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Holland Views: Walt Disney Co. – Price: $92; MCap: $148bn

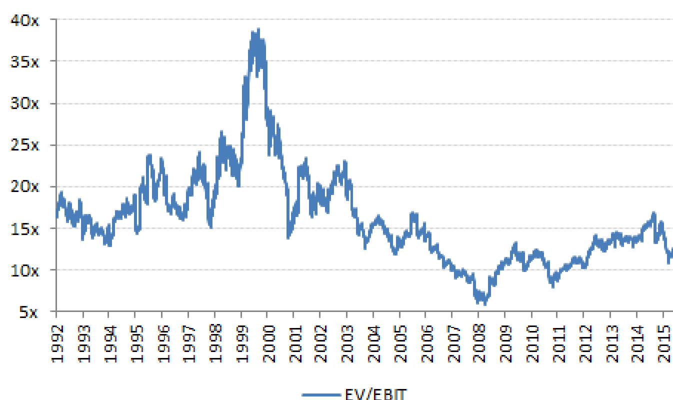
Content King

As the saying goes; 'you can have good news or cheap stocks, but not both". So as we unveil some new Holland research on a well-known global Franchise that looks cheap – be prepared for the negative slant on things by Mr Market. Today, we discuss one of the world's best-known brands[1] a business that generates c.$55bn in revenues, has been compounding profits at c.13% since 2003, is capital-light, and enjoys great returns of c.35%. It has a super track record of monetising its unique portfolio of entertainment content. This is a media company that has, under Michael Iger, transformed itself into a brand company – and it all started with a mouse.

It is our contention that – after a phase of judicious investment under Iger, Disney's medium-term content pipeline is exceptional, as are its operational credentials – both almost as good as it was in Walt Disney's hey-day. We see the next phase for Disney as one where the focus is, inevitably, on distribution. Just as video cassettes transformed the way that Disney monetised its back catalogue, so too, the internet may allow it to move from a wholesale to a direct-to-consumer model, allowing a commensurate improvement in pricing. Could Disney turn out to be one of the few old-school companies to truly benefit from the internet?

> *"The great lesson in microeconomics is to discriminate between when technology is going to help you and when it's going to kill you."* – Charlie Munger

Fig.1: Disney Valuation



Source: Capital IQ

Disney trades on 16x PE (last 12m), 10.5x EV/EBITA – its lowest level in four years (Fig.1). When divisions are looked at separately, given the growth and returns in Studios etc., one could say its core ESPN division is likely trading on closer to 10x PE! So let's get the bearish slant out of the way: Disney's critics contend that current group margins are at a cyclical peak, that the business is a forced serial acquirer and most notably that its cash-cow ESPN division is facing a double-whammy of structural demand decline due to cable TV 'cord-cutting' and rising sports content costs. Finally, the critics point out that Michael Iger – CEO par excellence – is departing in 2018 and so will leave a huge major managerial hole at the top. We have thought about all these arguments and will try to address each of them.

[1] Indeed, Disney is the highest ranking content brand (http://interbrand.com/best-brands/best-global-brands/2015/ranking/)

In short, we think the worries towards ESPN (the largest television sports network in the US) are overdone and we support this view via our work on Sky and WWE. Reminiscent of Sky plc, Disney investors seem to think – incorrectly in our view – that continual paying-up for sports rights monopolies will lead to margin dilution rather than growth and competitive positioning. We go further and suggest the internet might allow Disney to actually increase per-user ESPN prices when it moves away from its current wholesale distribution model (a move which may be gradual or sudden!). In that context, considering the growth, returns and culture, Disney's current group valuation (16x PE) then looks far more interesting for what is still one of the world's greatest brand businesses.

> *"There are actually businesses, that you will find a few times in a lifetime, where any manager could raise the return enormously just by raising prices—and yet they haven't done it. So they have huge untapped pricing power that they're not using. That is the ultimate no-brainer. ... Disney found that it could raise those prices a lot and the attendance stayed right up. So a lot of the great record of Eisner and Wells ... came from just raising prices at Disneyland and Disneyworld and through video cassette sales of classic animated movies"* – Charlie Munger, 'A Lesson on Elementary, Worldly Wisdom As It Relates To Investment Management & Business', 1994

Executive Summary – we think ESPN worries are overdone

Disney is a broad and diverse conglomerate so we had to pick our analytical fights with it, so to speak. ESPN is an obvious area to tackle. Our in-depth work on both WWE and Sky proved very useful in assessing ESPN and thinking-through how the ESPN business might evolve in an OTT ('Over The Top' i.e. direct to consumer via the internet) world. We outline a plausible scenario for ESPN later in the note. Suffice to say that ESPN's huge subscriber base of 90m million subscribers shows that its *wholesale* affiliate revenues per subscriber are incredibly low – only $8 per month by our calculations. For context[2], here in the UK, Sky plc is deriving c.£32 per subscriber per month just for Sky Sports (admittedly this is a retail price). In any shift to sell directly to the consumer via OTT, ESPN (by cutting out the middleman – i.e. the cable operator) has significant scope, we suggest, to raise unit prices sufficient to offset any meaningful fall in subscriber numbers.

It is thus important to remember that Disney is today, largely a wholesale business. Its content is predominantly sold via third-party channels such as movie theatres, cable networks and merchandisers. Of course, the internet is disrupting business models across the board – not least the cable TV companies who are feeling the effects of cord-cutting, Netflix et. al. Our contention is that the internet can at least sustain, not dilute, Disney's ESPN as it inevitably embraces the internet to distribute its content and in the process cut-out the cable middlemen.

As we highlighted above, way back in 1994, Munger highlighted Michael Eisner's record of embracing technology to raise prices at Disney – a point which is surely not lost on Eisner's protégé Iger. It is unconventional thinking to suggest that the same opportunity could present itself to Iger or his successor if Disney embraces a B2C model.

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

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[2] We are fully aware that ESPN is sold wholesale and Sky is sold direct-to-consumer, but the comparison is surely very relevant as it shows the scope of pricing upside were ESPN to shift to a direct sales model.

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