THE FINANCIAL PAGE
NOVEMBER 23, 2015 ISSUE

# SELLING THE GOLDEN-EGG GOOSE

**BY JAMES SUROWIECKI**

ILLUSTRATION BY CHRISTOPH NIEMANN

Few things currently spook investors more than the future of media companies. Just a couple of weeks ago, when Time Warner reported disappointing earnings and a gloomy outlook for 2016, its stock fell more than six per cent, and it's now down nearly twenty per cent for the year. The company blamed exchange rates and new investments, but investors saw only the deeper problems for the industry, including, most obviously, the rise of "cord cutting"—people abandoning traditional cable packages for streaming services. Richard Greenfield, a media and tech analyst at BTIG Research, told me, "The way people watch TV really is changing dramatically. And no traditional media company is doing a good job of dealing with it."

But one part of Time Warner is thriving in the new media landscape: HBO. It has more than a hundred and twenty million subscribers globally, and earned close to two billion dollars in profits last year. Its stand-alone streaming service, HBO Now, has attracted a million customers since it launched, last spring. And HBO has invested in a host of other new ventures, too—production deals with Jon Stewart, Issa Rae, and Bill Simmons, a news division, and so on. In a clear sign that it wants to be a bigger player in the streaming market, where children's content is crucial, it has acquired the rights to stream "Sesame Street." HBO has arguably never been more valuable. And that, oddly, makes this the perfect moment for Time Warner to let it go—to spin it off as a separate company in an I.P.O.

If HBO is doing so well, why get rid of it? One answer is that HBO would be far more valuable in the eyes of investors as a separate company. Big, diversified companies suffer from the so-called "conglomerate discount." The whole is worth less than the sum of its parts, because investors have trouble valuing corporate divisions and get worried about how the parts of a company interact. As Emilie Feldman, an assistant professor of management at Wharton and an expert on divestitures, puts it, "Spinning off a company allows the market to see it more clearly and value it more accurately." This is especially true when, as at Time Warner, different parts of a company have radically different business models and growth trajectories. HBO looks set to thrive in a cord-cutting world; Time Warner's cable networks are more likely to struggle. That brings down Time Warner's over-all price-to-earnings ratio (currently around sixteen). If HBO were trading on its own, that ratio would likely be much higher, which means that investors would be putting a higher value on every dollar HBO made.

Spinning off HBO would also have benefits for the day-to-day running of the company. It would be easier to tie people's pay directly to the company's performance: instead of Time Warner stock options (whose value depends on a lot of things other than HBO), employees would get HBO options. A study by Feldman found that spinoffs aligned managerial compensation and stock-market performance, and other studies have found that spinoffs also typically improve the way resources are allocated at the new company.

The idea of an HBO spinoff has been floated before, but Time Warner's C.E.O., Jeff Bewkes, has always resisted. That's no surprise. Selling off the crown jewels is never easy for an executive to contemplate. In a business as volatile as the media, giving up a cushion of steady earnings growth takes courage. And, even if you keep shares in the company you've spun off, it's hard not to fear you'll miss out if the I.P.O. turns out to be a real blockbuster. More fundamental, Time Warner without HBO would be a less interesting, less buzzy company. Running the company that owns Warner Bros. and the Turner networks wouldn't be quite the same as running the company that makes "Game of Thrones."

Still, the cost of failing to take advantage of HBO's buoyancy could be high, since on top of everything else a spinoff would be a good hedge against risk. Not that long ago, there were calls for Disney to spin off ESPN, which at the height of its power was valued at around fifty billion dollars. Disney didn't. And, while ESPN is still a dominant player in cable and reported solid numbers last week, it's clearly suffering from the effects of cord cutting and the rising cost of sports rights. In August, anxieties about its slowing growth provoked a meltdown in media stocks. ESPN is going to be tremendously profitable for years to come, but it's hard to argue that Disney wouldn't have been better off banking fifty billion dollars in 2014.

Spinoffs don't always make sense. If there were real synergies between HBO and the rest of Time Warner, the case for keeping it in-house would be stronger. But those synergies are hard to find: it's very telling that HBO's news venture is a partnership with Vice rather than with the Time Warner-owned CNN. If HBO were an independent company today, would anyone think that being bought by Time Warner would increase its value? To ask the question is to answer it. This is an era of radical uncertainty in the media business. But Time Warner can be very certain about one thing: in HBO, it has an asset that's worth close to thirty billion dollars in a spinoff. Time to cut that cord. ♦