you get your first subscriber, you've had to launch satellites, put an infrastructure into place, and get content. You have all of these expenses upfront before you get a single dollar of revenue." However, once subscriber numbers reach a certain level, the dollars start cascading to the bottom line. "That," he says, "occurs this year."

The number of paid subscribers at Sirius and XM has climbed from 1.5 million in 2003 to 19 million at the end of 2008. Whether it's Howard Stern spilling raunch or Bob Dylan spinning records, Sirius XM's programming does seem to have found a large and diverse audience among audiophiles, sports fans, news junkies, and others willing to pay \$13 a month for better variety, a clearer signal, and commercial-free music.

About half of all new cars are now equipped with satellite radio - Karmazin's goal is 70% - and the conversion rate of three-month trials into paying subscriptions has been just shy of 50%. Plus, once consumers sign up for Sirius or XM, they tend to get hooked: The churn rate last year was a mere 1.8%. "It's a very sticky, good product," says Bank.

In the fourth quarter of 2008, a devastating one for most companies, Sirius XM recorded its first operating profit ever (measured by Ebitda, or earnings before interest, taxes, depreciation, and amortization), as well as its first significant slug of free cash flow. Operating profit, which, like free cash flow, is a barometer of how much money is moving in and out of company coffers, was \$32 million in the fourth quarter, vs. the equivalent of a \$224 operating loss in 2007 (which was pre-merger). Free cash flow stood at \$29 million, vs. \$5 million. The company's net loss narrowed to \$249 million from \$405 million.

Within a few years Sirius XM won't just be profitable, Karmazin insists, "but very profitable." In an SEC filing from last December, Sirius XM said it expected operating earnings to rise from \$300 million this year to \$1.3

billion in 2012. (Wow!) Asked about that guidance, Karmazin says, "Nothing has changed." After our interview, however, Sirius XM announced that it is suspending guidance beyond 2009, citing the weak economy and cratering new-car sales. (Uh-oh.)

While it's easy to be skeptical about Karmazin's rosy outlook, he argues that Sirius XM never would have been able to sidestep bankruptcy if its underlying business weren't attractive and the cost savings from the merger - now \$425 million a year - weren't significant. "Liberty has spent a lot of time under the hood of the company," Karmazin says. "They've looked at the company. They sort of liked what they saw."

The operative phrase may be "sort of." In an interview with Fortune, Liberty Media CEO Greg Maffei makes it clear that Liberty's investment in Sirius XM is more opportunistic than strategic. "This is a high-risk time for this company, given its leverage and some of the challenges both in the financial markets and the car markets," says Maffei. "We have confidence they'll work it through, but it's got risk, and that's why we went in as a senior lender."

In other words, Liberty would not have been so willing to put a half-billion dollars into Sirius XM were it not for the somewhat usurious terms and the fact that its loan is secured by hard assets such as Sirius XM's satellites and broadcast spectrum rights. "As a senior lender, do we think that one of the assets that's attractive is the spectrum they have?" Maffei asks, sounding like someone who has considered every outcome. "Absolutely."

That's not to say Maffei doesn't want Sirius XM to succeed. As a 40% shareholder, Liberty will profit mightily if it does. Were Sirius XM stock to rebound only to \$1 a share, Liberty would turn a 100% profit, totally apart from any interest or principal payments on the \$530 million loan. Maffei is just being realistic about the challenges Sirius faces during a period of declining new-car sales (which are key to growing the subscriber base) and rising consumer interest in competing technologies.

Indeed, Martine Rothblatt, the entrepreneur who founded Sirius back in 1990 and is currently the CEO of biotech company United Therapeutics, thinks Sirius XM's entire business model has become dated. "There has been a huge growth in terrestrial alternatives," says Rothblatt, who was known as Martin Rothblatt before undergoing a sex-change operation in 1994. "As we move from third-generation to fourth-generation cellular, there's going to be ever more bandwidth available to distribute content totally via terrestrial cellular infrastructure. And that will leave fewer and fewer unique market attributes to satellite radio."

Basically, Rothblatt is envisioning a future in which free Internet radio services like Pandora, AOL Radio, and iTunes Radio are ubiquitous on car sound systems and cellphones. Internet radio would become the second new technology to undermine the market for satellite radio - iPods and MP3 players were the first - and Rothblatt doubts that satellite can compete with free services that offer thousands of stations, vs. 150 for Sirius and XM. "Technologies have their ideal times and places, and in my opinion the better time for satellite radio was 10 years ago," says Rothblatt, who thinks Sirius - which didn't begin broadcasting until 2002 - would have hit this sweet spot were it not for FCC red tape that delayed its launch.

Karmazin doesn't dismiss the threat posed by Internet radio. In fact, Sirius XM is about to join Pandora and AOL Radio in offering its own Apple ([AAPL](#), [Fortune 500](#)) iPhone application, thereby allowing iPhone users to stream Sirius or XM via 3G wireless. Still, he's dubious that computer-generated song playlists can compete with Howard Stern or Bob Dylan. "I'm starting at a premise that says radio is not just recorded music - radio is discovery of new music," he says. "Some people would like to be able to hear songs they haven't heard before and that are not on their iPod. Some want to listen to CNN or Howard Stern, and not just to music. That's why we have a laserlike focus on getting content - because we think that content is what wins."

Given the paucity of revenue that Internet radio is producing right now - the entire industry generated \$74 million last year, according to AccuStream iMedia Research, as compared to \$2.4 billion for Sirius XM - it's hard to imagine how Internet radio could compete for a shock jock like Howard Stern (whom Sirius is paying \$100 million a year) or for the rights to broadcast every Major League Baseball game (rights that XM is paying nearly \$60 million a year for).

Plus, one of the benefits of the Sirius/XM merger - aside from the cost savings - is that several years from now, once all Sirius and XM customers are on the same system, half of Sirius XM's spectrum will be freed for other uses. The company already sells some premium content - Sirius customers can now pay an extra \$4 a month to access the best XM channels, and vice versa - but Karmazin envisions a wider menu of premium radio content down the road. Maybe people "will want to get the superduper Howard Stern channel," he says.

Premium content wouldn't necessarily be limited to audio. Sirius XM currently offers a three-channel Backseat TV service for select Chrysler and Jeep SUVs. (For an extra \$7 a month, Sirius subscribers can get mobile feeds of the Disney Channel, Nickelodeon, and the Cartoon Network.) If Sirius XM wanted to launch more video channels, it would probably have a willing partner in Liberty Media, which owns half of DirecTV as well as several cable networks, including QVC and Starz.

During Liberty's fourth-quarter conference call with analysts, Maffei spoke excitedly of the possibility of turning Sirius XM's excess spectrum into a mobile video platform for DirecTV: "The great dream, perhaps, is that you have ... 150 audio channels on one consolidated Sirius XM platform that only consumed [half] of the spectrum, and [the other half] becomes therefore available for mobile video. That would be a great intersection of where the skills of Sirius XM and DirecTV reside."

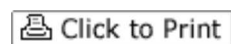
Asked about Maffei's musings, Karmazin doesn't want to be pinned down. "We could also have 130 more audio channels," Karmazin says. "We could go to Wal-Mart ([WMT](#), [Fortune 500](#)) and say, 'Hey, Wal-Mart, how would you like to have a channel that's just for you?' We could say, 'Hey, Mormon Church. How would you like to have a channel?'"

"There's just a lot of opportunities, and it's so refreshing to finally be able to think about them. Because for the last three months, all I've been thinking about is liquidity, liquidity, liquidity." ■

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