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Change the channel

Evan Lorenz writes:

Hollywood itself is fast becoming a kind of slasher movie. Highly profitable legacy television is in secular decline while online streaming continues to gush red ink. Balance sheets bulge with the debt that financed now-questionable acquisitions done in the twilight of the zero-rate era. In preview, *Grant's* is bearish on Paramount Global (PARA on the Nasdaq). We'd be reciprocally bullish on Warner Bros. Discovery, Inc. (WBD, also on Nasdaq), except for the flyaway price of its shares.

The age before digital streaming was a socialist paradise for the media companies that secured a place in the TV bundle. Cable companies like Comcast Corp. handled the marketing, delivery and other costs required to bring channels like Disney and Comedy Central to households nationwide. While media companies jockeyed to snag the biggest increase in broadcast fees, all channels on the dial benefited from annual price jumps.

Of course, the consumer paid. If you wanted to watch HBO but had no interest in sports, there was no à la carte way to pay for the premium entertainment channel without also buying ESPN. As a result, households that favored general entertainment subsidized sports fanatics and the high prices that sports leagues command for broadcast rights.

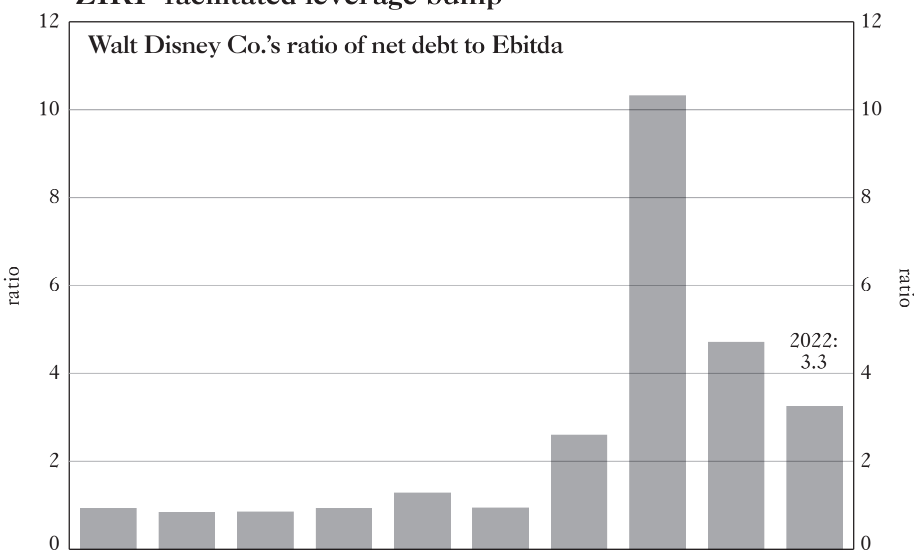
Netflix, Inc. upset this happy story in 2007 with the rollout of its streaming services. Now consumers had the option to watch shows and movies wherever and whenever they wanted at substantially lower prices. Today, Netflix's basic ad-free subscription starts at $9.99 per month versus a national average of $83 for cable TV.

As a result, consumers are cutting the cable cord. Today, around 78 million U.S. households, or 61% of the total, still pay for a cable TV bundle, down from around 100 million homes in 2011, or 85% of the total. The proportion of households watching prime time, or "linear," television is the lowest since 1993, the year before the arrival of satellite TV in America, MoffettNathanson, LLC reports. And the pace of cord-cutting accelerated to an all-time high of 6.2% of subscribers in the third quarter of last year from 6.1%, 5.1% and 4.9% in the three preceding quarters.

Taking the measure of those facts, as well as Netflix's nosebleed multiple during the everything bubble, old-guard media companies made aggressive plans for their own streaming channels. To entice would-be viewers, Walt Disney Co., Warner Bros. and peers ramped up spending to offer exclusive new content online. "The movie studios today are essentially licensing all their content to their own internal streaming services," Naveen Sarma, a senior director at S&P Global Ratings, tells me. "So the licensing and syndication revenues they used to get—that's all gone."

