The Walt Disney Company. (NYSE:DIS)

Recommend to add to 5%| PT: $110.97

September 9, 2023

CIMG Investment Research

Investment Thesis

Disney's parks business creates a margin of safety and is currently being overlooked by the market: Disney's parks and experiences are the key financial contributor of the business and are undervalued by the market. The parks and experiences segment provided over 65% of the company's operating income for the last year, and we project that it will continue to be the main source of free cash flow for the foreseeable future. At its core, Disney's way of making money is through creating IPs that is broadcasted to viewers through their linear and direct-to-consumer channels and then are monetized through the parks and experiences. This strategy has continued to perform well, even through changing economic environments, with yearly EBIT consistently increasing each year since 2008 (excluding the downturn from Covid). The parks and experiences segment has continued to improve in recent years with EBIT per visitor rising from $210 in 2019 to over $300 today. Disney has achieved this through increased demand raising ticket prices, the rollout of the Genie+ fast pass system, and a revamped merchandise strategy. While this level of domestic consumer spending is unlikely to continue, Disney has International strength and a growing cruise capacity to support the parks business over the next 12-18 months. We believe that the parks business provides Disney with a significant margin of safety. This business has the ability to provide significant levels of free cash flow to the business, nearly $5bn in 2019 and $7bn in 2022, to subsidize the struggling media business. From a valuation perspective, using a 12x multiple, our 2025 EBITDA estimate would support 80% of Disney's current valuation while the market's more ambitious estimate supports 85%. Viewing the rest of Disney's business with this in mind, we believe there is an asymmetric risk-reward with the media assets significantly undervalued.

Disney's media assets are being ascribed little long-term value however we see multiple avenues for growth: Disney Media is under-earning significantly compared to its competitors, with an EBITDA margin of only 7% compared to Netflix's 20% and WBD's 26% in 2023E. Despite the struggles, we believe that there is a clear road to profitability for Disney's DTC offerings now that management has shifted its strategy to prioritize profits. The first lever for achieving DTC profitability is raising prices and increasing the delta between the premium and ad-based tiers. We see advertising as an ARPU driver and believe that Disney prices these services to where they are agnostic to which service consumers choose. This difference has recently been increased from $3 to $6 for Disney+. We believe that in the long run Disney will be able to create a pricing difference similar to hulu's $10 difference, which has a more established advertising tier that has been around for over a decade. The lower-priced ad-based tier will also give price-sensitive consumers an option to stay with the platform and will lead to reduced churn from the price increases. Disney is also launching an ad supported tier in Europe this year that should help them continue to scale this part of the business. Cracking down on password sharing in 2024 will help to cut down on the 36% of users who currently share passwords. We view this as a positive now that Netflix has shown how cracking down on password sharing can help increase subscribers and operating income (Netflix's operating income went from decreasing 12% to increasing 15% the quarter after their attempts to stop password sharing). We view Hulu as a short term downside due to the minimum $9.2bn purchase price but ultimately see it helping Disney's streaming ambitions in the long run. When bundled together, Hulu and Disney have achieved the lowest churn in streaming due to Hulu's significantly larger content and their different targeted audiences. When combined with a potential OTT ESPN service we see the first truly full bundle that could be an entertainment solution for households.

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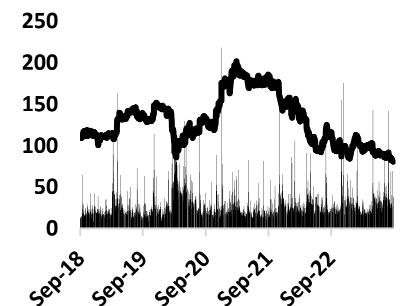
Figure 1: DIS 2 Year Stock Chart



Price	$81.58
PT	$111.24
Dividend Yield	0%
Upside	36%
52-Week Range	$79.75-119.18
Mkt Cap	$149.3b
NTM P/E	21.6x
NTM Prices/Sales	2.5x
NTM EV/EBITDA	13.2x
TTM Revenue	$87.8b

Short term noise has created an overly pessimistic view on Disney's ability to create value: Over the past five years, the market is up over 50% while Disney is down nearly 25%. While this performance has been warranted, there is now far too much pessimism priced into Disney's valuation. One area we see this is the linear networks portion of the business. From our valuation the market seems to be pricing in little to no long term value to this segment. The cable bundle has become the sports and news bundle with last year's most watched channels being Fox News, ESPN, and MSNBC. The cable bundle has also become increasingly focused on older audiences with 65% of linear tv being consumed by people older than 55. These are consumers that are typically wealthier than the average American household and are willing to pay rate hikes as they are unwilling or unable to navigate multiple streaming services. This segment will also be the largest beneficiary of the $5.5bn cost reduction that when announced, Disney received no credit for.

