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Peak superhero

The telltale symptom of Netflix Envy, a contagious corporate virus, is the urge to borrow money to invest in streaming media. Fellow-sufferers AT&T, Inc. and Disney Co. form the focus of this analytical reprise (see *Grant's*, Nov. 30 and April 6). To anticipate, we're bearish on AT&T's long-dated debt and on Disney across the capital structure. Creative destruction costs money, as the holders of low-yielding debt in heavily encumbered businesses may presently be reminded.

For many an investor, the trusty dividend is AT&T's winningest feature. The shares pay 7%, compared to 4.3% for Verizon, yet Telephone has delivered a negative 17.5% total return over the past two years. Compare and contrast the 20.6% gain for the S&P 500 or the 18.7% gain for Verizon. Ferocious competition to fill the finite hours which a worldwide audience can devote to watching a glowing screen explains part of this disappointment. Debt accounts for another part. Is the stock market discounting a cut in the dividend to protect the company's barely investment-grade credit ratings (Baa2/triple-B)? To judge by the relatively tight spreads at which Telephone debt changes hands, the bond market is so hoping.

On Sept. 30 AT&T's total debt, including operating leases and unfunded pension and post-retirement liabilities, tallied about $237 billion, or four times adjusted EBITDA, up from $178 billion two years ago. In absolute size it eclipses the indebtedness of any other nonfinancial, investor-owned business in the world and tops the encumbrance of Portugal ($217 billion). Almost half of the $26 billion in free cash flow that Telephone management anticipates this year is earmarked for dividends.

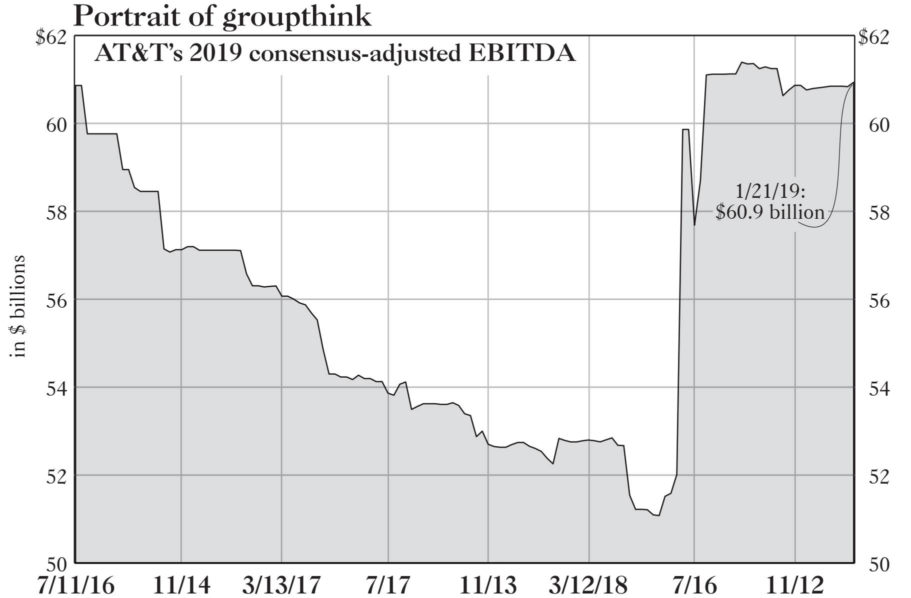
On Nov. 29 AT&T unveiled its strategy to launch a video-streaming service in the fourth quarter of 2019, a three-tiered affair to be made available in parallel with its existing HBO product. Is it confidence-building to repeat the word "confidence"? Management, which said it once, then twice, then 14 times, must think so. Still, the C-suite equivocated on the critical strategic question of whether to keep its own content or license the programming to third-party platforms like Netflix.

AT&T has pledged to lower debt, and it's paying it down by 5% a year. As deleveraging goes, it's a pace no faster than that set by the average high-yield borrower. The dividend may well be chopped, although as GE demonstrated, the first reduction may only whet expectations for the second.

There's risk in bonds, too. If $4\frac{1}{2}$s of 2048 traded 200 basis points wider, to 420 basis points over Treasurys, to yield 7.3%, their price would fall by 25%, erasing more than five years of income. As a reference, long-dated, high-yield bonds are spread at an average of 480 basis points over governments.