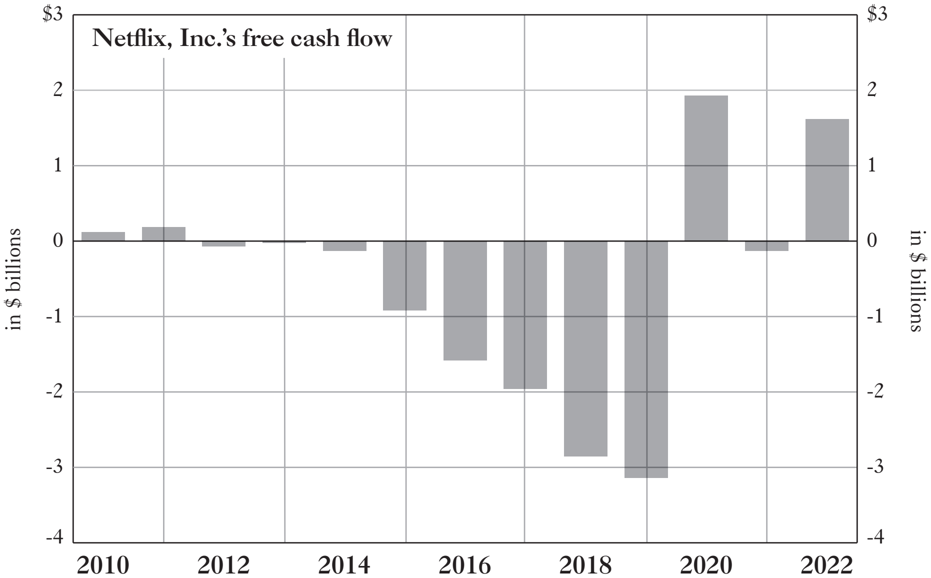
As a result, hit new shows like Disney's "The Mandalorian" are unavailable on cable. "For the first time in pay-TV's history, it got worse, and that's important," Matthew Ball, CEO of venture capital firm Epyllion Co. and a for-

ZIRP-facilitated leverage bump



source: The Bloomberg

In the catbird seat



source: The Bloomberg

mer head of strategy at Amazon Studios, told the tech website Stratechery last month. "The price kept going up…but for the first time content started getting harvested out" in favor of streaming channels.

Live sports and news are the lifeblood of cable, but even this content has begun to leak into streaming. Paramount airs NFL broadcasts on its Paramount+ channel and Comcast's NBCUniversal unit does that and more (e.g., NHL and the U.S. Open golf championship) on Peacock. Amazon.com, Inc. and Alphabet, Inc. (the parent company of YouTube) have paid billions for the NFL's Thursday and Sunday night broadcast rights. Last week, Madison Square Garden Sports Corp. announced it would launch its own streaming sports channel this summer.

However, only Netflix generates profits and positive free cash flow from streaming. In attempting to compete with the streaming kingpin, media companies spend on duplicative technology, marketing and general and administrative expenses that the cable operators previously covered. Add declining earnings from linear TV and a cyclically wobbly advertising market, and the current crop of weak earnings holds few surprises.

Nor do we forget the long-tailed consequences of the ZIRP-facilitated acquisition binge. Disney's 2019 purchase of 21st-Century Fox, Inc. for $71.3 billion, for example, has increased the Magic Kingdom's ratio of net debt to Ebitda to 3.3 times last year from 1 time in 2018.

This leaves Ba1/triple-B-rated Netflix up in the catbird seat. "[W]e're competing from a position of strength, as we lead the industry in terms of engagement, revenue and streaming profit," the company boasted in its fourth-quarter press release. "As a pure-play streaming company, we're also not anchored to shrinking legacy business models." Neither junk nor investment-grade but a bit of both, Netflix on Dec. 31, showed net debt of $8.3 billion, a sum equal to 1.4 times trailing Ebitda, while operating income covered interest expense by 8 times in 2022.

However, in the media business, earnings are lower and leverage is higher than they first appear. Ebitda is supposed to be a proxy for cash flows. But cash flows bear little resemblance to Ebitda, because cash outlays typically exceed the costs expensed for accounting purposes. Timing is one problem. Companies amortize the costs of content spending over many years, but new shows and movies seem to provide only a temporary uplift to online subscriber growth. Last year, Netflix amortized $14 billion of content outlays but spent $16.8 billion on shows and movies. Even so, the streamer generated more free cash flow than Disney ($1.6 billion versus $106 million) with less than half of the revenue.

