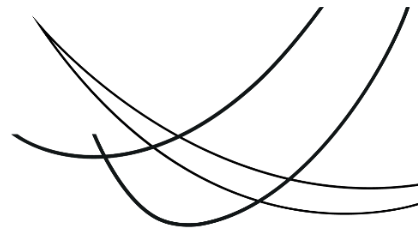


FP Tyndall Global Fund Commentary – September 2018

"When you're curious, you find lots of interesting things to do" – Walt Disney

Global equity markets were volatile over the month as China and the US got hostile over international trade, with more tariffs being imposed by both sides. Interestingly, as the country with the weaker hand in balance of trade, China has started reviewing some orders with US manufactures and looking to European and Asian alternatives, a move that is sure to irritate the US President. Nonetheless the US markets touched new all-time highs in the month and their 10-year yields broke through the psychological 3% barrier. We notice that companies are starting to question as to whether the elongated period of cheap money is coming to and end, which may lead to an uptick in M&A as they try and take advantage before the window closes. The US Fed raised rates for the third time this year and forecast a further rise in December, followed by three more hikes next year, which reinforces these concerns. We continue to prefer companies with solid balance sheets and self-funding durable cash flows.

With the lack of agreement between Theresa May and the EU as the opposing sides in the UK's exit from the EU stick to their starting positions, we expect that sterling may fluctuate in the coming month, especially around the EU summit on 17th-18th October. We also expect that the dollar and US yields may come into focus as US President Trump becomes focussed on populist twitter headlines in the run-up to the US mid-terms that are due to be held on November 6th.

The FP Tyndall Global Fund (B Inc) rose 0.11% over the month, resulting in a year-to-date returns of 10.79%.

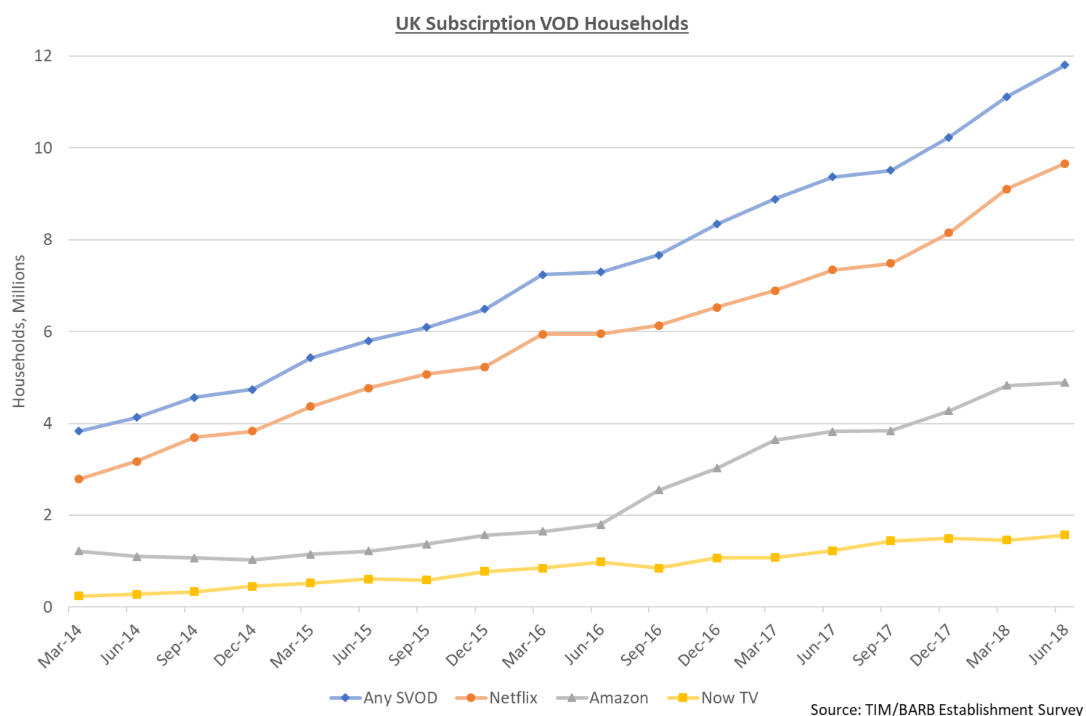
The following note comes with a health warning: Digital media companies are almost military-like in their love of acronyms; although we have tried to keep them to a minimum, a guide to explain the difference between the ESTs and SVODs and how they relate to each other is appended at the end of this note.

Ever since Comcast made an audacious bid for Disney (which we hold in the Fund) in 2004, there has been little love lost between the two companies. These hostilities have become more acute over the past 18 months as the two giants of the industry slugged it out over the assets of 21st Century Fox and Sky in an attempt to create a competitor to Netflix in the video streaming and pay-TV markets. After Comcast pulled out of the race to buy Fox's assets, it concentrated its efforts on obtaining a foothold in Europe through the majority stake in Sky with its 23 million subscribers; a deal that has almost doubled Comcast's subscriber base.