"Verizon Communications, Inc., which owes $167 billion, including operating leases and unfunded pension liabilities, or 3.4 times 2018 expected adjusted EBITDA, makes an interest-

Portrait of groupthink



source: Refinitiv

ing comparison," colleague Fabiano Santin relates. "Verizon has a small media presence, but it's a big dividend payer; it expects to allocate $10 billion of its $18 billion in free cash flow to the stockholders. Some 90% of Verizon's EBITDA is exposed to wireless, a still relatively healthy business, compared to 48% for AT&T. Verizon's network superiority, reflected in a lower churn rate (14.6% vs. 16.3%, based on last quarter's annualized rates) and higher wireless EBITDA margin (67% versus 53%), isn't debatable. Besides, AT&T is disadvantaged by the freefall of DirecTV, by the costly work of integrating Time Warner and by the demands for investment in its direct-to-consumer video platform.

"An enterprising investor might thus consider going long Verizon's 5.012s of 2049 and shorting AT&T's 4½s of 2048 for an annual cost of only 40 basis points," Santin goes on. "If the spread between the two converged, our investor would face a loss of 6%. If it widened by the afore-hypothesized 200 basis points, our investor would gain over four times more—so 6% down, 25% up, a not-unattractive risk-reward proposition."

Parenthetically, AT&T's 10-year notes yield 4.3%, or 155 basis points over Treasurys. Netflix's 10-year notes yield 6%, or 328 basis points over Treasurys. Thus, creditors judge Netflix to be twice as risky as AT&T. However, equity holders happily pay 48 times 2019 EBITDA for Netflix's enterprise value, though just seven times AT&T's. A fruitful topic for academic research.

On now to Disney, which ended fiscal year 2018 (on Sept. 29) with $65 billion of net debt, after giving effect to the immense Twenty-First Century Fox, Inc. acquisition. The purchase includes Fox's regional sports networks, which Disney hopes to sell for nearly $20 billion to satisfy the Department of Justice's anti-trust demands and thereby reduce the $48 billion debt required to close the transaction. Such would be a blessing to creditors, though bidders are scarce and Disney may end up spinning off the sports networks to shareholders instead. If so, deleveraging would be pushed into the future, and Disney would operate at 3.2 times adjusted EBITDA, up from 0.9 times before the acquisition.

Aug. 4, 2015 marks an epoch-making moment in the history of this great American enterprise. It was on that date, in the course of an otherwise cheerful quarterly earnings call (Disney had beaten estimates for the 11th period in a row) that CEO Bob Iger warned dialers-in of "some modest" subscriber losses at ESPN.

The stock, which had been trading at 21 times forward earnings, plunged by 9.2% the following day and has lagged the market ever since, producing a total return of minus 4.2%, vs. 35.1% for the S&P 500 and 5% for the media and entertainment subgroup of the S&P.

Though the Disney valuation magic is gone, the shares still command a 15½-times forward multiple, marginally higher than the S&P 500 and more than twice the multiples of such media peers as Viacom, Inc. (6.0 times), CBS Corp. (7.6), AMC Networks, Inc. (6.4), or Discovery, Inc. (7.2). A sign of the market's complacency is the short interest in the common, or lack thereof: at 1.8% of the float, it's lower than the 2.2% average of the past five years and the 4.1% high registered in the Iger-shock year of 2015.