Rising interest rates and a bear market in equity prices have a way of sharpening attention on the bottom line. In their fourth-quarter earnings calls, CEOs across the industry promised that losses for their streaming efforts either peaked last year or would decline after 2023. To make good on those prophecies, the companies are raising prices, cutting spending on content and slashing general and administrative expenses. They're pivoting on their content strategies, too: In the cause of boosting profits at in-house production studios, they're licensing shows and movies to competitors rather than holding them exclusively on their own platforms.

Except for Netflix, media companies need more subscribers in order to generate profits from their streaming efforts. However, according to an October report by data-analytics firm Kantar Group, the U.S. market is already saturated, with 87% of all households streaming content and the average family subscribing to 5.2 channels. It is unclear what will drive growth as consumers confront the new reality of higher prices for lower-grade content.

Dependence on the profits from linear TV makes the media companies especially sensitive to a potential recession, leading, as a slump would, to more cord-cutting, more churn in digital subscriptions and less ad revenues. On the advertising side, there's an additional wrinkle: In order to offer lower prices to consumers, streamers like Netflix and Disney are pushing ad-supported streaming tiers. As the volume of advertising goes up, the price that advertisers pay may go down.

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Each in its own way, Warner Bros. Discovery and Paramount Global underscore the opportunities and risks in media today. Both companies are offspring of mega-mergers: the 2022 tie-up of AT&T, Inc.'s WarnerMedia subsidiary and Discovery, Inc. in the case of Warner Bros.; and the 2019 combination of Viacom, Inc. and CBS Corp. in the case of Paramount. Warner and Paramount are both leveraged, with Warner's year-end net debt equal to 4 times consensus 2023 Ebitda and Paramount's to 5 times.

Those ratios fit a speculative-grade profile, and, indeed, Mr. Market has so designated both Warner and Paramount. Thus, the Warner senior unsecured 4.279s of 2032 trade at $86.87 to yield 6.2%, or 223 basis points over Treasurys. The Paramount senior unsecured 4.2s of 2032 are priced at $82.51 to yield 6.8%, or 282 basis points over Treasurys. Such spreads are closer to double-B-rated bonds (261 basis points) than to what is on offer from triple-B-rated issues (154 basis points). For the record, the rating agencies appraise each company as weak investment-grade.

Warner Bros. divides its operations into three units. Studios ($2.7 billion in adjusted Ebitda last year) encompasses Warner Bros. Pictures, New Line Cinema, Warner Animation Group and the DC Comics movie business as well as the video-game group. Networks ($10.1 billion) spans the gamut from basic cable channels such as TNT, TBS and the Cartoon Network to lifestyle channels like HGTV and the Food Network. Direct-to-consumer (negative $2.1 billion) encompasses streaming channels HBO Max and discovery+, which Warner expects to combine into a single service later this year.

Like many another media business, Warner has its work cut out for it. In the fourth quarter, measured year over year, pro forma for the merger and adjusted for currency movements, revenue declined by 9% and adjusted Ebitda by 2%. A drop in theatrical releases, a dip in cable TV fees and a slump in advertising revenue also took their toll.

About to take its toll now is the expiration of Warner's broadcast rights to NBA games after the 2024–25 season. Such rights drive Warner's TBS, TNT and Turner broadcast sports channels, which punch above their weight in terms of WBD's overall profitability. (In 2021, WarnerMedia accounted for 79% of the combined Warner and Discovery top line, and WarnerMedia's basic TV networks contributed 49% of the business unit's total gross profit.) Apple, Inc., Alphabet and NBC (which is owned by Comcast Corp.) are all reportedly interested in bidding for the NBA rights.

Such difficulties aside, there's a bull case for the company. For one thing, management is targeting $4 billion in merger-related cost savings through 2024. It delivered $1 billion of those savings last year and expects to eke out an additional $2 billion this year through a combination of rationalizing content spending, licensing content to third parties and cutting redundant workers and departments. "We're coming from an irrational time of overspending with very limited focus

Nothing wrong but the price

source: The Bloomberg

on return on investment," CFO Gunnar Wiedenfels told a Jan. 5 Citigroup conference. "I think others are going to have to make some adjustments that we frankly have behind us now."

Warner's balance sheet is the beneficiary. "I see net leverage very comfortably inside of 4-times by the end of 2023 and…within our gross leverage target of 2.5-times to 3-times by the end of 2024," Wiedenfels predicted on the Feb. 23 earnings call. In 2022, the company paid down $7 billion in debt.