After a sealed bid auction, Comcast outbid Disney/Fox for Sky by over 10% clinching the deal, by offering $39 billion (which represents a massive 12.6x EBITDA). The potential fly in the ointment of Fox owning 39% of Sky has been averted because given the price that Comcast offered for the shares, Fox agreed to tender their stake. Sky operates in a very similar manner to Comcast, licensing content

from third party providers and re-selling original content. With access to Sky's costly content rights which include the UK's Premier League football, widely considered to be its crown jewel; although others may argue that the Bundesliga, Champions League, F1, golf, cricket and rugby are equally attractive.

Sky launched its Over the Top (OTT) offering six years ago through its Now TV platform. Although it is growing in adoption, only 13.5% of subscribers are yet to take up on the option. The overall subscriber base has only grown by a CAGR of 2.5% over the past 5 years as the OTT growth is at the expense of traditional satellite numbers. Now TV, with 1.6 million SVOD subscribers in the UK, is dwarfed by Netflix (9.6 million subscribers) and Amazon (4.9 million).

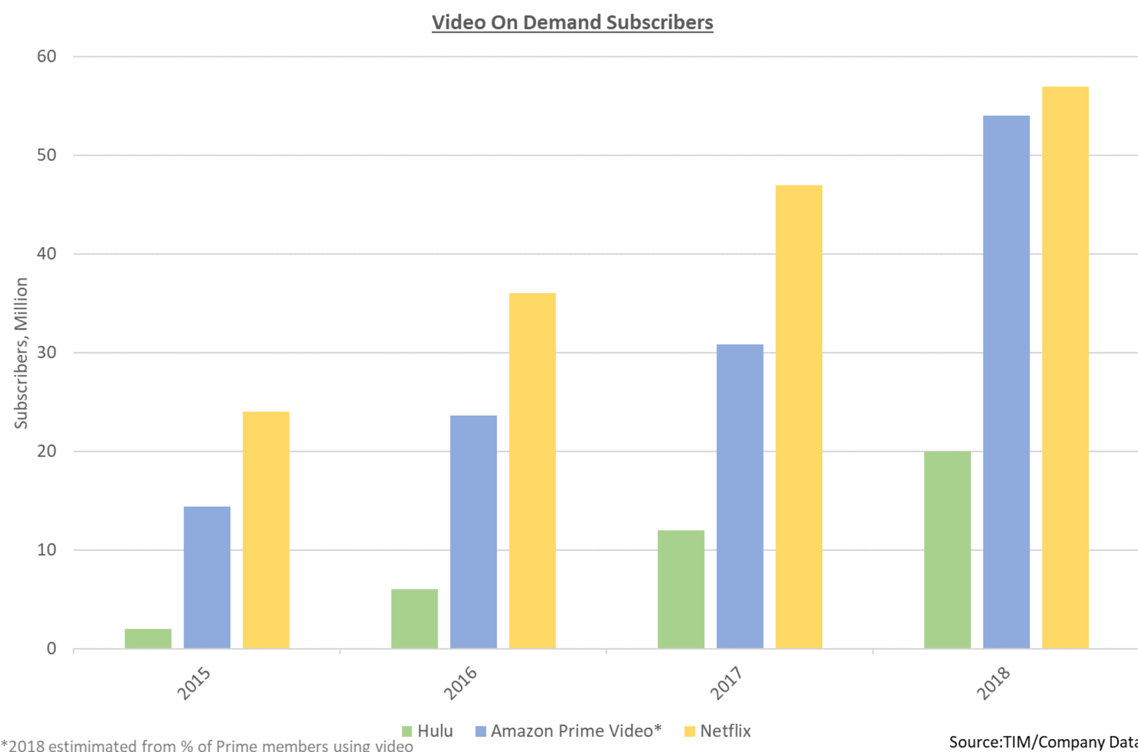


Given that Disney/Fox have agreed to sell their stake in Sky to Comcast, it suggests that they believe that Comcast has had to pay well over fair value for the company, a point that undoubtedly Comcast shareholders will also recognise; management may have difficult questions to answer in coming shareholder meetings. The benefits for Comcast, however, are that they no longer have to deal with its rival having 3 board seats and gaining revenues from Comcast's investments. The cash gain from selling the stake will significantly reduce the debt that Disney is raising to finance the Fox deal ($71bn) and go a long way to appeasing their shareholders; we know which side of this deal we prefer to be on, especially as Disney has a free cash flow yield of almost 6% without any of this M&A.

