HollAnd Advisors

Holland Views – Formula 1 (FWON) – Price: $34; MCap: $7.8bn

A simpler Formula

The Covid crisis has resulted in much change to some company capital structures. Formula 1 (FWON[1]) is notable as a company that has greatly reduced its debt and simplified its capital structure considerably – without issuing new shares: This is our third in-depth look at FWON since 2017[2]. As we first said then, we think F1 is a 'rare bird' investment. Today its shares offer value to longer term investors seeking great franchises and importantly now come with far less debt.

What attracted us to Formula 1?

> *"Content, you know, content is where the money is…and content will always be where the money is…but content distribution magnifies the value of content"* – **Warren Buffett**

- FWON shareholders own a share in an entire Sports League, an extremely rare asset
- F1 is a unique, globally recognised brand with 390m million unique global viewers
- With pricing power (i.e. contractual rate increases in promotion and sponsorship deals)
- F1 was under-managed/under-monetised under Eccelstone and now has top-class management with a long-term outlook. We see lots of opportunity to accelerate growth.
- This is an extremely asset light business and thus very high return on capital

  …in short, F1 is a dream business

And what has changed in the last three months?

Fig.1: Never waste a crisis: FWON is now a simpler and more resilient entry

	Jan-20	Jun-20
FWON market cap	$10.9bn	$7.8bn
non F1 equity stakes	c$6bn	c$0.6bn
FWON Net Debt	$5bn	$1.6bn
annual Interest costs	$195m	$89m
F1 2023 P/FCF est	12x	13x

Source: Holland Advisors

- A much **simplified capital structure** as per Fig.1
  - Equity stakes monetised (reduced from c.50% of MCap to c.10%)
  - Consequently, Net debt reduced from $5bn to $1.6bn
- **FWON shares -25% YTD**. ***Before*** any re-leveraging in coming years (ie sizeable buybacks of stock), this is a business that offers investors a **13% IRR's** (our best guess) from today's starting price.
- A **purer equity play** on F1 (no LiveNation exposure any more)

[1] We remind you that Formula 1 is publicly traded via a 'tracking stock' and is legally a part of John Malone's Liberty Media conglomerate. In this note, 'FWON' is the tracking stock/holding company, 'F1' is the operating compa1ny.

[2] Holland Views – FWON, Lollapalooza at speed, Nov 2017, $38 Holland Views – FWON, Economies of scale, Dec 2018, $31

- Team '**cost caps'** now agreed with the teams. Covid could prove the catalyst to "*create a financial structure for the sport that allows smaller teams to compete* " A renewal of the Concorde agreement has been deferred until 2021 but a sensible outcome that promotes growth is now very likely?

In this note we discuss:

1. Debt reduction and a simplified capital structure
2. A recap on the F1 machine - A cash cow and a growth engine
3. A word on the near-term uncertainty
4. And an updated look at Valuation

Debt reduction is welcome

Much as we love John Malone and his track record, we were never totally relaxed by his willingness to embrace debt (and, frankly, financial engineering) to juice equity returns. Even if his businesses are always cash generative and the tax benefits good (F1 enjoys a 7.5% cash tax rate in the UK!). Our work on Marriott and Ashtead's clever use of affordable through the cycle leverage has helped our understanding on this issue, but Malone and team do like to push it a little!

But we always liked the idea of being long term shareholders in Formula 1. So, it is with some relief that we see Greg Maffei (Malone's right-hand man and head of Liberty Media) de-lever FWON in April. His hand we suspect forced by lenders and the huge uncertainty about 2020 F1 race calendar. The group needed to reduce its significant interest costs and thus divested its 30% stake in Live Nation leaving a far less leveraged owner (FWON) of the Formula 1 racing business.

To remind you, the FWON tracking stock included a significant equity holding in Live Nation (worth c.$5bn as recently as February). That stake had halved in value by the time the asset was transferred to Liberty Media sister company Sirius XM along with $1.3bn of other FWON holding company debt liabilities in exchange for a $1.4bn cash injection. FWON shareholders also obtained 'call-spread option' allowing it to participate in any upside to Live Nation shares over the next 12 months (to $47).

Long story short, this action greatly simplifies FWON's capital structure and also means that debt leverage will likely fall further and quickly in the coming years. Assuming that 2021 reverts to a 'normality of sorts' in terms of F1 season schedule, the cash generation potential of this business could mean that Net Debt/EBITDA could fall below 1.5x as soon as 2023 (see Fig.2). We elaborate on this cash generation later and our model is available on request.