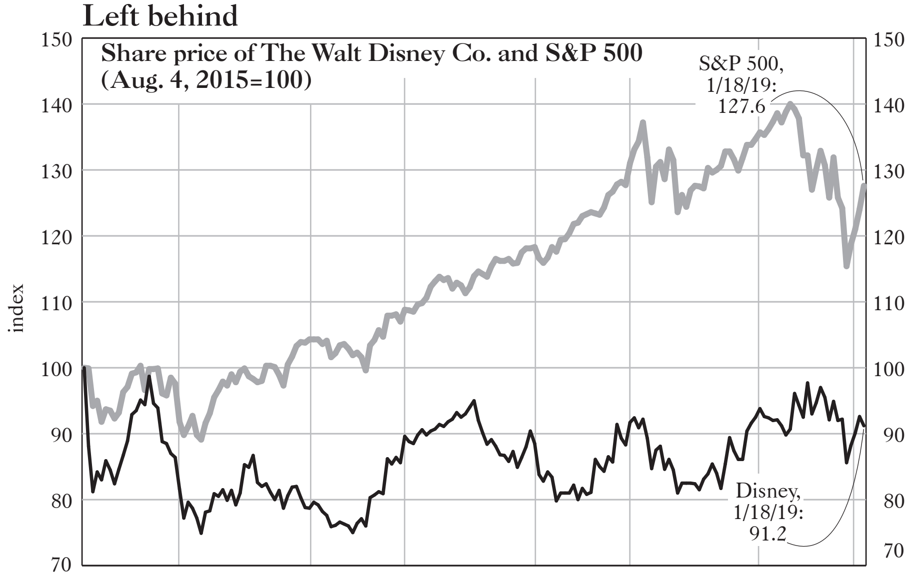
The Disney bulls eagerly anticipate the monetization of one of the world's richest troves of what the world today calls "content," including the rights to such billion-dollar franchises as Lucasfilm's *Star Wars* and Marvel's *X-Men*. In the day, Disney would produce its blockbuster movie, rake in the box office receipts and license it to cable, satellite and video subscription services like Hulu and Netflix. But the world is changing, and Disney's M.O. is changing with it. On the way out are third-party platforms; on the way in is the in-house video streaming service dubbed Disney+. Such is the vision of the future.

For now, though, Disney will keep its 60%-owned Hulu, in which Comcast and AT&T own 30% and 10%, respectively. Hulu, known for (among other hits) *The Handmaid's Tale*, boasted 25 million subscribers at the end of 2018, up from 17 million a year earlier. But it was costly growth, as losses climbed to $2.3 billion in fiscal 2018 from $270 million in 2015, the receipt of $1.5 billion in advertising income notwithstanding. Pro forma the Fox acquisition, the stake will be valued on Disney's balance sheet at $6 billion.

Wall Street analysts have proved no more prophetic about Disney than they have about Telephone. In September 2015, the month following the Iger candor shock, the forecasting consensus projected 2018 operating income at $18 billion, which proved $3 billion too high on account of the very weakness at ESPN to which the CEO had just alluded.

"Disney," Santin notes, "has turned the narrative to what's working, for instance, last year's $7.3 billion in worldwide box-office sales, behind only its previous $7.6 billion record in 2016. Driving up results were superhero

Left behind



source: The Bloomberg

movies such as *Black Panther*, *Avengers: Infinity War*, and *Incredibles 2*. They even overshadowed the *Star Wars* saga, which has saturated the market with three new movies since 2016 and one more to debut later this year. Disney's studio segment generated $2.9 billion in operating income, its best result ever, up 27% year-over-year."

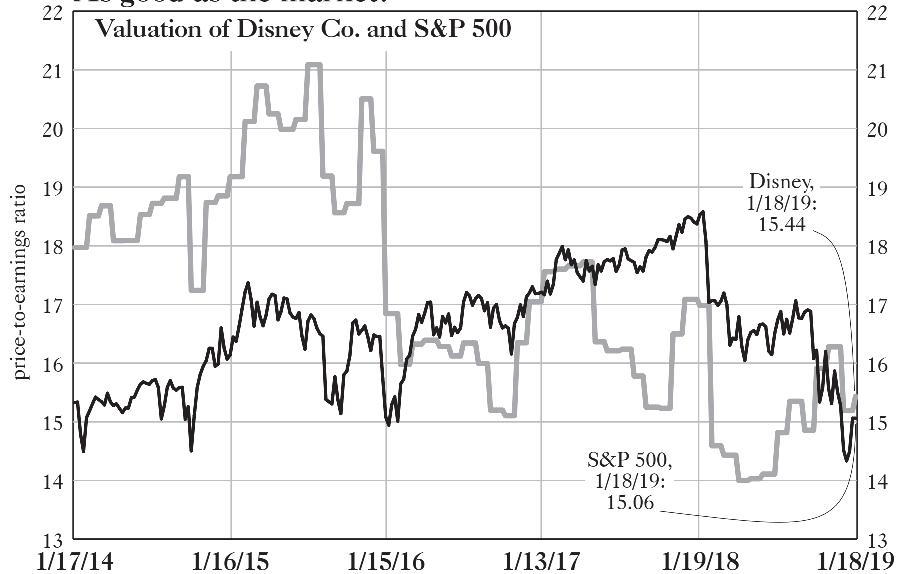
Brian Wieser, senior analyst at Pivotal Research, is a lonely Disney bear, but a respectful one. "If you were to bet on which of the videocentric companies will be around in 10 to 20 years, you've got a very good chance of imagining Disney more likely to be there than the others," he tells Santin. "But the problem is that if everyone is paying up for that, then the stock becomes overvalued and then the others look relatively cheap by comparison."

