

Walt Disney: Not as much magic in the kingdom

Walt Disney is one of the world's most iconic companies, and one that has endured for generations. Moreover, its products and rich library of family-orientated content have entertained families for generations, and are likely to continue doing so for years to come. Nonetheless, regardless of how enduring its' loveable characters are, Disney is not immune to the upheaval caused by Covid-19 and technology. In this article, we take stock of issues facing the company and ask whether some of the magic is dissipating?



Michael Porter

Most people associate Disney with Mickey Mouse and his loveable group of friends, but in reality, the company has expanded enormously since the early days, through new creations of its own, as well as acquisitions of other brands, characters and trademarks. In addition, Disney is far more than just a movie and theme park operator – it has diversified into a multi-faceted media conglomerate,

with operations in dozens of industries. The breadth of the company's operations can be summarized into four key divisions:

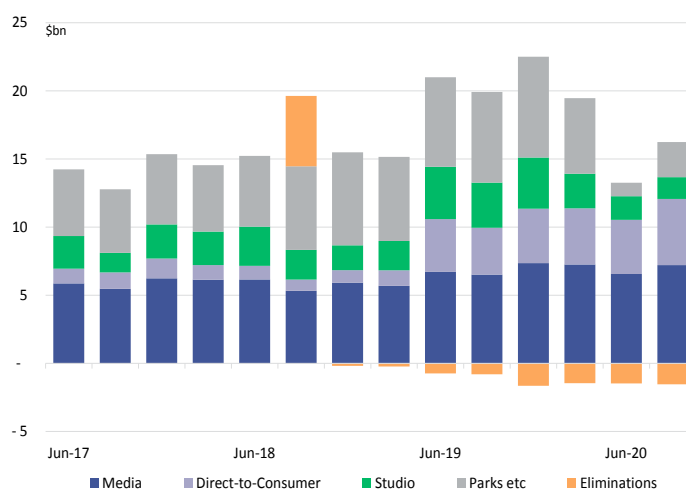
1. Media networks (which include cable tv and broadcasting). This in itself is a vast division, and includes content for their own channels (Disney, Disney Jnr, and Disney XD). They also own ESPN, the largest sports network in the US with rights to tennis, basketball, American Football and key golf events. In addition, they own National Geographic Channel, as well as Fox, and other smaller channels. This division produces content for those channels, and collects broadcasting fees from the likes of DSTv who broadcast the channels around the world.
2. Studio entertainment is their movie division, which produces movies, content and live shows (such as The Lion King) under the following studios: Walt Disney Pictures, Twentieth Century Fox, Marvel, LucasFilm, Pixar, Fox and Blue Sky. Any movie buff will identify with many of these studios, given the success of the Marvel franchise in recent years, as well as Star Wars and the loveable animation that we have come to expect from Pixar.
3. Parks, experiences and products house their global theme parks across the world, as well as their dedicated

SPEED READ

- 2020 was a tough year as Covid impacted on numerous business segments.
- The balance sheet has deteriorated, thanks to dwindling free cash flow generation and huge investment into their new streaming services.
- The share price does not reflect the rising risk profile. Consequently, we have reduced our exposure.

cruise ships, and package holiday operations. This division licenses all their trademarks and other intellectual property, and is responsible for the sale of all their branded merchandise – including the cuddly toy next to your child or grandchild's pillow.

DIVISIONAL REVENUES



Disney is a diversified media conglomerate with multiple irons in the fire. Revenues have stagnated due to the multiple impacts of Covid-19 on their operations.

- Direct to Consumer, and international divisions. This division houses the all-important new streaming services, as well as the broadcasting revenue earned outside of the US.

Covid-19 has exerted pressure on Disney across many of its core divisions.

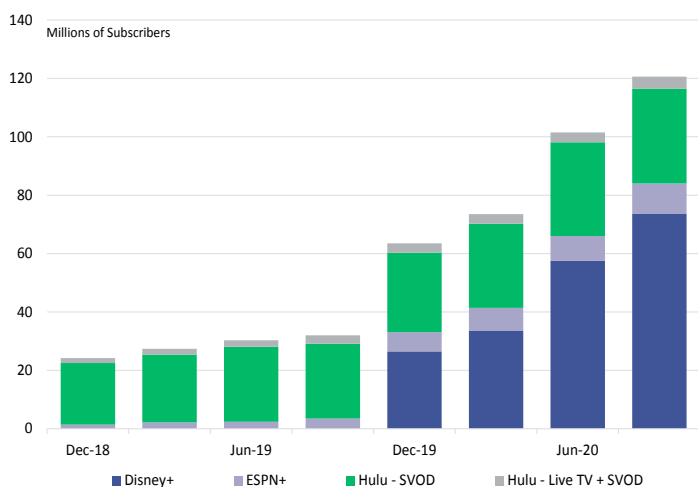
- Most obvious is the impact on parks and entertainment, which have been subject to severe social distancing restrictions. Whilst their main complex in Orlando has been open for a few months, it is only allowed to operate at 30% of capacity. Other parks, including Disneyland in California and those in Europe and Asia, remain closed or even more restricted.
- Media networks have likewise been affected, firstly through the lack of live sport, which has impacted on the profitability of ESPN, and furthermore through the delay in producing new content for their multitude of TV channels. As those who subscribe to DSTV will attest, the level of “reruns” is nauseating.
- It is a similar story for studio entertainment. Firstly, the production of new major blockbusters has been delayed / postponed, but the release of already-finished new content has also been delayed, leading to severe drop in profitability as costs have been incurred whilst revenues are yet to flow. Normally new movies are distributed exclusively through cinemas, and then released via TV and rentals. Cinemas remain shut and are probably one of the most affected industries by Covid. This prompted Disney to release Mulan through its own streaming service, rather than through cinemas, but the long-term viability and profitability of this model has still to be tested.

