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## investment report

### DreamWorks Animation SKG, Inc. (DWA)

#### business overview *From DreamWorksAnimation.com and Reuters.com*

DreamWorks Animation SKG (DreamWorks) is a video-production group, specifically oriented towards the development and production of computer generated (CG) animation films. Within the animated film industry, DreamWorks focuses mainly on family entertainment, with films that appeal to both children and adults, are graphically pleasing and sophisticated, and tell stories that are fun, comedic and creative.

DreamWorks has continually been a leader in their field. In 2004, DreamWorks become the first animation company to produce and distribute two CG animated films in one year. Furthermore, DreamWorks has consistently produced many hit films, one of which was Shrek 2, the third highest-grossing movie of all time!

The company itself is centered in almost entirely on the West Coast – they operate out of two main studios, one in Glendale, California and one in Redwood City, California. Dreamworks’ management team, headed by CEO Jeff Katzenberg, is considered to be one of the most experienced and dynamic groups in the entertainment industry. Much of that management team has been with the company since its creation.

At the beginning of 2006, DreamWorks terminated its distribution agreement with DreamWorks Studios, but entered into a variety of new relationships with companies such as Paramount, and Nickelodeon.

#### competition

competitor	company description	implications for DWA
DIS: The Walt Disney Company (Pixar)	Pixar, Studios is a digital animation studio founded in 1985. Last May, Pixar was acquired by The Walt Disney Co., a company it had worked with for many years prior to the purchase. Pixar’s goal when producing a film is to create memorable and “heart-warming” characters for audiences of all ages.	Pixar is DreamWorks’ largest competitor as they both target the same audience and produce extremely similar films. Pixar performs just as strongly as DreamWorks.
SNE: Sony Corporation (ADR)	Sony Corporation is a large company that oversees a many smaller Sony groups, such as Electronics, Games, and Pictures.	While Sony Pictures competes with DreamWorks, they are not as closely focuses on CG animation.

LGF: Lion's Gate Entertainment Corp.	Lion's Gate is a film production company that releases between 15 and 18 motion pictures annually. Other than film releases, Lion's Gate also focuses on television programming.	Lion's Gate, like Sony, does not focus specifically on CG animation and thus is only a less direct, and broader industry competitor.
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## financials

### income statement *From DreamWorksAnimation.com, DreamWorks Animation November 2006 10-Q*

The first thing we notice is that in 2004 DreamWorks' operating revenue plunged from \$1.1 billion in 2004 to \$462 million in 2005. It is important to realize that DreamWorks revenue is reflective of the revenue it is receiving from its films. If one year DreamWorks produces many films (as it did in 2004) its income is much higher than in years where it does not release such a high grossing film. However, overall, DreamWorks has continued to expand over the years.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(in thousands, except per share amounts)			
Operating revenue	\$ 55,584	\$ 87,107	\$ 190,566	\$ 289,421
Costs of revenue	29,739	55,559	97,194	161,903
Gross profit	25,845	31,548	93,372	127,518
Selling, general and administrative expenses	16,966	21,919	56,936	58,467
Operating income	8,879	9,629	36,436	69,051
Interest income, net	6,984	2,490	17,506	3,185
Other income, net	1,452	1,454	4,393	2,581
Decrease (increase) in income tax benefit	3,851	2,677	(3,764)	(8,682)
Income before income taxes	21,166	16,250	54,571	66,135
Provision for income taxes	10,699	16,906	18,112	24,784
Net income (loss)	\$ 10,467	\$ (656)	\$ 36,459	\$ 41,351
Basic net income (loss) per share	\$ 0.10	\$ (0.01)	\$ 0.35	\$ 0.40
Diluted net income (loss) per share	\$ 0.10	\$ (0.01)	\$ 0.35	\$ 0.40
Shares used in computing net income (loss) per				
Basic	103,250	103,092	103,235	103,055
Diluted	103,432	103,092	103,663	104,327

## balance sheet *From DreamWorksAnimation.com, DreamWorks Animation November 2006 10-Q*

Here it is extremely important to note that DreamWorks has been accumulating cash. They have gone from only \$3,000 cash in 2002 to over \$400 million in cash by 2005. Perhaps this suggests a possible acquisition – be it of another company or a new space, possibly expanding an opening another studio, a potential serious investment in extremely advanced technology. Furthermore, we should note that DreamWorks has been paying off debt year after year, a positive sign for the company.

