



**MUZAK HOLDINGS LLC  
MUZAK HOLDINGS FINANCE CORP**

**2008 Second Quarter Report**  
For the three and six months ended June 30, 2008

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**PART I—FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS.**

**MUZAK HOLDINGS LLC**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**(Unaudited)**

**(In thousands)**

	<u>June 30, 2008</u>	<u>December 31, 2007 (1)</u>
<b>ASSETS</b>		
Current assets:		
Cash	\$ 24,132	\$ 24,049
Restricted cash	927	752
Accounts receivable, net of allowances of \$1,536 and \$1,556	22,101	21,505
Inventories	9,471	8,601
Prepaid expenses and other assets	5,320	5,579
Total current assets	<u>61,951</u>	<u>60,486</u>
Restricted cash	982	1,122
Property and equipment, net	66,646	71,968
Goodwill	140,805	140,805
Intangible assets, net	45,423	52,339
Deferred subscriber acquisition costs, net	22,911	26,598
Deferred charges and other assets, net	2,309	3,421
Total assets	<u>\$ 341,027</u>	<u>\$ 356,739</u>
<b>LIABILITIES AND MEMBERS' DEFICIT</b>		
Current liabilities:		
Accounts payable	\$ 5,201	\$ 3,681
Accrued expenses (see Note 4)	20,823	25,426
Current maturities of long term debt (see Note 5)	436,842	1,190
Current portion of other liabilities	3,297	4,109
Advance billings	2,182	973
Total current liabilities	<u>468,345</u>	<u>35,379</u>
Long-term debt, net of current portion	25,722	461,850
Other liabilities, net of current portion	8,852	8,824
Commitments and contingencies		
Redeemable preferred units	287,375	263,529
Redeemable purchased Class A units	7,788	7,788
Members' deficit:		
Class A units	-	-
Accumulated deficit	(457,055)	(420,631)
Total members' deficit	<u>(457,055)</u>	<u>(420,631)</u>
Total liabilities and members' deficit	<u>\$ 341,027</u>	<u>\$ 356,739</u>

- (1) The year end consolidated balance sheet data was derived from audited financial statements but does not include all disclosures required by generally accepted accounting principles.

The accompanying notes are an integral part of these consolidated financial statements.

**MUZAK HOLDINGS LLC**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**  
**(In thousands)**

	Quarter Ended		Six Months Ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
Net Revenues:				
Music and other business services	\$ 47,193	\$ 47,927	\$ 95,551	\$ 95,632
Equipment and related services	16,147	14,866	30,254	29,502
	<u>63,340</u>	<u>62,793</u>	<u>125,805</u>	<u>125,134</u>
Cost of revenues:				
Music and other business services (excluding \$7,209, 8,031, 14,530 and \$16,223 of depreciation and amortization expense).	11,397	11,588	22,999	22,615
Equipment and related services	14,362	14,631	28,190	28,085
	<u>25,759</u>	<u>26,219</u>	<u>51,189</u>	<u>50,700</u>
	<u>37,581</u>	<u>36,574</u>	<u>74,616</u>	<u>74,434</u>
Selling, general and administrative expenses	19,943	20,293	41,074	41,433
Depreciation and amortization expense	11,388	12,097	22,937	24,367
	<u>6,250</u>	<u>4,184</u>	<u>10,605</u>	<u>8,634</u>
Income from operations	6,250	4,184	10,605	8,634
Other income (expense):				
Interest expense	(11,661)	(12,457)	(23,621)	(25,117)
Other, net	97	244	266	407
	<u>(5,314)</u>	<u>(8,029)</u>	<u>(12,750)</u>	<u>(16,076)</u>
Loss before income taxes	(5,314)	(8,029)	(12,750)	(16,076)
Income tax benefit	(83)	(105)	(172)	(207)
	<u>(5,231)</u>	<u>(7,924)</u>	<u>(12,578)</u>	<u>(15,869)</u>
Preferred return on redeemable preferred units	(12,164)	(10,296)	(23,846)	(20,081)
	<u>(17,395)</u>	<u>(18,220)</u>	<u>(36,424)</u>	<u>(35,950)</u>
Net loss attributable to common unit holders	\$ (17,395)	\$ (18,220)	\$ (36,424)	\$ (35,950)

The accompanying notes are an integral part of these consolidated financial statements.

**MUZAK HOLDINGS LLC**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(In thousands)**

	Six Months Ended	
	June 30, 2008	June 30, 2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net loss	\$ (12,578)	\$ (15,869)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Gain on disposal of fixed assets	101	195
Impairment of capitalized labor	675	741
Deferred income tax benefit	(163)	(221)
Depreciation and amortization	22,937	24,368
Amortization of senior discount, senior notes, and deferred financing fees	1,353	1,481
Amortization of deferred subscriber acquisition costs	7,079	7,735
Deferred subscriber acquisition costs	(3,390)	(3,757)
Change in unearned installment income	207	450
Change in certain assets and liabilities		
Accounts receivable	(596)	2,226
Inventory	(870)	2,207
Accounts payable	1,520	4
Accrued expenses	(4,603)	(1,617)
Advance billings	1,209	343
Other, net	63	(2,122)
Net cash provided by operating activities	12,944	16,164
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures for property and equipment	(11,469)	(10,874)
Capital expenditures for intangibles	(25)	(26)
Proceeds from sale of fixed assets	19	19
Net cash used in investing activities	(11,475)	(10,881)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Restricted cash used to collateralize letters of credit	(35)	(45)
Repayment of term loan	(526)	(526)
Payment of financing fees	-	(517)
Repayments of capital lease obligations and other debt	(825)	(1,165)
Net cash used in financing activities	(1,386)	(2,253)
<b>NET INCREASE IN CASH</b>	83	3,030
<b>CASH, BEGINNING OF PERIOD</b>	24,049	19,032
<b>CASH, END OF PERIOD</b>	\$ 24,132	\$ 22,062
Supplemental information:		
Interest paid	22,658	23,777

The accompanying notes are an integral part of these consolidated financial statements.

**MUZAK HOLDINGS LLC**  
**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN**  
**MEMBERS' DEFICIT**  
**(Unaudited)**  
**(In thousands, except for units)**

	Class A		Class B		Accumulated Deficit	Total Members' Deficit
	Units	Dollars	Units	Dollars		
<b>Balances, December 31, 2007</b>	125,164	\$ —	11,817	\$ —	\$ (420,631)	\$ (420,631)
Net loss (1)					(12,578)	(12,578)
Preferred return on preferred units					(23,846)	(23,846)
<b>Balances, June 30, 2008</b>	<u>125,164</u>	<u>\$ —</u>	<u>11,817</u>	<u>\$ —</u>	<u>\$ (457,055)</u>	<u>\$ (457,055)</u>

(1) Comprehensive loss equals net loss

The accompanying notes are an integral part of these consolidated financial statements.

**MUZAK HOLDINGS LLC**  
**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

**1. Overview**

*Organization* - Muzak Holdings LLC (and its subsidiaries (the “Company”)), previously known as ACN Holdings, LLC, was formed in September 1998 pursuant to the laws of the state of Delaware. The Company provides business music programming to clients through its integrated nationwide network of owned operations and franchises. All of the operating activities are conducted through the Company’s subsidiaries.

As of June 30, 2008, ABRY Partners, LLC and its respective affiliates, collectively own 64.2% of the beneficial interests in the Company’s voting interests.

*Basis of Presentation* - The consolidated financial statements include the accounts of the Company and its subsidiaries: Muzak LLC, Muzak Capital Corporation, Muzak Holdings Finance Corporation, Muzak Finance Corporation, Business Sound Inc., Electro Systems Corporation, BI Acquisition LLC, MLP Environmental Music LLC, Audio Environments Inc., Background Music Broadcasters Inc., Telephone Audio Productions Inc., Vortex Sound Communications Company Inc., Music Incorporated, and Muzak Houston, Inc. All significant intercompany items have been eliminated in consolidation.

