## Holland Views – Disney – Price: $110; Mcap: $164bn

# Margin of Safety

The disclosure[1] this week by Disney of a new divisional breakdown is worth bringing to your attention. It is noteworthy because it breaks out for the first time, Disney's segmental revenues and losses in its new 'Direct-to-Consumer & International' business unit. This is a pivotal business for Disney as the company migrates to an over-the-top distribution strategy ala Netflix.

The unit consists of revenues from the **ESPN+** service which launched last year and costs attributed to the **Disney+** unit (to be launched later this year) and the costs associated with the BAMTech and Hulu units. It also contains some legacy International TV channels profits.

Fig.1: New Disney headline divisional structure

**SUMMARY RECAST FISCAL 2018, 2017 AND 2016 SEGMENT RESULTS**

The following is a summary of segment revenues and operating income for fiscal 2018, 2017 and 2016 presented under the new segment reporting structure:

| | Year Ended | | |
|---|---|---|---|
| (unaudited; in millions) | **Sept. 29, 2018** | Sept. 30, 2017 | Oct. 1, 2016 |
| Revenues: | | | |
| Media Networks | **$ 21,922** | $ 21,299 | $ 21,326 |
| Parks, Experiences & Consumer Products | **24,701** | 23,024 | 22,258 |
| Studio Entertainment | **10,065** | 8,352 | 9,369 |
| Direct-to-Consumer & International | **3,414** | 3,075 | 3,306 |
| Eliminations | **(668)** | (613) | (627) |
| | **$ 59,434** | $ 55,137 | $ 55,632 |
| Segment operating income/(loss): | | | |
| Media Networks | **$ 7,338** | $ 7,196 | $ 7,804 |
| Parks, Experiences & Consumer Products | **6,095** | 5,487 | 5,198 |
| Studio Entertainment | **3,004** | 2,363 | 2,767 |
| Direct-to-Consumer & International | **(738)** | (284) | (38) |
| Eliminations | **(10)** | 13 | (10) |
| | **$ 15,689** | $ 14,775 | $ 15,721 |

**Source: Disney 8-k, January 2019**

In the research we published in November[2] we tried to tackle many of the investors' concerns related to this DTC roll out. We will not regurgitate them all again here (please see our November note re-attached).

The new point worth considering is that **the scale of losses already being incurred by the company (2018 loss of -$738m up from a loss of only -$38m two years earlier) is material**. Whilst this figure is almost certain to grow over the next two years as Disney builds this network-out in scale, we think the fact that current profitability is being dragged by this amount offers a more quantifiable margin of safety versus a the headline PE multiple.

Simply put, Disney is today valued at 16x its 2018 historic earnings, but this multiple falls to c.15x or less if we ex-out the taxed losses associated with this new strategic network investment. (Actually, as shown in the Appendix, the DTC losses are even greater than $738m as this is just the divisional total including international existing operational profits. DTC Losses and those of Bamtech and Hulu were a combined $1.05bn in 2018).

[1] https://www.thewaltdisneycompany.com/disney-provides-financial-information-on-its-direct-to-consumer-and-international-business/

[2] Holland Views – Disney – Game Changer, Nov 2018

This insight, i.e. that historic profit levels are carrying losses is relevant we believe. Without a clear view of what future Disney profitability will look like, investors are taking a 'wait and see' approach to its network plan. Whilst logical, this means that all are thinking the same way.

Our thoughts on valuation have considered the idea from the opposite angle. That is, if the Disney network **is** ultimately a success then future profitability will be higher than today and the PE of the shares higher also to reflect its then dominant position both in direct-to-consumer media as well as Content and Parks. i.e. as shareholders we will do well (how well, we will have to wait to find out but a continuation of past EPS compounding of c.9 to 13% plus a PE re-rating to say 20x could easily result in 15-20% IRRs for today's investor).

This is all plausible. But, just as important is the inverse: what happens in the case that the Network were to fail to be a financial success? This is where we think today's valuation against historical earnings is relevant. In the case of failure, Disney would most likely (eventually) revert to some form of distribution of its content via others Networks (see our original note for greater discussion of this). In such a scenario, future Disney might look a lot like old Disney but with these start-up losses eliminated. As such, the modest starting-valuation of historic earnings is a useful backstop and suggests a good margin of Safety. Ergo:

*"Heads I win, Tails I don't lose too much"* **- anon**

## Global content awaits tipping point

We think Disney an exceptional Franchise business that has many very attractive traits. That the success or otherwise of its transition to direct-to-consumer distribution is unknown is why the shares are offered at the current valuation. When/if the network rollout is a success and subscribers join in large numbers then the final piece of the investor jigsaw will be visible. As a result, the shares will then likely not sit on their current valuation. However, we concede that such investment phases by companies are hard to time for investors and greater investment/losses could well mean the shares stay modestly valued for longer than planned. We have noted before that 'good' companies want to make such transitions really pay off so often they can end up spending more for longer during an investment phase to get exactly the right outcome. This is a combination of factors (more expense for longer) Mr Market rarely encourages or applauds! (Please see an attached 2017 piece on Sports Direct that discussed this exact issue generically).

Having spent a good deal of time recently on the economics of content (See also Formula One piece) we are firmly of the view that global content business if well run and modestly valued are very attractive assets. At the point in time that they start to really monetise themselves in the new online world is when investors will re-appraise their value. We do not know when but we feel that this day will come for Disney (and Formula One) like it has for WWE, and we want to be owners of the share when it does. In the meantime, well we don't think we lose too much.

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

**Contact:**

HollAnd Advisors

Holland Advisors London Limited
2nd Floor Berkeley Square House
London
W1J 6BD

Tel: (0)871 222 5521
Mob: (0)7775 826863
www.hollandadvisors.co.uk

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