	<u>September 30,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>
	(unaudited)	
	(in thousands, except par value and share amounts)	
<b>Assets</b>		
Cash and cash equivalents	\$ 535,967	\$ 403,796
Trade accounts receivable, net of allowance for doubtful accounts	1,424	10,186
Receivable from affiliate, net of allowance for doubtful accounts	6	97,991
Film inventories, net	638,858	535,886
Property, plant, and equipment, net of accumulated depreciation and amortization	81,887	85,293
Income taxes receivable	12,350	35,851
Deferred taxes, net	29,770	80,175
Goodwill	34,216	34,216
Prepaid expenses and other assets	37,652	29,782
<b>Total assets</b>	<u>\$ 1,372,124</u>	<u>\$ 1,313,176</u>
<b>Liabilities and Stockholders Equity</b>		
<b>Total liabilities</b>	321,776	364,065
Commitments and contingencies		
Non-controlling minority interest	2,941	2,941
<b>Total stockholders equity</b>	<u>1,047,407</u>	<u>946,170</u>
<b>Total liabilities and stockholders equity</b>	<u>\$ 1,372,124</u>	<u>\$ 1,313,176</u>

## statement of cash flows *From DreamWorksAnimation.com, DreamWorks Animation November 2006 10-Q*

Net income has decreased as we enter 2006, perhaps due to a lack of movie releases earlier in the year (although DreamWorks has many new releases planned). It seems Dreamworks has began to reduce their purchasing this year, perhaps related to their recent trend in saving cash.

	<u>September 30,</u> <u>2006</u>	<u>2005</u>
	(in thousands)	
<b>Operating activities</b>		
Net income	\$ 36,459	\$ 41,351
Net cash provided by operating activities	<u>134,555</u>	<u>401,299</u>

<b>Investing activities</b>		
Purchases of property, plant, and equipment	(1,307)	(3,733)
Purchases of short-term investments	ó	(21,800)
Sale of short-term investments	ó	550
<b>Net cash used in investing activities</b>	<b>(1,307)</b>	<b>(24,983)</b>
<b>Financing Activities</b>		
Bank borrowings and other debt	ó	4,597
Payments on bank borrowings	ó	(27,772)
Payments on capital leases	(635)	(593)
Receipts from exercise of stock options	697	2,822
Excess tax benefits from employee equity awards	393	ó
Purchase of treasury stock	(1,532)	(6,119)
Paramount signing bonus deemed a contribution from controlling stockholders	75,000	ó
Repayment of Universal Studios advance	(75,000)	ó
<b>Net cash used in financing activities</b>	<b>(1,077)</b>	<b>(27,065)</b>

## valuation

Because DreamWorks is in a very cyclical industry, it is hard to value the company based on the numbers below (such as P/E ratio and Price to Book ratio). These numbers are largely correlated with earnings, which vary from quarter to quarter with DreamWorks based on how many movies they are releasing.



key metric	DWA	comparison to industry	comparison to S&P 500	implications for DWA
P/E Ration	30.7	28.30	17.460	DreamWorks has a relatively high PE ratio in comparison to its industry and the S&P 500, meaning that it is slightly pricey from the valuation standpoint or that investors may value the stock and be willing to pay more for it.

Price to Book	2.92	10.28	2.755	DreamWorks has a low P/B ratio relative to the industry, suggestive of the fact that investors do not value the company much higher than its book value.
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## investment opportunities

DreamWorks has outperformed third quarter expectations of research analysts in many of the top firms

### high DVD sales

DreamWorks ability to exceed expectations is partly due to the high DVD sales of Madagascar. Recently, there has been stabilization in the DVD market which provides encouragement that DVD sales will continue to rise.

### low costs

Dreamworks has been able to lower its SG&A costs significantly. Thus, it has been able to produce successful movies like Madagascar while minimizing expenses. Such a strategy helps increase EPS and confidence in the company's ability to increase profitability.

### flushed away

Flushed Away, released in early November has already grossed \$64,447,833 worldwide as of December 6, 2006. The movie cost \$149 million to produce, so it seems there will be at least a break even profit and this can help push the stock price.

### repurchase program

DreamWorks seems keen to begin a repurchase program after mid January, which will lead to a temporary boost in stock price.

### upcoming movie slate

DreamWorks has a strong movie slate which includes Madagascar 2, Shrek 3 and the Seinfeld Bee Movie.