Certain financial information included in the accompanying unaudited interim consolidated financial statements has been condensed and certain footnote disclosures have been omitted. Such information and disclosures are normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States. These financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Muzak Holdings LLC Annual Report for the year ended December 31, 2007.

The financial statements as of June 30, 2008 and the financial statements for the three months ended June 30, 2008 and 2007 are unaudited; however, in the opinion of management, such statements include all adjustments (consisting solely of normal recurring adjustments) necessary to state fairly the financial information included herein. The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and reported amounts of revenues and expenses during the period. Actual results could differ from those estimates. Results of operations for interim periods are not necessarily indicative of results for the full year.

On December 21, 2007, Muzak Holdings LLC and Muzak LLC announced their plans to periodically furnish financial information to the public on their Web site, muzak.com, and to de-list with the SEC and cease furnishing periodic reports to the Securities and Exchange Commission’s EDGAR system. While disclosures previously furnished to the Securities and Exchange Commission will remain accessible via EDGAR’s archives, all new disclosures and reports, beginning in 2008, are solely accessible at the Company’s website. The companies are considered “voluntary filers” under the current rules and regulations of the Securities and Exchange Commission and have the flexibility under such regulations and the terms of their indentures to explore alternative disclosure mechanisms and to fulfill their contractual disclosure obligations outside of the Securities and Exchange Commission’s electronic filing system. The companies believe that furnishing such disclosures on the Company’s website will be more cost efficient and a better use of resources while still enabling the companies to provide disclosure similar in quality and frequency.

*Liquidity* - Approximately \$436.8 million of the Company’s long term debt is scheduled to mature in the first quarter of 2009. The Company currently plans to address these impending maturities as part of the proposed consolidation or combination with DMX, Inc. As previously disclosed, such combination is contingent on a sale of the entities to an as yet unidentified third party buyer. As of August 14, 2008, Moelis & Company, the investment banking firm retained to represent Muzak and DMX, Inc., continues to coordinate the marketing and sale of the two companies. The Company’s future consolidation or combination with DMX, Inc. is contingent on the success of this process—a process that is focused on a sale of the entities to an as yet unidentified third party buyer. Moelis has been distributing the offering memorandum to interested and qualified purchasers and providing access to virtual data rooms. The Company is pleased with the level of interest generated and the progress made to date. In the interim, the companies remain independent and Muzak continues to compete and to provide, without disruption, the highest quality products and services to its clients. Should such transaction fail to be consummated, the Company would be required to explore other refinancing or restructuring opportunities that would likely adversely affect the positions of current debt and equity holders.

## 2. Property and Equipment

Property and equipment consists of the following (in thousands):

	<u>Useful Life (years)</u>	<u>June 30, 2008</u>	<u>December 31, 2007</u>
Equipment provided to subscribers	5	\$ 220,970	\$ 217,042
Capitalized installation labor	5	42,842	45,394
Equipment	4-7	52,692	49,593
Other	3-30	23,453	23,257
		<u>339,957</u>	<u>335,286</u>
Less accumulated depreciation		<u>(273,311)</u>	<u>(263,318)</u>
		<u>\$ 66,646</u>	<u>\$ 71,968</u>

Included in equipment and other at June 30, 2008 and December 31, 2007 is \$3.2 million and \$4.1 million, respectively, of equipment under capital leases, net of accumulated depreciation of \$18.9 million and \$18.0 million at June 30, 2008 and December 31, 2007, respectively. Depreciation of property and equipment was \$8.0 million and \$8.6 million for the quarters ended June 30, 2008 and 2007, respectively and \$16.1 million and \$17.5 million, respectively, for the six months ended June 30, 2008 and 2007.

### 3. Intangible Assets

Unamortized intangible assets consist of the following (in thousands):

	<u>June 30, 2008</u> Carrying Amount	<u>December 31, 2007</u> Carrying Amount
Goodwill	\$ 140,805	\$ 140,805

Amortized intangible assets consist of the following (in thousands):

	<u>Useful Life</u> (years)	<u>June 30, 2008</u> Gross Carrying Amount	<u>December 31, 2007</u> Gross Carrying Amount
Income producing contracts	12	\$ 153,541	\$ 153,900
License agreements	20	5,102	5,102
Trademarks	5	15,436	15,412
Non-compete agreements	3-5	275	275
Other	20	10,831	10,831
		<u>\$ 185,185</u>	<u>\$ 185,520</u>
Less accumulated amortization		<u>(139,762)</u>	<u>(133,181)</u>
		<u>\$ 45,423</u>	<u>\$ 52,339</u>

Aggregate amortization expense was \$3.4 million for each of the quarters ended June 30, 2008 and 2007, respectively and \$6.8 million for each of the six months ended June 30, 2008 and 2007, respectively.

The estimated future amortization expense based on intangible assets existing as of June 30, 2008 is as follows (in thousands):

<u>Fiscal Year Ending</u>	
2008 (remaining six months)	\$ 6,836
2009	13,663
2010	12,967
2011	5,606
2012	1,382

### 4. Accrued Expenses

Accrued expenses are summarized below (in thousands):

	<u>June 30,</u> 2008	<u>December 31,</u> 2007
Accrued interest	\$ 8,185	\$ 8,577
Accrued compensation and benefits	3,272	5,151
Amounts payable to franchisees	2,463	4,051
Sales, property and income taxes payable	1,784	1,674
Licensing royalties	2,819	2,272
Other	2,300	3,701
	<u>\$ 20,823</u>	<u>\$ 25,426</u>

## 5. Debt

Debt obligations consist of the following (in thousands):

	<u>June 30, 2008</u>	<u>December 31, 2007</u>
Long term debt:		
Term Loan – Senior credit facility	\$ 101,850	\$ 102,375
Senior notes	219,844	219,726
Senior subordinated notes	115,000	115,000
Senior discount notes	24,245	24,245
Other	1,625	1,694
	<u>462,564</u>	<u>463,040</u>
Total debt obligations	462,564	463,040
Less current maturities	(436,842)	(1,190)
	<u>\$ 25,722</u>	<u>\$ 461,850</u>

### Debt Maturities and Liquidity

Approximately \$436.8 million of the Company's long term debt is scheduled to mature in the first quarter of 2009. The Company currently plans to address these impending maturities as part of the proposed consolidation or combination with DMX, Inc. As previously disclosed, such combination is contingent on a sale of the entities to an as yet unidentified third party buyer. Should such transaction fail to be consummated, the Company would be required to explore other refinancing or restructuring opportunities that would likely adversely affect the positions of current debt and equity holders. There can be no assurance that any of the aforementioned or other financing options will be successful.

### April 2005 Term Loan Facility – Due January 2009

On April 15, 2005, the Company refinanced its then existing Senior Credit Facility with a new \$105.0 million senior secured term loan facility ("New Senior Credit Facility"). A portion of the proceeds was used to repay the then existing outstanding term and revolving loans and accrued interest, to provide collateral for outstanding letters of credit under the then existing Senior Credit Facility, and to pay fees and expenses. The then existing Senior Credit Facility has been terminated. On March 16, 2007, the Company amended the New Senior Credit Facility, by extending the maturity from April 15, 2008 to January 19, 2009 and reducing the applicable margin by 1.0%. The amendment also includes a provision for a prepayment penalty of 1.0% if certain events occur prior to the one year anniversary of the amendment. The Company incurred fees associated with this amendment of \$0.5 million.

The New Senior Credit Facility is payable in quarterly installments of 0.25% of the original outstanding balance (\$105.0 million) beginning September 2005 until final maturity on January 19, 2009. The New Senior Credit facility is guaranteed by certain of our direct and indirect subsidiaries and is secured by a first priority security interest in (i) substantially all of the Company's tangible and intangible assets and (ii) the capital stock of the Company's subsidiaries. The non-guarantor subsidiary is minor (as defined by Rule 3-10 of Regulation S-X) and the consolidated amounts in the Company's financial statements are representative of the combined guarantor's financial statements. The New Senior Credit Facility contains a senior secured leverage ratio (the ratio of Senior Secured Debt as of such date of determination to Consolidated EBITDA on a last twelve months (LTM) basis) and various other restrictive covenants, which are customary for such facilities. In addition, the Company is generally prohibited from incurring additional indebtedness, incurring liens, paying dividends or making other restricted payments, consummating asset sales, entering into transactions with affiliates, merging or consolidating with any other person or selling, assigning, transferring, leasing, conveying, or otherwise disposing of assets. Management believes that the Company was in compliance with these covenants as of June 30, 2008.