Fig.2: A "simpler" capital structure

Capital Structure	Mar 17	2017		2019	May-20	2021e	2022e	2023e
F1 bank loans (with covenants). Libor +2.5%	$ 3,844	$ 3,302	$2,900	$2,900	$ 2,900			
FWON group debt					$ 700			
Total FWON Debt	**$ 2,853**	**$ 2,494**	**$4,979**	**$5,677**	**$ 3,600**			
F1 cash					$ 536			
FWON Cash	$ 443	$ 420	$ 419	$ 587	$ 1,400			
FWON Net Debt (c)	**$ 2,410**	**$ 2,074**	**$4,458**	**$5,090**	**$ 1,664**	**$1,332**	**$ 910**	**$ 377**
F1 Net Debt (for covenants)					$ 2,364	$ 2,032	$ 1,610	$ 1,077
interest rate assumption				@5%				
Stated Covenant Leverage (NB **F1 opco** only)		reported	5.3x	5.1x	6.0x	3.7x	2.6x	1.5x

Source: Holland Advisors

The F1 cash machine + growth engine

Formula is a sports league, like say MLB, FIFA, Premier League or the Olympics. It owns the preeminent global motorsport racing brand (F1) and has almost no capital requirements as it does not host the race events itself. These being bid for by outside providers.

At its basic level, its primary costs are just its (admittedly very well paid[3]) employees. These employees negotiate rules and contracts with the regulator (FIA), track owners ('Promoters'), media buyers (TV execs), advertisers and the racing teams. In the past, we have compared F1 to businesses such as Manchester United and WWE as per Fig.3. We strongly recommend a re-reading of our last in-depth report on FWON *(Holland Views – Formula One, Economies of scale - $31, Dec 2018)* from which Fig.3 originated. That note looks in detail at "the economics of content" and "Why F1 is a premium sports asset". As F1 increases its fan engagement and racing becomes more of a spectacle we expect broadcasting and advertising revenues to increase leading to faster growth in profitability.

Fig.3: Thinking about scaling the business and operating leverage

Mix (% of sales)	Man U				WWE					Formula 1		
		2006	2017	cagr		2009	2017	2021e	cagr		2015	2021e
non-scalable	"Match Day"	43%	19%	4%	Live events	27%	19%			Track Fees	35%	
					Other					Paddock	18%	
"Scalable"	Broadcasting	28%	33%	14%	TV rights+PPV	43%	34%	58%	18%	Broadcasting	32%	
	Commercial	28%	48%	17%	Network	0	23%	20%		Ads	14%	
	total scalable mix	57%	81%		total scalable	43%	67%	78%		total scalable	46%	?
	group margins	24%	34%		margins	19%	14%	31%		margins	27%	33%
margin expansion realised/estimated			+10% points					+12% points				+6% points

Source: ***Holland Views – FWON, Economies of Scale, $31, Dec 2018***

Last year, F1 generated about $2bn in revenues, paying away about half of that to the teams (this share being determined by the Concorde Agreement). After this and its own staff costs FWON generated an EBITDA margin of 22-24%. The 33% suggestion we made of likely 2021 margin has not been achieved, but it should act as an indication as to how marginally profitable we think future growth at F1 might be.

For further insight into future potential profitability we highlight the percentage of revenue companies like Manchester United and WWE derive from scalable sources, (i.e. adverting or broadcast fees). These have risen in each case from 40-50% to c.80% in 8-10 years. Not only does F1 feel under monetised when you get near the sport, but this is also evidential in the figures above. Today's margins seem too low to us given a) the rarity of this asset in a global context, b) a comparison to how other sports media businesses monetise their content and c) the asset light nature of the FWON business model. Restructuring the Concorde agreement will likely help but FWON grow its margins but in truth it is the revenue growth of the entire sport that will really bring strong operational gearing.

Fig.3b: Live sport and why "the network will never cancel it"

> The exponential growth of Premier League TV deals has now attracted a different kind of investor: a raft of American businessmen who have learned how to extract profit in the NFL, MLB and NBA, Kroenke being one of the canniest. They have learned an important lesson. Sports teams, franchises, aren't tethered: they are entertainment products; a studio from which a never-ending series every bit as engrossing as *The Wire* or *The Sopranos* plays out season after season after season. And the best bit? The network will never cancel it. But characters are bumped off or moved on, as St Louis

Source: James Montague, The Billionaires Club

[3] Pre-Liberty ownership, F1's then 360 staff received $54m cash salaries and $98m worth of equity!