It was not all bad through. Following the success of Netflix, Disney took the strategic decision two years ago to pull its content away from Netflix and launch its own, competing, streaming service, called Disney+. This was launched in November 2019, and by the end of September, it had almost 74 million subscribers to Disney+ alone, and 121 million subscribers across its 4 streaming products. It is worth mulling on the above statistic for a second. In less than 12 months, they managed to sign up 74 million subscribers – about 1% of the global population. That is even more impressive when one considers that its only available in a few select jurisdictions.

Unfortunately, the growth in streaming has not been sufficient to offset the pressure felt elsewhere. In fact, despite the growth in subscribers, streaming is still unprofitable. Profits for the year ended September 2020 were \$8.1 billion, down from \$13.7 billion for the prior year. Given the year that was, that is not unexpected, and profitability should bounce back as the pandemic fades. Nonetheless, the results do give pause for thought, and raise a few red flags.

Like most companies, Disney has a reasonably high level of debt. Total debt levels are just shy of \$60 billion. Taking their cash balances into account, net debt is reduced to \$40 billion, not necessarily a problem for a company with a market capitalization of \$280 billion. \$35 billion of debt was raised back in early 2019 for the acquisition of Twentieth Century Fox, but net debt levels have been relatively stagnant thereafter. In combination with a collapse in profitability, that has pushed the ratio of net debt to EBITDA to uncomfortable levels, and has raised a red flag in our internal analysis of the company.

DISNEY STREAMING SUBSCRIBERS



Subscriber growth to Disney’s own streaming products has been nothing short of phenomenal. They have managed to sign up about 1% of the global population to Disney+ in less than 12 months.

NET DEBT / EBITDA RATIO



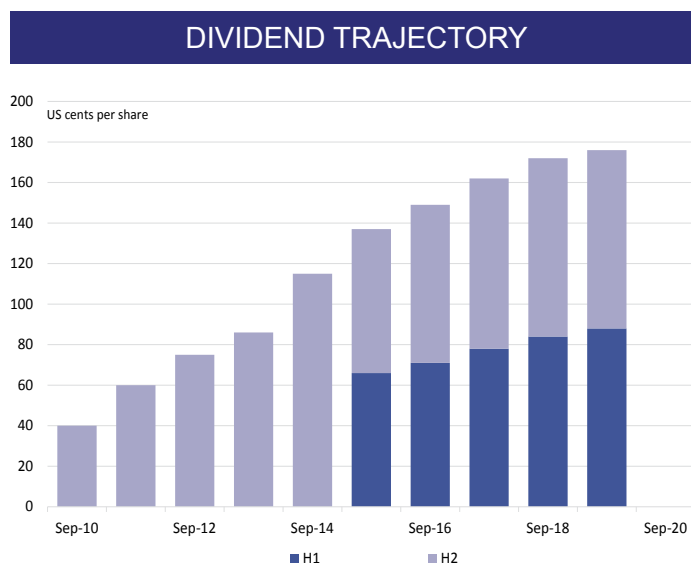
Stagnant debt levels and declining profitability have put the balance sheet under pressure. A ratio above 4x raises a red flag in terms of our analysis.

Allied to the high debt levels, free cash flow has dried up – thanks to a weaker operational performance, lower advertising revenues, and the cash required to develop their streaming services.

Where to from here? Surely as the pandemic recedes, Disney will recover like every other company? We have no doubt that this will be the case, but believe that some caution is warranted against “irrational exuberance”. Firstly, it is going to take time before theme parks are open and operating at 100% capacity. Given that bulk vaccinations are unlikely to be implemented before June 2021 at the earliest, we feel that Disney’s financial year to September 2021 will remain weak. Secondly, whilst they do have a pipeline of new material awaiting release, it will take time for fresh new content to be produced, and this will create a lag in their pipeline over the next 2 years. Thirdly, they will have to continue to invest heavily into Disney+ if they are to remain competitive against the likes of Netflix and others. This will remain a drain on cash resources.