## investment risks

Some analysts anticipate an ever-increasing cost for DreamWorks films. There is also uncertainty that Over the Hedge DVD sales will be high since there is competition from other animated DVDs being released at the same time. Finally, Shrek 3 might not be as successful as expected since it is being released in a highly competitive season. Its release date is falling 2 weeks after Spiderman 3 and one week before Pirates of the Caribbean 3

# full financial statements *From DreamWorksAnimation.com, DreamWorks Animation November 2006 10-Q*

## income statement

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## balance sheet

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	(unaudited)	
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Income taxes receivable	12,350	35,851
Deferred taxes, net	29,770	80,175
Goodwill	34,216	34,216
Prepaid expenses and other assets	37,652	29,782
Total assets	<u>\$ 1,372,124</u>	<u>\$ 1,313,176</u>
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
Accounts payable	\$ 4,175	\$ 7,201
Payable to affiliate	ó	2,667
Payable to Paramount	54,634	ó
Payable to stockholder	47,699	73,789

Accrued liabilities	57,444	55,014
Other advances and unearned revenue	37,926	30,863
Obligations under capital leases	1,629	2,264
Universal Studios advance	ó	75,000
Bank borrowings and other debt	118,269	117,267
<b>Total liabilities</b>	<b>321,776</b>	<b>364,065</b>
Commitments and contingencies		
Non-controlling minority interest	2,941	2,941
Stockholders' equity		
Class A common stock, par value \$.01 per share, 350,000,000 shares authorized, 52,815,060 and 52,556,483 shares issued, as of September 30, 2006 and December 31, 2005, respectively	528	526
Class B common stock, par value \$.01 per share, 150,000,000 shares authorized, 50,842,414 shares issued and outstanding	508	508
Class C common stock, par value \$.01 per share, one share authorized and issued and outstanding	ó	ó
Additional paid-in capital	750,165	683,857
Retained earnings	306,364	269,905
Less: Treasury stock, at cost, 326,948 and 256,805 shares, as of September 30, 2006 and December 31, 2005, respectively	(10,158)	(8,626)
<b>Total stockholders' equity</b>	<b>1,047,407</b>	<b>946,170</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,372,124</b>	<b>\$ 1,313,176</b>

## statement of cash flows

	September 30,	
	2006	2005
	(in thousands)	
<b>Operating activities</b>		
Net income	\$ 36,459	\$ 41,351
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization and write off of film inventories	92,832	155,755
Stock compensation expense	16,058	15,187
Depreciation and amortization	6,303	6,316
Revenue earned against advances and unearned revenue	(39,738)	(35,549)
Deferred taxes, net	50,405	22,070
Change in operating assets and liabilities:		
Trade accounts receivable	8,762	5,784
Receivable from/Payable to Distributor for Distribution and Services Agreements	149,958	415,530
Film inventories	(197,97)	(203,64)
Prepaid expenses and other assets	(8,458)	(18,460)
Payable to stockholder	(26,090)	5,289
Accounts payable and accrued expenses	(773)	(12,544)
Income taxes	(3,384)	(21,571)
Advances and unearned revenue	50,195	25,784
Net cash provided by operating activities	<u>134,555</u>	<u>401,299</u>
<b>Investing activities</b>		
Purchases of property, plant, and equipment	(1,307)	(3,733)
Purchases of short-term investments	ó	(21,800)
Sale of short-term investments	ó	550
Net cash used in investing activities	<u>(1,307)</u>	<u>(24,983)</u>
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Excess tax benefits from employee equity awards	393	ó
Purchase of treasury stock	(1,532)	(6,119)
Paramount signing bonus deemed a contribution from controlling stockholders	75,000	ó
Repayment of Universal Studios advance	(75,000)	ó
Net cash used in financing activities	<u>(1,077)</u>	<u>(27,065)</u>
Increase in cash and cash equivalents	132,171	349,251
Cash and cash equivalents at beginning of period	<u>403,796</u>	<u>63,134</u>
Cash and cash equivalents at end of period	<u>\$ 535,967</u>	<u>\$ 412,385</u>
Supplemental disclosure of cash flow information:		
Cash paid (refunded) during the period for income taxes, net	<u>\$ (29,302)</u>	<u>\$ 27,863</u>
Cash paid during the period for interest, net of amounts capitalized	<u>\$ 123</u>	<u>\$ 5,807</u>
Supplemental disclosure of non-cash operating activities:		
Transfer on January 31, 2006 of net receivable from affiliate to Paramount for Distribution and Services Agreements	\$ 102,509	\$ ó