In James Montague's, the Billionaire Club, he illustrates why the Major League owners in the US are so attracted to the UK's Premiership football teams. Montagu reminds readers that Sports Teams are ultimately entertainment businesses with a never-ending, engrossing scripts and thus highly sought-after by TV networks! We think that logic applies to F1 too albeit that we think the script has become a little predictable in recent seasons.

The indisputable economics of content

We will add a little math to this thinking. When doing our work on Manchester United in our economies of scale piece (December 2018) we calculated something that surprised us as outsiders to this industry. Fig.4 shows that a content distributor (say cable channel) that has:

- Revenue growth of 6% pa and who wishes to maintain very aggregable, 20% margins
- Will happily pay a content producer 11% more for their content each year

This we think an important conclusion. Without it is easy to attach a too simplistic commentary to sport rights that is convenient, but untrue. i.e. that they are vanity assets with unaffordable player salaries and rights costs that have been bid up by media companies to uneconomic levels. Fig.4 we suggest is the evidence to justify why sports rights are extremely valuable and why a doubling of content costs every 6-7 years is actually reasonable (equates to 11% pa). This work we feel is equally (if not more) important in an OTT world as it was in a cable/broadcast one. Readers with long memories will know that the lack of need to play famous player salaries was one of the reasons we liked WWE. Formula 1 is one more step up again as they do not own the teams, but the very league itself.

Fig.4: The economics of content

Simple P&L of a content Aggregator								
years		0	1	2	3	4	5	5y cagr
	cagr							
Subscribers	2%	50	51	52	53	54	55	
Subscription price	4%	10	10	11	11	12	12	
Notional Revenue		500	530	563	597	633	672	6%
Variable Costs % of sales	30%	150	159	169	179	190	201	
Fixed Network costs	30%	150	155	159	164	169	174	
Cost Growth (say RPI)	3%							
Content as % sales		21%	22%	23%	24%	25%	26%	
Implied Content costs		105	117	129	143	158	175	11%
content cost Per subscriber		2.1	2.3	2.5	2.7	2.9	3.2	
Profit Before Tax		95	100	105	111	116	122	
Distributor Group PBT Margin		19%	19%	19%	19%	18%	18%	

Source: Holland Advisors

A recap on the F1 growth potential

The exciting part for equity investors in F1 is not the racing, but the untapped opportunity to add significant value via more races, festivals around races, online media streaming + far more sponsorship/co-branding all for a very limited incremental capital cost. These growth opportunities excited Malone and team at the time of their purchase and they still excited us today. All future growth will be capital likely have very high marginal returns.

We wrote before *(Holland Views – Formula One, Lollapallooza…at speed, $38, Nov 2017)*, of the key improvements that could drive revenue growth:

- Improving the racing spectacle for fans, night races, city races, weekend festivals
- More races
- Better penetration of US market, where Ecclestone was not trusted
- Better commercial terms with teams
  - Lowering team costs with car spec standardisation and budget caps
  - Aligning team and F1 interests to promote growth
- Better commercialisation (broadcasting and sponsorship deals)

We acknowledge those changes have been harder and taken longer to implement than Liberty and we ourselves envisaged back in 2017, but there is clear progress. This quote from Greg Maffei from last November's capital markets day gives useful context on the company's progress since 2017.

> *We made the investments over the last few years in marketing and sponsorship and research and they're going to start paying off. Importantly, we did our deal with the FIA, improved the car specs and the cost-cap. We're working on the team agreements, which I believe will proceed favourably and they're going to set us up for improved fan engagement continuing growth in sponsorship broadcast and promoter value, allow us to fund more growth initiatives, allow us to increase dollars for the teams and then continue the economic sustainability of the business. I think we're at the beginning of a virtuous cycle, you're seeing some of that kick off in '19, but we're super excited about what's going to happen in the next several years.*

Source: Greg Maffei, Nov 2019

When spending time inside Formula 1 we find two things. One is a great passion for the sport at a global level. The other is the focus on the details. Crucially it was the details that needed to be worked out first before any real change in commercialisation of the sport could take place. The detail we refer to is around car specification, track changes to permit more overtaking, team budgets, DRS system ++. Think of a sport you love (say football) and the controversy over every change that has ever taken place (back passes, goal line technology). Each is designed to make the sport more of a spectacle, but they take time to enact. Formula 1 is no different, except that these changes had to be agreed by all and were important to make the sport more of a spectator spectacle. Few of them have yet to benefit the racing we see each week.