Prior to being amended on March 16, 2007, indebtedness under the term loan bears interest at a per annum rate equal to the Company's choice of (i) Base Rate (which is the highest of prime rate and the Federal Funds Rate plus .5%) plus a margin of 3.75% or (ii) the offered rates for Eurodollar deposits ("LIBOR") of one, two or three months, as selected by the Company, plus a margin of 4.75%. On March 16, 2007, the applicable margin was reduced by 1.0% with an amendment to the term loan facility. As of June 30, 2008, the interest rate on the term loan was 6.65%.

### Senior Notes – Due February 2009

Muzak LLC together with its wholly owned subsidiary, Muzak Finance Corp., has \$220.0 million in principal amount of 10% Senior Notes which mature on February 15, 2009. Interest is payable semi-annually, in arrears, on May 15 and November 15 of each year. The Senior Notes are general unsecured obligations of Muzak LLC and Muzak Finance Corp. and

are subordinate to existing and future secured debt and are senior to Muzak LLC's existing Senior Subordinated Notes. The Senior Notes are guaranteed by the Company and certain of the Company's direct and indirect subsidiaries (See Note 10). The indenture governing the Senior Notes prohibits the Company from making certain payments such as dividends and distributions of capital stock; repurchases or redemptions of capital stock, and investments (other than permitted investments) unless certain conditions are met by the Company. After February 15, 2007, the issuers may redeem all or part of the Senior Notes at a redemption price equal to 102.5% of the principal which redemption price declines to 100% of the principal amount in 2008.

#### **Senior Subordinated Notes – Due March 2009**

Muzak LLC together with its wholly owned subsidiary, Muzak Finance Corp., has \$115.0 million in principal amount of 9<sup>7</sup>/<sub>8</sub>% Senior Subordinated Notes ("Senior Subordinated Notes") which mature on March 15, 2009. Interest is payable semi-annually, in arrears, on March 15 and September 15 of each year. The Senior Subordinated Notes are general unsecured obligations of the Muzak LLC and Muzak Finance Corp and are subordinated in right of payment to all existing and future Senior Indebtedness of Muzak LLC and Muzak Finance Corp. The indenture governing the Senior Subordinated Notes prohibits Muzak LLC from making certain payments such as dividends and distributions of its capital stock; repurchases or redemptions of its capital stock, and investments (other than permitted investments) unless certain conditions are met by Muzak LLC. As of March 15, 2007, the issuers may redeem all or part of the Notes at a redemption price equal to 100% of the principal.

#### **Senior Discount Notes – Due March 2010**

The Company together with its wholly owned subsidiary Muzak Holdings Finance Corp. has \$24.2 million in principal amount of 13% Senior Discount Notes (the "Senior Discount Notes") due March 2010. The Senior Discount Notes were fully accreted as of March 15, 2004. From and after March 15, 2004, interest began accruing at a rate of 13% per annum. Interest is payable semi-annually in arrears on each March 15 and September 15 to holders of record of the Senior Discount Notes at the close of business on the immediately preceding March 1 and September 1. Muzak Holdings LLC does not have any operations or assets other than its ownership of Muzak LLC. Accordingly, Muzak Holdings LLC is dependent upon distributions from Muzak LLC in order to pay interest. Muzak LLC's New Senior Credit Facility, Senior Notes, and Senior Subordinated Notes indentures impose restrictions on its ability to make distributions to Muzak Holdings LLC. The New Senior Credit Facility, the Senior Notes, and Senior Subordinated Notes indentures permit Muzak LLC to make payments and distributions to Muzak Holdings LLC in an amount sufficient to permit Muzak Holdings LLC to make cash interest payments when due, however the senior credit facility requires that certain financial covenant levels be met in order to make such distributions.

#### **Other Debt**

Muzak LLC assumed \$2.4 million of promissory notes in connection with an acquisition in 1999. All of the notes, with the exception of one, aggregating \$1.6 million, bear interest at 9.9% and mature in November 2016. Effective October 2006, the Company is required to make monthly principal and interest payments until maturity.

#### **Annual Maturities**

Annual maturities of long-term debt obligations are as follows (in thousands):

2008 (remaining six months)	\$	598
2009		436,482
2010		24,418
2011		191
2012		211
Thereafter		820

The Annual maturities schedule includes the principal amount of the Senior Notes. Substantially all of the 2009 maturities will occur in the first quarter of 2009.

Total interest paid by the Company on all indebtedness was \$12.9 million and \$13.7 million for the quarters ended June 30, 2008 and 2007, and \$22.7 million and \$23.8 million for the six months ended June 30, 2008 and 2007, respectively.

#### **6. Redeemable Preferred Units**

The Company was in violation of unit coverage ratio, leverage ratio, and annualized operating cash flow under the Securities Purchase Agreement as of June 30, 2008. The Company has been in default of the unit coverage ratio since June

2003, of leverage ratio since December 31, 2003, and of annualized operating cash flow since June 2004. As a result of the defaults, the preferred units accrue at a preferential return of 17% per annum as long as the default is continuing. The Company is projecting to be out of compliance with the unit coverage ratio (the ratio of consolidated operating cash flow to the sum of consolidated interest expense plus the aggregate Series A preferred return, as more specifically defined in the Securities Purchase Agreement) and leverage ratio for the foreseeable future. As a result of non-compliance with unit coverage ratio and leverage ratio for four consecutive quarters (a Class B and Class A default under the Securities Purchase Agreement, respectively), two of the three preferred unit holders were each entitled to be designated as either a Class B or Class A Director, although neither party has elected to so designate a Class B or Class A Director pursuant to their rights under the Securities Purchase Agreement. As such, the number of Class B Directors and Class A Directors remains unaffected by these defaults. Compliance with either one of the leverage or unit coverage ratios and not the other still entitles the same two preferred unit holders to designate a director as provided in the Securities Purchase Agreement until such time as the Company complies with the applicable ratio. The foregoing defaults do not result in a cross default under the New Senior Credit Facility or the indentures governing the Senior Notes, the Senior Subordinated Notes, and the Senior Discount Notes.

## 7. Restructuring Charges

In June 2005, the Company implemented a revised business plan which entailed streamlining the size of its sales force in order to achieve more moderate growth. This revised business plan seeks to reduce the number of annual new client location additions. This revised plan has contributed to our ability to generate modest positive free cash flow. While there can be no assurances, we expect that the associated decrease in capital investments under the revised business plan will continue to contribute towards our goal of generating free cash flow after debt service obligations.

In conjunction with the revised business plan in June 2005 and the reorganization of the field management in January 2006, the following table is a summary of the remaining accrued liability for the restructuring charges (in thousands):

	<b>Lease Impairment Costs</b>
Accrued liability as of December 31, 2007	\$ 103
Cash payments	<u>(32)</u>
Accrued liability as of June 30, 2008	<u>\$ 71</u>

Lease impairment costs relate to certain field office facilities in which the Company has excess office space. The charge reflects the present value of costs that will continue to be incurred under lease contracts without economic benefit due to the excess office space, offset by assumed sublease rental income of approximately \$1.1 million.

The Company will pay the charges relating to the remaining field office leases over the remaining terms of the leases principally through December 2013.

## 8. Muzak Holdings Finance Corp. and Muzak Finance Corp.

Muzak Holdings Finance Corp. and Muzak Finance Corp. had no operating activities during the three or six months ended June 30, 2008 and 2007.

