Warner Bros. Discovery [NASDAQ: $WBD]

Initiate at BUY | PT: $20.62 | 2.5% Weight

November 11, 2022

CIMG Investment Research

A Merger Created Media Behemoth

Warner Bros. Discovery is the product of a $43B merger between Warner Media and Discovery in April 2022. After a tumultuous four years, AT&T spun off WarnerMedia in 2018 citing opportunities to lighten the debt load and re-focus CapEx on telecommunications. As a result of the merger, WBD hopes to realize at least $3.5B in cost synergies to drive FCF and pay down debt. It also provides an opportunity to combine the HBO Max and Discovery streaming platforms, which we believe will reaccelerate subscriber growth, minimize churn, and help the platform reach scale and profitability. Despite all of this, the stock has been dragged down by selling pressure from former AT&T shareholders, a large debt load in the current macro environment, and ST softness in the linear advertising market. We have much confidence in management's ability to deliver on guidance, and thus find WBD trading far below its intrinsic value.

Investment Thesis

Synergy capture from the merger will drive $3.5B in FCF growth to pay down debt. Within WBD's $35bn cost base, management has highlighted four areas where they see the highest cost cutting opportunities. Within their US operations, they see over $2B in duplicative corporate and SG&A functions. Internationally, they have identified over $1B in overhead inefficiencies. Management also expects to drive synergies from $6bn in non-content DTC costs such as duplicative marketing, tech stacks, and back-office roles. As of 3Q22, they expect to exit the year with $750M in run-rate synergies and capture at least another $2.75B in 2023 and 2024. This will allow them to rein in their high leverage (5.1x as of 3Q22) by meeting their EBITDA targets of $12B and $14B in 2023 and 2024 and paying down debt. We expect these synergies to be meaningful drivers of FCF margins and believe that the street is assigning little value to them due to short term uncertainty.

Management's track record of synergy execution gives us conviction on the merger. In 2017, Discovery acquired Scripps Networks for $14.6bn and highlighted over $350mn in synergies. At the end of their targeted time frame, management successfully achieved over $600mn of synergies. This acquisition also forced Discovery to take on significant leverage of 5.7x at close, but they were able to de-lever to 3.4x a year later, a year ahead of schedule, which gives us confidence in current execution on management's target to de-lever to 3-3.5x by YE2024.

WBD will combine their two streaming services to reaccelerate subscriber growth and turn DTC profitable by 2024. WBD has several levers to drive profitability in DTC, mainly resulting from the combination of their streaming services in Spring 2023. We believe the libraries of content on HBO Max and Discovery+ are extremely complimentary and will help WBD reach their "critical scale" of 120-130M subscribers by 2025. Another key lever is the previously outlined $6B in non-content DTC cost synergies. As streaming continues to consolidate, we believe these businesses have increasingly significant pricing power. The median American consumer spends $20-30 on streaming platforms each month, which is 70-80% less than the average price of a cable bundle from CHTR or CMCSA. The streaming market has historically sold their library at a massive discount to chase subscribers, but as the space becomes more penetrated, streamers are placing more emphasis on profitability, with price increases being a key lever they expect to pull. Since the merger, management has also reaffirmed their devotion to limiting spend to content that can make them a profitable return, choosing to license content to other streamers that is FCF negative. We believe these levers will be responsible for $3-4B in EBITDA growth in DTC over the next 3 years.

Telecom, Media, and Entertainment

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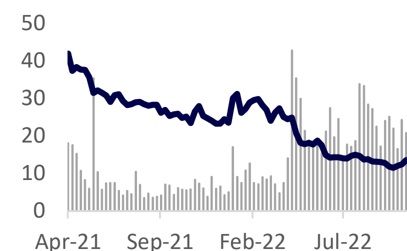
Figure 1: Stock Chart & Volume Since Merger



Price	$11.84
Dividend Yield	0.00%
PT	$20.62
Upside	74%
52-Week Range	$9.53 – $31.55
Dil Shrs Outstand	2.4bn
Mkt Cap	$28.75bn
Ent Value	$81.37bn
Net Debt/EBITDA	5.1x
2023 EV/EBITDA	7.2x
PF 2021 Revenue	$45.3bn

A perfect storm of short-term uncertainty and indiscriminate selling has left WBD trading at a huge discount to its LT value. Advertising accounts for nearly a quarter of WBD's revenue and generally declines at high single digit to low double digit in a recessionary period. This short-term weakness has caused a massive sell-off in media stocks, and we believe the market is assigning little value to synergy execution and FCF production. The market is also very focused on WBD's declining linear business. Our view is that linear will be around for a long time, with sports and news proving to be extremely difficult to monetize on streaming. Even with high single digit declines through 2023 and mid-single digits declines thereafter in revenue and EBITDA, we believe the business is significantly undervalued, largely because of synergy capture and DTC turnaround. Another reason the stock has sold off is the structure of the merger. 71% of WBD shareholders were AT&T shareholders after the merger closed. These dividend seeking, conservative shareholders have created artificial selling pressure that provides us with an entry point to invest on a 3–5-year time horizon.

Valuation

We modeled WBD using an 8-year levered DCF. We did so to illustrate the effect of mandatory principal repayment and interest expense reduction on LT levered FCF. We used a 10% discount rate and a 2% LTGR to arrive at a price target of $20.62, representing 74% upside from Friday's close of $11.84.

Company Overview

WarnerMedia and Discovery merged on April 8, 2022. WarnerMedia was spun off from AT&T for $43B after their initial acquisition of WarnerMedia in 2018 for $85B. WarnerMedia is a combination of assets including Warner Brother's Studios, HBO and HBO Max, and a linear TV business that includes channels such as TBS, TNT, CNN, and more. Discovery is more of a traditional media company, focusing mostly on linear TV, having started their streaming service, Discovery+, just last year. Discovery is known for being the leader in non-scripted, linear content with channels such as Discovery Channel, HGTV, Food Network, TLC, and more. The combined linear business is expected to account for over 25% of total viewership time on linear networks, which could be a meaningful driver of affiliate fees and advertising revenue in the future. Another key strategic pillar of the merger is combining the two streaming services, HBO Max and Discovery+ to drive subscriber growth on the platform.

Industry Overview

As consumers continue to cut the cord, WBD's primary linear TV business is in a structural decline. The effect on the company, however, has been far more neutral until recently, with revenues for the networks segment declining in the low single digits over the last few years. Affiliates like Discovery or WarnerMedia have been able to push affiliate fee increases onto the cable providers to mitigate the effects of cord cutting. There has also been an increase in the CPM (cost per 1000 impressions) paid by advertisers on linear TV as cord cutters leave the cable bundle for subscription video services without advertising, decreasing linear TV ad inventory and increasing prices. We see these effects dwindling over the next several years as cord cutting continues, but we believe the new scale of the company will mitigate linear TV revenue deficits.

In place of the declining linear business, WBD has a growing Direct-to-Consumer business which competes with other streaming platforms such as Netflix and Disney+. The industry is at an inflection point where profitability is beginning to matter. The playbook of Netflix, and Disney to an extent, has always been to spend the most money possible to capture as many subscribers as possible and reach scale. But, as the bond market has become less accessible and the industry more competitive, disciplined content spend is more important than ever. We believe this is a strength of WBD, specifically given their focus on high quality content and a multi-faceted monetization strategy that yields a higher return on content spend. Instead of releasing movies directly to streaming, they plan to utilize their leading studio to recoup production costs in the theater before releasing them on DTC. Supporting their linear network also allows them to make a positive return on content spend that they can use to underwrite DTC content costs until that business reaches profitability.