Cash Generation

We outline our simple P&L/EBITDA model below but first reference a slide from the Liberty Media's analyst day last November. Our clients will remember our recent work on American Tower, Ashtead and Marriott – all highly cash generative businesses which judiciously use constant debt leverage to provide cheap funding for growth and an efficient capital structure. Arguably, John Malone was the pioneer of this approach four decades ago. Thus, it should not be a surprise to see a Malone company a) being highly cash generative and b) using debt to enhance equity returns. Fig.5 shows this mindset clearly.

In 2020 arguably the bankers had the upper hand (for once) over Malone, insisting on a recap as F1 high leverage met zero revenues. The result, as we showed in Fig.1, is a business that might find itself under levered in say 2023. Investors should not expect it to stay that way. Once post-Covid resilience is proven and growth restarts it would be very very surprising were Formula 1 not to be a significant purchaser of its own shares.

Fig.5: A reminder of the cash generation on offer (pre-Covid)

…F1 and FWON Expanding Free Cash Flow

FWON Cumulative Free Cash Flow (2020 through 2023)	
($ in millions)	
F1	
Free Cash Flow[1]	$1,600
OpCo Leverage Capacity (within 5.0-5.5x Target)[1]	$800
Estimated Restricted Payments	$250
F1 Free Cash Flow	**$2,650**
FWON	
Monetizeable Corporate Assets (i.e. BATR, private assets)	$300
Live Nation Margin Loan Capacity	$600
(less) Estimated Corporate Expense	($450)
FWON Free Cash Flow	**$3,100**

Source: Liberty Media, November 2019

Near-term uncertainty

Greg Maffei and Chase Carey have done a good job of restructuring and simplifying FWON's debt and capital structure. They have boosted liquidity and continue to work with teams and tracks to keep the F1 ecosystem as intact as possible for fans, teams and promoters through the lockdown. Obviously, this year is a 'write-off' from a profit perspective and both we and the company are working on the assumption that the 2021 season can revert to some sort or 'managed normality' in terms of event safety and attendance (NB the 2021 season does not start until March 21). We might add that an F1 event is a large-scale social event, but what might be in its favour from a Covid restriction perspective is that it is an outdoor event.

A cursory look at 2020 is relevant just to assess the cash burn. Fig.6 gives a stab at how it might play out. It is still in planning stages but F1 is hoping to host 15-18 races this year through to Dec 2020..? The number of races and attendance (especially of later races) will obviously have a bearing on cash generation. Revenues are most at risk from Track Promoter revenues. Though these are typically a flat fee, F1 is being flexible with the track owners. Our finger in the air estimate is that group revenues could more than halve this year to c.$900m.

- We should note the recent development that Sky has secured significant refunds from The Premiership and is seeking similar concessions from other leagues including Formula 1.
- We should also note that F1 has addressed recent press speculation that it may need to support lower-tier F1 teams financially saying *"those are discussions we've not had to date"*.
- The good news is that most of F1's cost base is variable. It is essentially Team Payments and Employee labour costs. 'Other cost of sales' essentially are pass-throughs of paddock and freight forwarding costs.
    - Team payments are actually determined as a percentage of 'pre-Team payment EBITDA' but roughly approximates to 50% of revenues. There are contractual minimum payments which could kick in if more races get cancelled.
- Long story short, assuming that F1 realises its 15-18 race ambition this year, it is plausible that the F1 opco should cover its (now much lower) group interest costs of c.$100m.

- The reality of F1 racing is that much of the financial pain will be bourne by those that have the large Opex budgets related to it (i.e. the teams and the race promoters).

- As an asset light business FWON will be exposed to its share of revenues, but sizable losses should be unlikely. Importantly this means a further deterioration of the balance sheet is unlikely also.