## 9. Commitments and Contingencies

### *Indemnification*

Muzak's Limited Liability Company Agreement dated as of March 18, 1999, as amended, provides for indemnification of directors and officers, including advancement of reasonable attorney's fees and other expenses, in connection with all claims, liabilities and expenses arising out of the management of Muzak's affairs. Such indemnification obligations are limited to the extent Muzak's assets are sufficient to cover such obligations. Muzak carries directors and officers insurance that covers such exposure for indemnification up to certain limits.

### *Litigation*

We are the subject of, or a party to, various proceedings in the ordinary course of our business. Management believes that such proceedings are routine in nature and incidental to the conduct of our business, and that none of such proceedings, if

determined adversely to the Company, would have a material adverse effect on our consolidated financial condition or results of operations.

As of June 30, 2008, the Company has approximately \$8.1 million in outstanding capital expenditure commitments covering a five-year period. The Company is the lessee under various operating and capital leases for equipment, vehicles, satellite capacity, and buildings.

## **10. Guarantors**

The following schedules set forth condensed consolidating financial information for the quarters and six months ended June 30, 2008 and 2007 for (1) Muzak Holdings, LLC, (2) Muzak LLC, a co-issuer of the Senior Notes and Senior Subordinated Notes, (3) Muzak Finance Corp., a co-issuer of the Senior Notes and Senior Subordinated Notes and a wholly-owned subsidiary of Muzak LLC, and (4) on a combined basis, the subsidiary guarantors of the Senior Notes and Senior Subordinated Notes which include MLP Environmental Music, LLC, Business Sound, Inc., BI Acquisition LLC, Audio Environments, Inc., Background Music Broadcasters, Inc., Muzak Capital Corporation, Telephone Audio Productions, Inc., Muzak Houston, Inc., Vortex Sound Communications Company, Inc., and Music Incorporated, and a subsidiary that is not a guarantor of the Senior Subordinated Notes. The guarantor subsidiaries are direct and indirect wholly-owned subsidiaries of Muzak Holdings, LLC and have fully and unconditionally, jointly and severally, guaranteed the Senior Notes and Senior Subordinated Notes of Muzak LLC and Muzak Finance Corp. Muzak Holdings, LLC has also fully and unconditionally, jointly and severally, guaranteed the Senior Notes and Senior Subordinated Notes. The subsidiary that does not guarantee the Senior Notes and Senior Subordinated Notes represents less than 3% of consolidated total assets, members' interest, revenues, loss before income taxes and cash flow from operating activities. Therefore, the non-guarantor subsidiary information is not separately presented in the tables below but rather is included in the column labeled "Guarantor Subsidiaries".

**Condensed Consolidating Balance sheets as of June 30, 2008**  
(unaudited)(In thousands)

	<u>Muzak Holdings LLC (Parent)</u>	<u>Muzak LLC (Co-issuer)</u>	<u>Muzak Finance Corp (Co-issuer)</u>	<u>Combined Guarantor Subsidiaries*</u>	<u>Eliminations</u>	<u>Consolidated</u>
<b>ASSETS</b>						
<b>Current assets:</b>						
Cash	\$ —	\$ 24,132	\$ —	\$ —	\$ —	\$ 24,132
Restricted Cash	—	927	—	—	—	927
Accounts receivable, net	—	21,812	—	289	—	22,101
Inventories	—	9,471	—	—	—	9,471
Prepaid expenses and other assets	—	5,320	—	—	—	5,320
<b>Total current assets</b>	<b>—</b>	<b>61,662</b>	<b>—</b>	<b>289</b>	<b>—</b>	<b>61,951</b>
Restricted Cash	—	982	—	—	—	982
Property and equipment, net	—	55,311	—	11,335	—	66,646
Intangible assets, net	—	180,300	—	5,928	—	186,228
Deposits and other assets, net	75	25,145	1,109	—	(1,109)	25,220
Advances in/due from subsidiary	—	11,030	—	6,532	(17,562)	—
Investment in Subsidiary	(125,771)	20,789	—	—	104,982	—
<b>Total assets</b>	<b>\$ (125,696)</b>	<b>\$ 355,219</b>	<b>\$ 1,109</b>	<b>\$ 24,085</b>	<b>\$ 86,311</b>	<b>\$ 341,027</b>
<b>LIABILITIES AND MEMBERS' DEFICIT</b>						
<b>Current liabilities:</b>						
Accounts payable	\$ —	\$ 5,152	\$ —	\$ 49	\$ —	\$ 5,201
Accrued expenses (see Note 4)	921	18,353	6,062	1,549	(6,062)	20,823
Current maturities of long term debt	—	436,706	334,844	136	(334,844)	436,842
Current portion of other liabilities	—	3,297	—	—	—	3,297
Advance billings	—	2,182	—	—	—	2,182
<b>Total current liabilities</b>	<b>921</b>	<b>465,690</b>	<b>340,906</b>	<b>1,735</b>	<b>(340,906)</b>	<b>468,345</b>
Long-term debt, net of current portion	24,245	51	—	1,426	—	25,722
Other liabilities, net of current portion	—	8,717	—	135	—	8,852
Advances in/due from subsidiary	11,030	6,532	116,746	—	(134,308)	—
Redeemable Preferred Stock	287,375	—	—	—	—	287,375
Redeemable Class A units	7,788	—	—	—	—	7,788
Members' deficit/Shareholder equity	(457,555)	(125,771)	(456,543)	20,789	561,525	(457,055)
<b>Total liabilities and members' deficit</b>	<b>\$ (125,696)</b>	<b>\$ 355,219</b>	<b>\$ 1,109</b>	<b>\$ 24,085</b>	<b>\$ 86,311</b>	<b>\$ 341,027</b>

\* Also includes non-guarantor which is considered to be "minor".

**Condensed Consolidating Statements of Operations for the Three Months Ended June 30, 2008**  
**(unaudited) (In thousands)**

	<u>Muzak Holdings LLC ("Parent")</u>	<u>Muzak LLC (Co-issuer)</u>	<u>Muzak Finance Corp (Co-issuer)</u>	<u>Guarantor Subsidiaries*</u>	<u>Eliminations</u>	<u>Consolidated</u>
<b>Net Revenues</b>						
Music and other business services	\$ —	\$ 46,307	\$ —	\$ 886	\$ —	\$ 47,193
Equipment and related services	—	16,147	—	—	—	16,147
	<u>—</u>	<u>62,454</u>	<u>—</u>	<u>886</u>	<u>—</u>	<u>63,340</u>
<b>Cost of Revenues</b>						
Music and other business services excluding depreciation and amortization expense	—	11,097	—	300	—	11,397
Equipment and related services	—	14,362	—	—	—	14,362
	<u>—</u>	<u>25,459</u>	<u>—</u>	<u>300</u>	<u>—</u>	<u>25,759</u>
Selling, general & administrative	—	19,769	—	174	—	19,943
Management fee	—	(177)	—	177	—	—
Depreciation & amortization expense	—	11,098	—	290	—	11,388
	<u>—</u>	<u>6,306</u>	<u>—</u>	<u>(56)</u>	<u>—</u>	<u>6,250</u>
<b>Income (Loss) from Operations</b>	—	6,306	—	(56)	—	6,250
<b>Other income (expense)</b>						
Interest expense	(815)	(10,807)	(8,711)	(39)	8,711	(11,661)
Other, net	—	97	—	—	—	97
Equity in earnings of subsidiaries**	(4,416)	(12)	—	—	4,428	—
	<u>(5,231)</u>	<u>(4,417)</u>	<u>(8,711)</u>	<u>(94)</u>	<u>13,139</u>	<u>(5,314)</u>
<b>Loss before income taxes</b>	(5,231)	(4,417)	(8,711)	(94)	13,139	(5,314)
<b>Income tax benefit</b>	—	—	—	(83)	—	(83)
<b>Net loss</b>	<u>\$ (5,231)</u>	<u>\$ (4,417)</u>	<u>\$ (8,711)</u>	<u>\$ (11)</u>	<u>\$ 13,139</u>	<u>\$ (5,231)</u>

\* Also includes non-guarantor which is considered to be "minor".