Declining leverage and a self-help story make the Warner Bros. common stock an interesting option on traditional media. There is no guarantee that the company will succeed in its efforts, but with WBD priced to a 13.6% free-cash-flow yield based on 2023 estimates and an 18.6% yield based on the 2024 guesstimate, an investor would be paid handsomely if it does. Better, of course, the 21.3% free-cash-flow yield entry point on that gamble (based on 2023 estimates) at which WBD shares traded at the start of the year.

Another element in the story is that Warner Bros. may play a key role in future consolidation. As it is, the world supports more than 200 streaming services. This is not only confusing for the consumer but costly to everyone, given the substantial amount of duplicative costs. The solution is for current streamers to pool resources, thus re-creating the cable TV bundle on a smaller scale, or for the industry to consolidate through a series of mergers.

"Importantly, Warner does not own a broadcast network (Fox, ABC, NBC or CBS)," a fact that would hinder tie-ups with other media companies, Craig Inman, a managing director at Artisan Partners, L.P., which is long the stock, tells me. "They can merge with NBC. They can merge with Paramount [which owns CBS]. They can do a lot of different deals that bring more scale and rationalization to the industry."

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Like Warner Bros, Paramount divides its business into a TV unit ($5.5 billion in adjusted Ebitda last year), a movie division ($272 million) and streaming operations (a deficit of $1.8 billion). The network division includes the broadcast channel CBS in addition to cable channels, such as MTV, Showtime, Nickelodeon and BET. The movie studios include eponymous Paramount Pictures as well as Nickelodeon Studio and Miramax. Paramount has multiple streaming channels, including Pluto TV, Paramount+, BET+, Showtime and Noggin.

In contrast to WBD, Paramount reported a strong fourth quarter—at least at the headline level. Revenues grew by 2% year over year and adjusted Ebitda by 10%. In the final three months of the year, the company added a record 9.9 million subscribers to its Paramount+ streaming platform, bringing total subscriptions to 56 million.

However, the good news ended on the profit-and-loss statement. For the full year, Paramount posted a free-cash-flow deficit of $500 million, excluding discontinued operations.

Unlike WBD, Paramount is ramping up spending to accelerate its push into streaming. While CEO Robert Bakish says that 2023 will be the year of "peak investment," he's mum on the strategy by which, or timetable on which, the direct-to-consumer unit might reach profitability. In its projection of rising direct-to-consumer losses in 2023, by the way, Paramount stands alone.

Alphabet's YouTube subsidiary presents another headache. According to a Jan. 13 report in *The Wall Street Journal*, YouTube is testing a new free, ad-supported TV streaming channel—FAST, in industry jargon—to compete with Paramount's own successful FAST offering, Pluto TV. This makes sense from a strategic point of view: YouTube counts more than 2.5 billion monthly users on its site, and Alphabet is paying $2 billion per year for the rights to broadcast Sunday NFL games. If YouTube can convert even a small portion of its viewers to its FAST channel, then Pluto, which late last year counted 79 million viewers of its own, might feel the pinch.

"In addition," a Feb. 16 MoffettNathanson report notes, "we believe Paramount's leakage of premium content such as the NFL to Paramount+ weakens the company's hand as it enters affiliate renewals, further weighing on future growth." As a reminder, the TV division accounts for the vast majority of Paramount's profits.

On the Feb. 16 Paramount earnings call, CFO Naveen Chopra acknowledged the likelihood of a free cash-flow deficit in 2023 larger than last year's negative $500 million. That anticipated drainage notwithstanding, Paramount pays a dividend equal to 4.5% of the current stock price. It's an income stream that's important to Redstone family-controlled National Amusements, Inc., which holds 9.8% of Paramount shares outstanding but controls 77.4% of the vote. Important or not, the payment will either need to be funded through asset sales or by the assumption of additional debt. As to the former, Reuters reported last month that Paramount's Simon & Schuster book division is for sale again after a federal judge at the end of October blocked Penguin Random House's proposed $2.2 billion acquisition of S&S on the grounds that the deal would reduce competition.

The Street is more negative on Paramount (13 of the 28 analysts covering the stock say sell, and short interest foots to 17.2% of the float) than on WBD (only one of the 27 analysts on the case says sell, and short interest is just 3% of the float). However, Paramount trades at fully 10.7 times enterprise value to consensus 2023 Ebitda. This is not only premium to Warner (7.4 times), it is also rich compared to tech giant Alphabet (9.5 times). Time to change the channel, we judge.

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