Fig.6: Team payment % and revenue growth are key to profit growth

F1 PRO-FORMA Income Statement	2013	2014	2015	2016	2017	2018	2019	2020e	2021e	2022e	2023e
# of Races		19	21		20	21	21	15-18	"22"		
Revenue	**1639**	**1702**	**1697**	**1796**	**1783**	**1827**	**2022**	**900**	**2123**	**2229**	**2341**
YoY		4%	0%		-1%	2%	11%		5.0%	5.0%	5.0%
Team payments	797	863	903		919	913	1012	450	1062	1070	1124
as % sales	49%	51%	53%		51.5%	50.0%	50.0%	50%	50%	48%	48%
other cost of sales	308	295	263		300	360	381	250	400	400	370
Gross Profit	**534**	**544**	**531**	**540**	**564**	**554**	**629**	**200**	**662**	**759**	**847**
Gross margin	33%	32%	31%	30%	32%	30%	31%	22%	31%	34%	36%
Sales and admin (cash)	116	190	213	90	125	154	147	120	150	170	150
D&A					451	452	446	446	446	446	446
stock comp					24	16	19	19	19	19	19
Corp overheads			35	45	41	42	42	35	35	35	35
Op profit (before corp overheads)	**418**	**354**	**318**	**299**	**-36**	**-68**	**17**	**-385**	**47**	**124**	**232**
F1 adjusted OIBDA [Gross profit less S&	**478**	**481**	**464**	**450**	**439**	**400**	**482**	**115**	**547**	**624**	**732**
adj OIBDA margin	29%	28%	27%	25%	25%	22%	24%	13%	26%	28%	31%
FWON OIBDA (ie incl 'Corporate' overheads)			**429**	**405**	**398**	**358**	**440**	**80**	**512**	**589**	**697**
clean margin			25%	23%	22%	20%	22%	9%	24%	26%	30%

Source: Holland Advisors

Valuation and conclusion

We guestimate that FWON could generate $533m of true Free Cash Flow by 2023. This assumes a 5% revenue cagr from a $2.1bn starting revenue figure. (NB this level of growth is maybe modest when most race promotion contracts had 5%pa escalators in them, i.e. it assumes little LT growth form any innovation or more races). Some operational gearing is assumed with EBITDA margins rising to 30% by 2023. **That suggests a 13x P/FCF multiple in 2023.** This is far too low for what will then be a global leader in sports rights. Moving that multiple to 25x would give shareholders 76% upside in 3-4years(13%pa). Crucially however this assumption takes no account of the use of cashflow for its most likely accretive purpose, buy backs. A re-levering of the business to only 3x 2023 EBITDA (low by Malone standards) would enable a sizable buy backs accelerating shareholder returns.

Fig.7: Cash generation to drive de-levering and low free cash mulitple

VAL	2013	2014	2015	2016	2017	2018	2019e	2020e	2021e	2022e	2023e
FWON OBIDA			429	405	398	358	440	80	512	589	697
FCF conversion rate		90%	386		358	322	396	72	460	530	627
FWON net debt					2074	4458	5090	1664	1332	910	377
interest rate					5.00%	4.31%	5.00%	5.00%	5.00%	5.00%	5.00%
interest			121		220	192	195	110	89	63	41
tax					31	29	35	7	40	45	53
un taxed Levered FCF			**266**		**138**	**130**	**201**	**-38**	**371**	**467**	**586**
taxed Levered FCF					**107**	**101**	**166**	**-45**	**332**	**422**	**533**
implied rump F1 equity VAL after non-F1 debt [a-b]							**$7,182**				
P/levered FCF (aka PE multiple)			27x		67x	71x	43x	-159x	22x	17x	13x

Assumed F1 2022 PE:	25x	$ 8,296	$ 10,548	$ 13,324
non-F1 listed stakes VAL (2018 VAL)		$ 876	$ 876	$ 876
Total equity valuation		$ 9,172	$ 11,424	$ 14,200
Upside v's FWON VAL (a) today		14%	42%	76%
IRR to 2023 **(BEFORE re-leveraging or buybacks)**				13%

Source: Holland Advisors

In our December 2018 piece this was our conclusion on Formula 1:

> F1 is a rare and unique asset that is being reformed and commercialised under the tutelage of an excellent team of media asset managers. ~~High debt and~~ a tracking stock security are not ideal but we think F1 presents a one-off chance to buy a potentially great global asset that is neither priced for its rarity nor the operational gearing that might one day turn up when an improved product that is run in more commercial manner delivers more scalable and growing revenues operational gearing following closely behind.

Source: ***Holland Views – FWON, Economies of Scale, $31, Dec 2018***

What is interesting in 2020 is that Covid-19 and the destruction it has brought to the leisure businesses has resulted in the removal of our greatest past reservation for FWON, i.e. leverage. All the benefits of a future rationalisation and commercialisation of F1 still remain and the longer-term multiple we are paying for the shares is co-incidentally similar to that when we looked at the opportunity in 2017+2018. But at those points we were faced with a company needing to de-lever itself. Not only is the risk of leverage, and the accidents it can cause, greatly reduced, but its prudent re-use one day could see returns for equity shareholder enhanced long after Covid is a distant memory.

Buy Formula 1

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