\*\* Amount excludes the net loss of Muzak Finance Corp (which is a wholly-owned subsidiary of Muzak LLC) as the interest expense recorded by Muzak Finance Corp, which relates solely to the Senior Notes and Senior Subordinated Notes, is also reflected in Muzak LLC's results of operations due to both of these entities being co-issuers of the Senior Notes and the Senior Subordinated Notes. Muzak Finance Corp has no results of operations other than the interest expense on the Senior Notes and Senior Subordinated Notes.

**Condensed Consolidating Statements of Operations for the Six Months Ended June 30, 2008**  
**(unaudited) (In thousands)**

	<u>Muzak Holdings LLC</u> <u>("Parent")</u>	<u>Muzak LLC</u> <u>(Co-issuer)</u>	<u>Muzak Finance Corp</u> <u>(Co-issuer)</u>	<u>Guarantor Subsidiaries*</u>	<u>Eliminations</u>	<u>Consolidated</u>
<b>Net Revenues</b>						
Music and other business services	\$ —	\$ 94,625	\$ —	\$ 1,812	\$ —	\$ 95,551
Equipment and related services	—	30,254	—	—	—	30,254
	—	124,879	—	1,812	—	125,805
<b>Cost of Revenues</b>						
Music and other business services excluding depreciation and amortization expense	—	22,683	—	616	—	22,999
Equipment and related services	—	28,190	—	—	—	28,190
	—	50,873	—	616	—	51,189
Selling, general & administrative	—	40,971	—	277	—	41,074
Management fee	—	(362)	—	362	—	—
Depreciation & amortization expense	—	22,312	—	625	—	22,937
Income (Loss) from Operations	—	10,674	—	(69)	—	10,605
Other income (expense)						
Interest expense	(1,629)	(21,912)	(17,511)	(80)	17,511	(23,621)
Other, net	—	267	—	(1)	—	266
Equity in earnings of subsidiaries**	(10,949)	23	—	—	10,926	—
Loss before income taxes	(12,578)	(10,949)	(17,511)	(149)	28,437	(12,750)
Income tax benefit	—	—	—	(172)	—	(172)
Net loss	\$ (12,578)	\$ (10,949)	\$ (17,511)	\$ 23	\$ 28,437	\$ (12,578)

\* Also includes non-guarantor which is considered to be "minor".

\*\* Amount excludes the net loss of Muzak Finance Corp (which is a wholly-owned subsidiary of Muzak LLC) as the interest expense recorded by Muzak Finance Corp, which relates solely to the Senior Notes and Senior Subordinated Notes, is also reflected in Muzak LLC's results of operations due to both of these entities being co-issuers of the Senior Notes and the Senior Subordinated Notes. Muzak Finance Corp has no results of operations other than the interest expense on the Senior Notes and Senior Subordinated Notes.

**Condensed Consolidating Statements of Cash Flows for the Six Months Ended June 30, 2008**  
**(unaudited) (In thousands)**

	Muzak Holdings LLC ("Parent")	Muzak LLC (Co-issuer)	Muzak Finance Corp (Co-issuer)	Guarantor Subsidiaries*	Eliminations	Consolidated
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>						
Net cash provided by/(used in) operating activities	\$ (471)	\$ 13,366	\$ —	\$ 49	\$ —	\$ 12,944
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>						
Proceeds from sale of fixed assets	—	19	—	—	—	19
Capital expenditures (for property, plant & equipment and intangibles)	—	(11,494)	—	—	—	(11,494)
Net cash used in investing activities	—	(11,475)	—	—	—	(11,475)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>						
Restricted cash used to collateralize letters of credit	—	(35)	—	—	—	(35)
Repayment of term loan	—	(526)	—	—	—	(526)
Repayment of capital lease obligations and other debt	—	(761)	—	(64)	—	(825)
Advances to/from subsidiaries	471	(486)	—	15	—	—
Net cash provided by/(used in) financing activities	471	(1,808)	—	(49)	—	(1,386)
<b>NET INCREASE IN CASH</b>	—	83	—	—	—	83
<b>CASH, BEGINNING OF PERIOD</b>	—	24,049	—	—	—	24,049
<b>CASH, END OF PERIOD</b>	\$ —	\$ 24,132	\$ —	\$ —	\$ —	\$ 24,132

\* Also includes non-guarantor which is considered to be "minor".

**Condensed Consolidating Balance sheets as of December 31, 2007**

(In thousands)

	<b>Muzak Holdings LLC (Parent)</b>	<b>Muzak LLC (Co- issuer)</b>	<b>Muzak Finance Corp (Co- issuer)</b>	<b>Combined Guarantor Subsidiaries*</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>ASSETS</b>						
<b>Current assets:</b>						
Cash	\$ —	\$ 24,049	\$ —	\$ —	\$ —	\$ 24,049
Restricted cash	—	752	—	—	—	752
Accounts receivable, net	—	20,941	—	564	—	21,505
Inventories	—	8,601	—	—	—	8,601
Prepaid expenses and other assets	—	5,579	—	—	—	5,579
<b>Total current assets</b>	—	59,922	—	564	—	60,486
Restricted cash	—	1,122	—	—	—	1,122
Property and equipment, net	—	71,968	—	—	—	71,968
Intangible assets, net	—	175,260	—	17,884	—	193,144
Deferred charges and other assets, net	129	29,885	1,823	5	(1,823)	30,019
Advances in/due from subsidiaries	—	9,455	—	5,776	(15,231)	—
Investment in subsidiary	(114,822)	20,670	—	—	94,152	—
<b>Total assets</b>	\$ (114,693)	\$ 368,282	\$ 1,823	\$ 24,229	\$ 77,098	\$ 356,739
<b>LIABILITIES AND MEMBERS' DEFICIENCY</b>						
<b>Current liabilities:</b>						
Accounts payable	\$ —	\$ 3,562	\$ —	\$ 119	\$ —	\$ 3,681
Accrued expenses	921	23,028	6,061	1,477	(6,061)	25,426
Current portion of other liabilities	—	4,109	—	—	—	4,109
Current maturities of long term debt	—	1,071	—	119	—	1,190
Advance billings	—	973	—	—	—	973
<b>Total current liabilities</b>	921	32,743	6,061	1,715	(6,061)	35,379
Long-term debt	24,245	436,097	334,726	1,508	(334,726)	461,850
Other liabilities	—	8,488	—	336	—	8,824
Advances in/due from subsidiaries	9,455	5,776	100,068	—	(115,299)	—
Redeemable Preferred units	263,529	—	—	—	—	263,529
Redeemable Class A units	7,788	—	—	—	—	7,788
Members' deficiency/Shareholder equity	(420,631)	(114,822)	(439,032)	20,670	533,184	(420,631)
<b>Total liabilities and members' deficiency</b>	\$ (114,693)	\$ 368,282	\$ 1,823	\$ 24,229	\$ 77,098	\$ 356,739

\* Also includes a non-guarantor which is considered to be "minor".



**Condensed Consolidating Statements of Operations for the Three Months Ended June 30, 2007**  
**(unaudited) (In thousands)**

	Muzak Holdings LLC ("Parent")	Muzak LLC (Co-issuer)	Muzak Finance Corp (Co-issuer)	Guarantor Subsidiaries*	Eliminations	Consolidated
<b>Net Revenues</b>						
Music and other business services	\$ —	\$ 46,937	\$ —	\$ 990	\$ —	\$ 47,927
Equipment and related services	—	14,866	—	—	—	14,866
	—	61,803	—	990	—	62,793
<b>Cost of Revenues</b>						
Music and other business services excluding depreciation and amortization expense	—	11,254	—	334	—	11,588
Equipment and related services	—	14,631	—	—	—	14,631
	—	25,885	—	334	—	26,219
Selling, general & administrative	—	20,118	—	175	—	20,293
Management fee	—	(198)	—	198	—	—
Depreciation & amortization expense	—	11,703	—	394	—	12,097
Income (Loss) from Operations	—	4,295	—	(111)	—	4,184
<b>Other income (expense)</b>						
Interest expense	(815)	(11,613)	(8,808)	(29)	8,808	(12,457)
Other, net	—	246	—	(2)	—	244
Equity in earnings of subsidiaries**	(7,109)	(37)	—	—	7,146	—
Loss before income taxes	(7,924)	(7,109)	(8,808)	(142)	15,954	(8,029)
Income tax benefit	—	—	—	(105)	—	(105)
Net loss	\$ (7,924)	\$ (7,109)	\$ (8,808)	\$ (37)	\$ 15,954	\$ (7,924)

\* Also includes non-guarantor which is "minor" as defined by Rule 3-10 of Regulation S-X.