Then, too, film production makes up only 19% of Disney's 2018 operating income (the cyclical and capital-intensive Parks and Resorts segment chips in 28%). Besides, the peak-superhero moment is conceivably at hand. It was only two decades ago that Marvel Entertainment, escaping from bankruptcy, offered Sony nearly every hero in its comic-book Valhalla—Iron Man, Thor, Ant-Man, Black Panther and others—for the grand total of $25 million. Sony passed on the offer. Perhaps it was management incompetence, or maybe just a different cycle. (More than 100 years passed after its 1605 debut before the original version of Shakespeare's *Merchant of Venice* was again performed in London, in 1741. If there's a cycle in the Bard, there's a cycle in everything.) In a 2010 sale, Marvel fetched $4 billion; Disney was the buyer.

Iger has kept his gift for plain speaking. In response to a question about the riskiness of the new video subscription initiative during a year-end interview in *Barron's*, the Disney chief had this to say: "Not doing anything, really, creates more uncertainty than this. I can imagine other companies in other industries in similar positions in the past 50 years. Eastman Kodak watching the advent of digital photography probably comes to mind the most."

It's not the analogy that comes first to the lips of most CEOs. "We're looking for Wall Street to show some patience while we prove [the direct-to-consumer strategy] out," Iger continued. "While I won't say [that Wall Street is] cheering us on, they're definitely giving us the room to prove that we can do it."

As good as the market?



source: Refinitiv

"Wall Street" is, of course, a big tent, under which many different voices and views may flourish. One of these voices belongs to the independent Craig Moffett, co-founder and one-half of the eponymous research firm MoffettNathanson. In September congressional testimony, Moffett had this to say:

> What we are witnessing with the emergence of Closed Media is the re-allocation, and re-concentration, of risk. When Comcast and others euphemistically refer to "global scale," what they are really saying is that, in the future, massive scale will be required in order to underwrite the enormous risk of abject failure. Content production has always been a risky business; investors intuitively understand that hits are rare and failures frequent. In response, the media industry has become rather adept at syndicating risk. But the risks that are inherent in content productions are dramatically amplified in the context of Closed Media (that is, the edifice built upon the content production "engine" is orders of magnitude larger, and, by virtue of being direct-to-consumer rather than pre-sold to others, volatility will only rise.) All this makes the risks of failure dramatically higher.

In 2015, Iger's truth-telling badly rattled the market. Not so in 2018-19, as the Disney share price has mostly fluctuated with the market. Fifteen sell-side analysts call the stock a buy, eight as a hold and only one—the afore-quoted Wieser—as a sell. Insiders, though, including Iger, seem curiously impatient, having dumped $92 million worth of stock in the last 12 months. A not unimaginable re-rating to 10 times earnings would take the DIS share price down by nearly 40%.

Wall Street's patience is manifest on the credit side of the capital structure, too. The Disney 4⅛s of 2044 ($1 billion outstanding; A2/single-A-plus) trade at par to yield 4.1% to maturity, or 107 basis points over Treasurys. If the credit spread widened 200 basis points, the bond price would tumble to 86 cents, erasing more than three years of income.

Mr. Market never explains, but the poor share-price performance of AT&T and Disney may reflect past results rather than discount future difficulties—in AT&T's case, perhaps, regret over the 2014 DirecTV acquisition and competition in its wireless and wireline business; in Disney's case, fear of ESPN. "Give each company credit for identifying the problems of legacy assets," Santin comments, "but debit each for the leverage they took aboard to acquire studios with rights to squadrons of superhero characters under the premise that the old heroes will serve as a kind of commercial kryptonite against Netflix, Amazon, and others producing more content than people have time to watch.

"Perhaps," Santin closes, "this video frenzy will turn out to be just another ZIRP-driven, post-2008 bubble in profitless businesses. Disney paid 12 times EBITDA for Fox, AT&T paid 13.9 times EBITDA for Time Warner, even as currently listed media stocks trade for 7 to 8 times EBITDA. At current credit spreads and equity valuations DIS and T alike seem to be capitalized for stability. Disruption seems a better bet. In which case, giants will fall."

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