The net result of the pressures described above is that Disney decided to forego a dividend for the current financial year – the first time in years. We are concerned that Disney’s 2021 financial year could be another tough 12 months, as the impact of the pandemic will only really start to fade at the tail end of the year. With another year of poor profitability and weak cash generation, the balance sheet could weaken further, prompting an equity raise. The market can ignore a deteriorating balance sheet for a long time, but if or when it becomes a focal point, the reaction can be severe. Furthermore, it is hard to see the company

resuming dividends in the next 12 - 18 months under this scenario.



Disney did not pay a dividend in 2020, and we are concerned that it might be 18 months before dividends resume.

Despite the pressure facing Disney, the share is trading near record highs, a situation that we do not feel adequately reflects the rising risk profile. Consequently, and despite its blue-chip status, we have taken the decision to take handsome profits and reduce our exposure to the company. We still retain some exposure given the excellent long-term potential for Disney, but will be watching trends closely for any signs that further action is necessary.



A rather empty Disneyland. Covid has kept the visitors away.



Given the uncertainty over a second wave of Covid, we cannot predict with any certainty when we will be allowed to resume our seminars. Until we have clarity, we will continue with our online videos and presentations. Please ensure that you subscribe to our Facebook page and YouTube channel to be kept up to date.



www.facebook.com/harvardhouse



www.youtube.com/harvardhouse

Please RSVP to Clare Mitchell on 033 3302164 or clarem@hhgroup.co.za.

Topic: N/A

Natal Midlands

Date: N/A

Venue: Fernhill Hotel
Midmar / Tweedie Road
(almost opposite entrance to Midmar)

Morning Time: 10am for 10.30am

Evening Time: 5.30pm for 6pm

Johannesburg

Date: N/A

Venue: Rosebank Union Church, Cnr
William Nichol and St Andrews
Road, Hurlingham

Time: 7am for 7.30am

CONTACT DETAILS:

For more information on the range of products and services offered by Harvard House Investment Management and its associated companies (including Harvard House, Chartered Accountants), or for any financial advice, please contact the Company at:

HARVARD HOUSE GROUP



3 Harvard Street, Howick, 3290, South Africa



P.O. Box 235, Howick, 3290, South Africa



+27 (0) 33 330 2164



+27 (0) 33 330 2617



admin@hhgroup.co.za



www.hhgroup.co.za

Disclaimer:

The information contained in this newsletter comes from sources believed to be reliable, but Harvard House Investment Management (Pty) Ltd, Harvard House Financial Services Trust, Harvard House Insurance Brokers and Harvard House, Chartered Accountants (collectively known as the Harvard House Group), do not warrant its completeness or accuracy. Opinions, estimates and assumptions constitute our judgment as of the date hereof and are subject to change without notice. Past performance is not indicative of future results. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Any investor who wishes to invest with the Company should seek additional advice from an authorized representative of the firm. The Company accepts no liability whatsoever for any loss or damages whatsoever and howsoever incurred, or suffered, resulting, or arising, from the use of this newsletter. The contents of this newsletter does not constitute advice as contemplated in the Financial Advisory and Intermediary Services Act (FAIS) of 2002.

The Harvard House unit trusts are registered under the Boutique Collective Investments. Custodian: Standard Executors & Trustees: Tel (021) 007-1500. Collective Investments are generally medium to long term investments. The value of participating interests may go down as well as up and past performance is not necessarily a guide to the future. Collective Investments are traded at ruling prices and can engage in script lending. Forward pricing is used. Commission and incentives may be paid and if so, are included in the overall cost. This fund may be closed to new investors. Collective Investment prices are calculated on a Net Asset Value basis and auditor's fees, bank charges, trustee and RSC levies are levied against the portfolio. The portfolio manager may borrow up to 10% of portfolio NAV to bridge insufficient liquidity. Boutique Collective Investments is a member of ASISA and is an authorised Financial Services Provider. Should you have any further queries or complaints regarding the suite of units trusts offered by The Harvard House Group please contact: Boutique Collective Investments Call Centre, Tel: (021) 007-1500, Email: clientservices@bcis.co.za. For your information, the FAIS ombudsman provides an independent and objective advisory service. Should you not be satisfied with the outcome of a complaint handled by Boutique Collective Investments, please write to, The Ombudsman, PO Box 74571, Lynnwoodridge, 0040. Telephone (012) 470 9080/99. Fax (012) 348 3447. Email: info@faisombud.co.za

Harvard House Investment Management (Pty) Ltd*, Licence no: 675

Harvard House Insurance Brokers*, License no. 44138

Harvard House Financial Services Trust*, Licence no: 7758
(2002)

* Authorised financial service providers in terms of FAIS