\*\* Amount excludes the net loss of Muzak Finance Corp (which is a wholly-owned subsidiary of Muzak LLC) as the interest expense recorded by Muzak Finance Corp, which relates solely to the Senior Notes and Senior Subordinated Notes, is also reflected in Muzak LLC's results of operations due to both of these entities being co-issuers of the Senior Notes and the Senior Subordinated Notes. Muzak Finance Corp has no results of operations other than the interest expense on the Senior Notes and Senior Subordinated Notes.

**Condensed Consolidating Statements of Operations for the Six Months Ended June 30, 2007**  
**(unaudited) (In thousands)**

	<u>Muzak Holdings LLC ("Parent")</u>	<u>Muzak LLC (Co-issuer)</u>	<u>Muzak Finance Corp (Co-issuer)</u>	<u>Guarantor Subsidiaries*</u>	<u>Eliminations</u>	<u>Consolidated</u>
<b>Net Revenues</b>						
Music and other business services	\$ —	\$ 93,624	\$ —	\$ 2,008	\$ —	\$ 95,632
Equipment and related services	—	29,502	—	—	—	29,502
	—	123,126	—	2,008	—	125,134
<b>Cost of Revenues</b>						
Music and other business services excluding depreciation and amortization expense	—	21,939	—	676	—	22,615
Equipment and related services	—	28,085	—	—	—	28,085
	—	50,024	—	676	—	50,700
Selling, general & administrative Management fee	—	41,080	—	353	—	41,433
Depreciation & amortization expense	—	(402)	—	402	—	—
	—	23,597	—	770	—	24,367
Income (Loss) from Operations	—	8,827	—	(193)	—	8,634
<b>Other income (expense)</b>						
Interest expense	(1,630)	(23,415)	(17,616)	(72)	17,616	(25,117)
Other, net	—	411	—	(4)	—	407
Equity in earnings of subsidiaries**	(14,239)	(62)	—	—	14,301	—
Loss before income taxes	(15,869)	(14,239)	(17,616)	(269)	31,917	(16,076)
Income tax benefit	—	—	—	(207)	—	(207)
<b>Net loss</b>	<b>\$ (15,869)</b>	<b>\$ (14,239)</b>	<b>\$ (17,616)</b>	<b>\$ (62)</b>	<b>\$ 31,917</b>	<b>\$ (15,869)</b>

\* Also includes non-guarantor which is "minor" as defined by Rule 3-10 of Regulation S-X.

\*\* Amount excludes the net loss of Muzak Finance Corp (which is a wholly-owned subsidiary of Muzak LLC) as the interest expense recorded by Muzak Finance Corp, which relates solely to the Senior Notes and Senior Subordinated Notes, is also reflected in Muzak LLC's results of operations due to both of these entities being co-issuers of the Senior Notes and the Senior Subordinated Notes. Muzak Finance Corp has no results of operations other than the interest expense on the Senior Notes and Senior Subordinated Notes.

**Condensed Consolidating Statements of Cash Flows for the Six Months Ended June 30, 2007**  
**(unaudited) (In thousands)**

	Muzak Holdings LLC ("Parent")	Muzak LLC (Co-issuer)	Muzak Finance Corp (Co-issuer)	Guarantor Subsidiaries*	Eliminations	Consolidated
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>						
Net cash provided by/(used in) operating activities	\$ (54)	\$ 15,723	\$ —	\$ 495	\$ —	\$ 16,164
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>						
Proceeds from sale of fixed assets	—	19	—	—	—	19
Capital expenditures (for property, plant & equipment and intangibles)	—	(10,900)	—	—	—	(10,900)
Net cash used in investing activities	—	(10,881)	—	—	—	(10,881)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>						
Restricted cash used to collateralize letters of credit	—	(45)	—	—	—	(45)
Repayment of term loan	—	(525)	—	—	—	(525)
Repayment of capital lease obligations and other debt	—	(1,082)	—	(84)	—	(1,166)
Payment of financing fees	—	(517)	—	—	—	(517)
Advances to/from subsidiaries	54	357	—	(411)	—	—
Net cash provided by/(used in) financing activities	54	(1,812)	—	(495)	—	(2,253)
<b>NET INCREASE IN CASH</b>	—	3,030	—	—	—	3,030
<b>CASH, BEGINNING OF PERIOD</b>	—	19,032	—	—	—	19,032
<b>CASH, END OF PERIOD</b>	\$ —	\$ 22,062	\$ —	\$ —	\$ —	\$ 22,062

\* Also includes non-guarantor which is "minor" as defined by Rule 3-10 of Regulation S-X.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Certain statements contained in this Quarterly Report include what are commonly referred to as forward-looking statements. Some of these statements can be identified by terms and phrases such as "anticipate", "believe", "intend", "expect", "could", "may", "will" and similar expressions, may include references to assumptions that we believe are reasonable, and relate to our future prospects, developments and business strategies.

Forward-looking statements involve risks and uncertainties, including, but not limited to those related to our substantial leverage and debt service requirements, restrictions imposed by the terms of our indebtedness, our history of net losses, our lack of readily available funds to borrow, our dependence on satellite delivery of our products, our dependence on third parties to license music rights, possible disruption posed by new business strategies and initiatives, the impact of natural disasters on our client locations and our support facilities, future capital requirements, the impact of competition and technological change, the availability of cost-effective programming, the impact of legislation and regulation, our dependence on the contributions of key personnel, the ability to control or impact client cancellations, potential conflicts posed by the significant ownership stake of our controlling equity holder, risks associated with the effect of general economic conditions and other factors discussed in our filings, reports, and public disclosures.

You must remember that our expectations may not turn out to be correct, even though we believe they are reasonable. In light of the foregoing risks and uncertainties as well as those that have yet to be identified, we cannot and do not guarantee that any future transactions or events will happen as described or that they will happen at all. Any forward-looking statements speak only as of the date on which they were made, and we expressly disclaim any duty whatsoever to update such forward-looking statements.

### **Recent Developments**

As of August 14, 2008, Moelis & Company, the investment banking firm retained to represent Muzak and DMX, Inc., continues to coordinate the marketing and sale of the two companies. The Company's future consolidation or combination with DMX, Inc. is contingent on the success of this process—a process that is focused on a sale of the entities to an as yet unidentified third party buyer. Moelis has been distributing the offering memorandum to interested and qualified purchasers and providing access to virtual data rooms. The Company is pleased with the level of interest generated and the progress made to date. In the interim, the companies remain independent and Muzak continues to compete and to provide, without disruption, the highest quality products and services to its clients

Effective May 15, 2008, the authorized number of Directors of Muzak LLC was expanded from one to five members. After expressing a desire to so serve, the existing members of the Board of Directors of Muzak Holdings LLC were nominated by Royce Yudkoff to fill the vacancies that were created after such change, and each nominee has been duly elected to hold office until such time as his successor is elected and qualified or until his earlier resignation or removal. The Board of Directors of Muzak LLC now includes J. Travis Hain, Robert P. MacInnis, Scott R. Poole, Stephen P. Villa, and Royce G. Yudkoff.