It's also important to note that most of Disney's issues are self-inflicted. Chapek led the growth at all cost streaming strategy that would ultimately lead to the company losing $1.5bn in just one quarter. Disney's content has also suffered significantly over the past couple of years with a noticeable drop-off in quality. We believe this is largely a result of Chapek choosing to take financial control away from creative heads, like Kevin Feige, who with full control in the past have created excellent films. The company also over-hired which led to the previously mentioned $5.5bn cost reduction. These challenges have created the inflection point of Iger's return. The company is now focused on improving Disney's content, reducing costs in the media business, and turning DTC profitable. While this restructuring will take time, we believe that the market is not looking through this transition, instead focusing on headwinds, ESPN OTT and the Charter dispute, that we believe Disney can work through. Throughout this transition the challenged media assets will be supported by the parks business which generated nearly $7bn in FCF last year.

Company Overview

Disney was created in 1923 and through a series of mergers has become the most accomplished production studio with the best intellectual property collection in the world. Today the company consists of two segments, the parks business, Disney parks, experiences, and products, as well as the media business, Disney media and entertainment distribution. Within DMED the company owns linear networks including ABC, Disney Channel, ESPN, and Fx. This segment also has a 50% equity investment in A+E which owns A&E, History, and Lifetime. The direct-to-consumer segment of DMED consists of Disney's three streaming services, Disney+, Hulu, and ESPN+ domestically while Star+ is their international product. Theatrical and content licensing is the third part of DMED which is where tentpole content including Marvel and Pixar films are produced. DPEP consists of the business's 2 domestic, Disneyworld in Orlando, FL and Disneyland in Anaheim, CA, and 4 international, Disneyland Shanghai, Tokyo Disneyland, Disneyland Paris, and Disneyland Hong Kong. From a financial perspective, DPEP brought in nearly 29bn of revenue, 35% of total revenue, and $8bn in operating income in FY2022. In DMED linear networks reported $28bn in revenue and $8.5bn in operating income, DTC brought in $19.5bn in revenue but lost over $4bn, and CS&L reported $8bn in revenue with a loss of 300mn. The main drivers of DPEP revenue come from tickets purchased at each of the parks, merchandise spend, and cruises. At DMED cable affiliate fees, DTC subscriptions, and advertising are the main revenue drivers.

Industry Overview

Disney competes with a number of companies in the direct-to-consumer and linear market, with their main competitors being Netflix, Paramount, and Warner Bros Discovery. The streaming space is extremely competitive, with Netflix being the only company whose streaming generates consistent profits. The push from streaming companies over the past few years to grow subscriber counts at all costs has kept these companies from making profits and has forced them to change their strategies in order to become profitable. The main change made in order to achieve profitability has been significant price hikes and content cost cutting. The competitive nature of the space is expected to force out some of the less profitable companies and narrow down the streaming field significantly while dropping the price for content as more of it becomes available for distributors to buy. The price of sports rights has gone up significantly over the past two decades with linear distributors paying a premium to sports leagues in order to keep fans from leaving their service. This has led to increasingly expensive cable bundles that caused customers who were not interested in watching sports to leave their linear providers. Linear TV's elevated prices pushed these consumers over to streaming which has led to the rise of DTC offerings and the decline of linear television. Media companies have responded to this change by putting out their best content on their streaming networks and releasing all content made for linear onto their streaming platforms simultaneously.

Valuation

To value this company we built out each segment's revenue drivers and expenses to reach operating income for each of the four segments, linear networks, direct-to-consumer, content sales and licensing, and parks and experiences. Through this we reached a valuation of $110 with half of our valuation coming from a terminal EBITDA multiple of 10x and the other half coming from a DCF using a 10% discount rate and 2% long-term growth rate.