On April 7, 2008, Muzak LLC and DMX, Inc announced that they had been informed by the Antitrust Division of the U.S. Department of Justice (DOJ) that the DOJ's investigation into the proposed merger of the companies, to allow for a sale to a third party, would be closed without an antitrust challenge. The companies are now cleared to proceed with the proposed transaction subject, ultimately, to the review by federal regulators of the identity and ownership interests (among other things) of an as yet to be identified third party buyer. In connection with the aforementioned proposed transaction, the Company has incurred costs of \$0.3 million and \$0.8 million for the quarter ended June 30, 2008 and 2007, respectively and \$1.1 million and \$1.6 million for the six months ended June 30, 2008, and 2007, respectively, which are included in selling, general and administrative expenses.

Approximately \$436.8 million of the Company's long term debt is scheduled to mature in the first quarter of 2009. The Company currently plans to address these impending maturities as part of the proposed consolidation or combination with DMX, Inc. As previously disclosed, such combination is contingent on a sale of the entities to an as yet unidentified third party buyer. Should such transaction fail to be consummated, the Company would be required to explore other refinancing or restructuring opportunities that would likely adversely affect the positions of current debt and equity holders.

There also can be no assurance that the Company will be able to refinance or restructure its financial obligations. The Company is dependent upon obtaining continued or alternative financing in the event a transaction is not consummated. Notwithstanding any such refinancing and or restructuring, the Company believes that client and vendors will not experience any disruption or encounter any negative impact to their continued receipt of quality products and services or timely payments. (See Liquidity and Capital Resources)

On December 21, 2007, Muzak Holdings LLC and Muzak LLC announced their plans to periodically furnish financial information to the public on their Web site, muzak.com, and to de-list with the SEC and cease furnishing periodic reports to the Securities and Exchange Commission's EDGAR system. While disclosures previously furnished to the Securities and Exchange Commission will remain accessible via EDGAR's archives, all new disclosures and reports, beginning in 2008, are solely accessible at the Company's website. The companies are considered "voluntary filers" under the current rules and regulations of the Securities and Exchange Commission and have the flexibility under such regulations and the terms of their indentures to explore alternative disclosure mechanisms and to fulfill their contractual disclosure obligations outside of the Securities and Exchange Commission's electronic filing system. The companies believe that furnishing such disclosures on the Company's website will be more cost efficient and a better use of resources while still enabling the companies to provide disclosure similar in quality and frequency.

## Results of Operations

Set forth below are discussions of the results of operations for Muzak Holdings LLC for the quarter and six months ended June 30, 2008 compared to the quarter and six months ended June 30, 2007. The following discussions should be read in conjunction with our Condensed Consolidated Financial Statements and accompanying Notes thereto included elsewhere herein and with our 2007 Annual Report.

*Net Revenues.* Revenues were \$63.3 million for the quarter ended June 30, 2008, and were \$62.8 million for the quarter June 30, 2007. Music and other business services revenue decreased \$0.7 million, or 1.5%, in 2008 as compared to the quarter ended June 30, 2007 and remained flat for the six months ended June 30, 2008 compared to the six months ended June 30, 2007.

Equipment and related services revenue increased 8.6% or \$1.3 million and 2.5% or \$0.8 million in 2008 as compared to the quarter and six months ended June 30, 2007. The increase is primarily due to higher equipment sales during the quarter and six months ended June 30, 2008. The majority of this increase came from additional sales to customers adding extensive audio and video packages in sites.

*Cost of Revenues.* Cost of revenues was \$25.8 million and \$26.2 million for the quarters ended June 30, 2008 and 2007, respectively, and were \$51.2 million and \$50.7 million for the six months ended June 30, 2008 and 2007, respectively. Total cost of revenues as a percentage of revenues was 40.7% and 41.8% for the quarter ended June 30, 2008 and 2007, respectively, and 40.7% and 40.5% for the six months ended June 30, 2008 and 2007, respectively. Costs of music and other business services revenue as a percentage of music and other business services revenue was 24.1% and 24.2% for the quarters ended June 30, 2008 and 2007 respectively, and 24.1% and 23.6% for the six months ended June 30, 2008 and 2007 respectively.

Costs of equipment and related services revenue as a percentage of equipment and related services revenue was 88.9% and 93.2% for the quarter and six months ended June 30, 2008 compared to 98.4% and 95.2% for the quarter and six months ended June 30, 2007. In addition to equipment costs, these costs include salary, payroll taxes, and employee benefit related costs associated with our field install and service technicians as well as the management and centralized staff that supervises and schedule such technicians. Additionally, these costs also include the warehouse and purchasing functions and vehicle related expenses. The increase in margin on equipment and related services revenue is attributed to the increase in sales to customers adding extensive audio and video equipment to sites.

*Selling, general and administrative expenses.* Selling, general, and administrative expenses were \$19.9 million and \$20.3 million for the quarter ended June 30, 2008 and 2007, respectively, and \$41.1 million and \$41.4 million for the six months ended June 30, 2008 and 2007, respectively. Amortization of deferred subscriber acquisition costs, a non-cash component of selling, general, and administrative expenses was \$3.5 million and \$3.8 million for the quarter ended June 30, 2008 and 2007, respectively, and \$7.1 million and \$7.7 million for the six months ended June 30, 2008 and 2007, respectively. This \$0.3 million and \$0.6 million decrease in amortization of deferred subscriber costs is consistent with the lower installation levels experienced in the quarter and six months ended June 30, 2008 as compared to the 2007 periods. The \$0.3 million increase in other selling, general, and administrative expenses for the six months ended June 30, 2008 as compared to the 2007 period is associated with increases in salaries and benefits, and additional marketing activity offset by

lower insurance costs. Included in both periods are approximately \$0.3 million and \$0.8 million for the quarter ended June 30, 2008 and 2007, respectively, and \$1.1 million and \$1.6 million for the six months ended June 30, 2008 and 2007, respectively, in expenses associated with the DMX transaction.

*Depreciation and amortization expenses.* Depreciation and amortization expense was \$11.4 million and \$12.1 million for the quarters ended June 30, 2008 and 2007, respectively, and \$22.9 million and \$24.4 million for the six months ended June 30, 2008 and 2007, respectively. Depreciation expense decreased \$0.7 million and \$1.5 million in the three and six months ended June 30, 2008 compared to 2007 due to certain subscriber investments and other fixed assets becoming fully amortized in 2008, along with the lower levels of subscriber investments as a result of lower installations. Amortization expense for the three and six months ending June 30, 2008 and 2007 remained flat at \$3.4 million and \$6.8 million, respectively.

*Interest expense.* Interest expense decreased \$0.8 million to \$11.7 million for the quarter ended June 30, 2008 compared to the same 2007 period and decreased \$1.5 million to \$23.6 million for the six months ended June 30, 2008 compared to the same 2007 period. The yearly decrease is due to a decrease in overall interest rates associated with our New Senior Credit facility, which until March 2007 bore interest at LIBOR plus a 4.75% margin. In March 2007, the margin was reduced to 3.75%, which attributed to the decrease in interest expense for the quarter and six months ended June 30, 2008 over the 2007 period. Interest income generated on the outstanding cash balance is reflected in other income. Interest income was \$0.1 million and \$0.4 million for quarters ending June 30, 2008 and 2007, respectively, and \$0.3 million and \$0.6 million for the six months ended June 30, 2008 and 2007, respectively.

*Income tax provision.* Income tax benefit was \$83 thousand and \$105 thousand for the quarters ended June 30, 2008 and 2007, respectively, and \$172 thousand and \$207 thousand for the six months ended June 30, 2008 and 2007, respectively. Although the Company is a limited liability company and is treated as a partnership for income tax purposes, the Company has several subsidiaries that are taxable corporations. The income tax benefit relates to these corporate subsidiaries.

*Net Loss.* The combined effect of the foregoing resulted in a net loss of \$5.2 million and \$7.9 million for the quarters ended June 30, 2008 and 2007, respectively, and \$12.6 million and \$15.9 million for the six months ended June 30, 2008 and 2007, respectively.

## Liquidity and Capital Resources

The Company evaluates the operating performance of its business using several measures, one of them being EBITDA as defined by our Senior Discount Notes, Senior Subordinated Notes, and Senior Notes indentures (defined as earnings before interest, income taxes (benefits), depreciation, and amortization plus all non-cash items reducing consolidated net income for such period except for any non-cash items that represent accruals of, or reserves for, cash disbursements to be made in any future accounting period, minus all non-cash items increasing consolidated net income for such period) (“EBITDA pursuant to the Notes”). EBITDA pursuant to the Notes is not intended to be a performance measure that should be regarded as an alternative to, or more meaningful than, net income as a measure of performance, as determined in accordance with generally accepted accounting principles, known as GAAP. However, management believes that EBITDA pursuant to the Notes provides useful information because it is used to determine our ability to incur additional indebtedness. Consolidated Leverage ratios (defined as total debt, excluding non-recourse debt, less unrestricted cash divided by EBITDA pursuant to the Notes on a last quarter annualized basis) are the measure used to determine our ability to incur additional indebtedness under the indentures.

The following table provides a reconciliation from net income to EBITDA pursuant to the Notes.

	Quarter Ended	
	June 30, 2008	June 30, 2007
Net loss	\$ (5,231)	\$ (7,924)
Interest expense	11,661	12,457
Income tax benefit	(83)	(105)
Depreciation and amortization	11,388	12,097
Non-cash impairment charges	305	390
EBITDA pursuant to Notes	<u>\$ 18,040</u>	<u>\$ 16,915</u>
Consolidated Leverage Ratio for the Company	6.05 x	6.54 x
Consolidated Leverage Ratio for Muzak	5.72 x	6.18 x

	Six months Ended	
	June 30, 2008	June 30, 2007
Net loss	\$ (12,578)	\$ (15,869)
Interest expense	23,621	25,117
Income tax benefit	(172)	(207)
Depreciation and amortization	22,937	24,367
Non-cash impairment charges	675	742
EBITDA pursuant to Notes	<u>\$ 34,483</u>	<u>\$ 34,150</u>

Non-cash impairment charges reflect the write-off of capitalized installation labor upon client contract terminations.

Approximately \$436.8 million of the Company's long term debt is scheduled to mature in the first quarter of 2009. The Company currently plans to address these impending maturities as part of the proposed consolidation or combination with DMX, Inc. As previously disclosed, such combination is contingent on a sale of the combined entity to an as yet unidentified third party buyer. As of August 14, 2008, Moelis & Company, the investment banking firm retained to represent Muzak and DMX, Inc., continues to coordinate the marketing and sale of the two companies. The Company's future consolidation or combination with DMX, Inc. is contingent on the success of this process—a process that is focused on a sale of the entities to an as yet unidentified third party buyer. Moelis has been distributing the offering memorandum to interested and qualified purchasers and providing access to virtual data rooms. The Company is pleased with the level of interest generated and the progress made to date. In the interim, the companies remain independent and Muzak continues to compete and to provide, without disruption, the highest quality products and services to its clients. Should such transaction fail to be consummated, the Company would be required to explore other refinancing or restructuring opportunities that would likely adversely affect the positions of current debt and equity holders. There also can be no assurance that the Company will be able to refinance or restructure its financial obligations. The Company is dependent upon obtaining continued or alternative financing in the event a transaction is not consummated. Notwithstanding any such refinancing and or restructuring, the Company believes that client and vendors will not experience any disruption or encounter any negative impact to their continued receipt of quality products and services or timely payments.

The Company does not have available unused credit line therefore, our principal source of funds is cash generated from operations and our current cash balances. Cash was primarily used during the first six months of 2008 to make investments in new client locations, fund operations, and to make interest payments on our indebtedness. Cash flows provided by operations were \$12.9 million and \$16.2 million, cash flows used in investing activities were \$11.5 million and \$10.9 million, and cash flows used in financing activities were \$1.4 million and \$2.3 million in the six months ended June 30, 2008 and 2007, respectively.

Working capital was a net use of \$3.3 million in the six months ended June 30, 2008 as compared to a net source of \$1.0 million in the same period for 2007. Accounts receivable and inventory balances resulted in a use of \$1.5 million in the six months ended June 30, 2008 compared to a source of \$4.4 million in the six months ended June 30, 2007.

The majority of our capital expenditures are comprised of the initial investment for the installation of equipment for new client locations. During the six months ended June 30, 2008, our total initial net investment in new client locations was \$11.2 million, which was comprised of equipment and installation costs attributable to new client locations of \$7.8 million and \$3.4 million in subscriber acquisition costs (included in cash provided by operating activities in the consolidated statement of cash flows) relating to these new locations. The subscriber acquisition costs are capitalized and are amortized as a component of selling, general and administrative expenses over the initial contract term or five years, whichever is shorter. We also received installation revenue of \$1.3 million relating to new locations. This revenue is deferred and amortized as a component of equipment and related services revenue over the initial contract term or five years, whichever is shorter.

We also invested \$3.6 million in system upgrades, furniture and fixtures, and computers to be used at our headquarters. Our investment to replenish the equipment exchange pool relating to our drive-thru systems client locations was \$0.7 million during the six months ended June 30, 2008.

Over the next twelve months, our future need for liquidity will arise primarily from principal and interest payments on our indebtedness and capital expenditures for investments in new client locations. The following table summarizes contractual obligations and commitments as of June 30, 2008 (in thousands).

	Payments due by Period						Total
	Remaining 6 months 2008	2009	2010	2011	2012	After 2012	
Long-term debt	\$ 598	\$436,482	\$ 24,418	\$ 191	\$ 211	\$ 820	\$462,720
Interest	21,918	14,767	1,708	115	95	155	38,758
Capital lease obligations	998	821	279	—	—	—	2,098
Operating leases	4,279	8,185	7,590	5,690	4,501	18,913	49,158
Unconditional purchase obligations	1,050	2,100	2,100	2,100	744	—	8,094
<b>Total Contractual Cash Obligations</b>	<b>\$ 28,843</b>	<b>\$462,355</b>	<b>\$ 36,095</b>	<b>\$ 8,096</b>	<b>\$ 5,551</b>	<b>\$ 19,888</b>	<b>\$560,828</b>

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

For the period June 30, 2008, the Company did not experience any material changes in market risk disclosure that affect the quantitative and qualitative disclosures presented in the Annual Report for the year ended December 31, 2007.

### Item 4. Evaluation of Disclosure Controls and Procedures

The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes those policies and procedures that:

- (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the Company's assets;
- (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that the Company's receipts and expenditures are being made only in accordance with authorizations of the Company's management and directors; and
- (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Management, including the Company's Chief Executive Officer and Chief Financial Officer, does not expect that the Company's internal controls will prevent or detect all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of internal controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. Also, any evaluation of the effectiveness of controls in future periods are subject to the risk that those internal controls may become inadequate because of changes in business conditions, or that the degree of compliance with the policies or procedures may deteriorate.

There have been no changes during the six months ended June 30, 2008 that have materially affected, or are reasonably likely to materially affect, our Internal Controls over financial reporting as previously disclosed in our 2007 Annual Report filed on the Company's website [www.muzak.com](http://www.muzak.com).

## **PART II—OTHER INFORMATION**

### **ITEM 1. Legal Proceedings.**

Except as otherwise disclosed under Note 9, entitled “Commitment and Contingencies,” of the Consolidated Financial Statements set forth in this Quarterly Report, there have been no material developments in legal proceedings involving the Company since those reported in the Company’s Annual Report for fiscal year ended December 31, 2007.

### **ITEM 1A. Risk Factors**

Risk factors which could cause actual results to differ materially from those suggested in any forward-looking statements include but are not limited to those discussed or identified in this document, in our public filings with the Securities and Exchange Commission, and in our annual report for 2007, including those factors set forth in Part I, Item 1A of such report. There have been no material changes in the risk factors previously disclosed in our 2007 Annual Report.

### **ITEM 6. Exhibits.**

None