With the acquisition of 21st Century Fox's media assets Disney gains another 30% of the video-streaming service (SVOD & AVOD) Hulu, to add to the 30% it already owns. This brings into question the medium Disney intends to utilise as it converts to a subscription-based company. Comcast still owns 30% of Hulu (with AT&T owning the final 10%), so there could be some room for manoeuvre here. UK takeover law prohibits conditional stake exchanges, so the future of their stake should not

have been discussed while Fox/Disney were deciding whether they were going to tender their shares in Sky.

In the US, Hulu is growing rapidly, despite Netflix's head start, thanks to successful serials such as The Handmaid's Tale, but is yet to venture outside the US; Netflix already has 77 million non-US subscribers and have recently signed a deal with Sky that will further entrench its dominance as it will be accessible to Sky subscribers. Hulu and Netflix thus far have pursued very different strategies: Netflix has focussed on adding subscribers, while Hulu has focussed on revenues for its owners; both strategies, however, have proved to cash flow negative to date. Disney may have greater international streaming ambitions through Fox's Star service, which reaches 720 million viewers in India and MEA (The Middle East & Asia)



In any discussions over the future of Comcast's stake in Hulu, Disney should hold the upper hand as Sky is profit enhancing while Hulu is not; it made a loss in the region of $1.5bn last year. Furthermore, it is uncertain what Disney's future intentions with Hulu are. Prior to the deal with Fox, Disney had purchased BAMtech, a rival streaming company, and had been pursuing its ambitions using that platform, it intends to launch two services, one for adults and one for minors (or adults with a taste for Disney cartoons) in 2019. Disney believes that the strength of the Disney franchises are such that it can succeed on a BAMTech based strategy despite Netflix's head start; this is especially true in children's programming where Netflix's currently woeful offering that is laden with G and PG programmes[1].

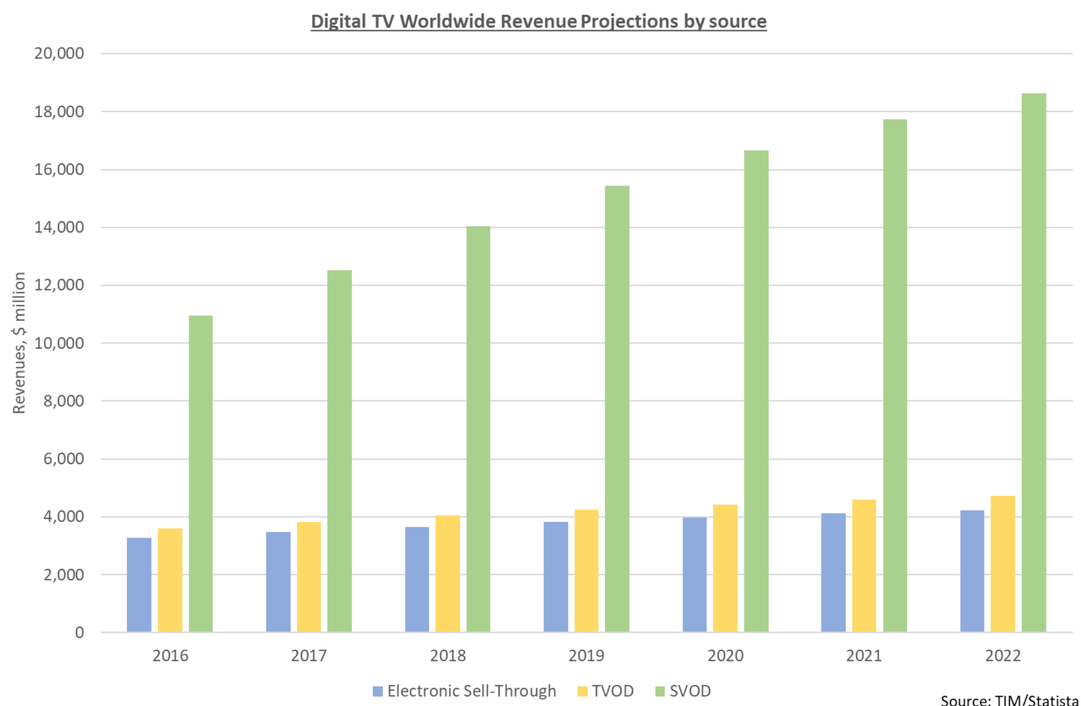
Such is the belief in the appeal of its own franchises, Disney has decided to terminate its distribution agreement with Netflix from 2019, so customers will have to subscribe to a Disney-backed platform to access Fox, Marvel, Pixar, Lucas Film, National Geographic or Disney content once the Fox deal is

[1] As an aside, for those who read August's newsletter, BAMtech has signed a deal with Riot games to live stream 'League of Legends' as it ventures into the esports arena.

closed. The company will be encouraged by the recent success it has had with ESPN+, the direct to consumer streaming service for sports, which registered 1 million subscribers in the first 5 months.

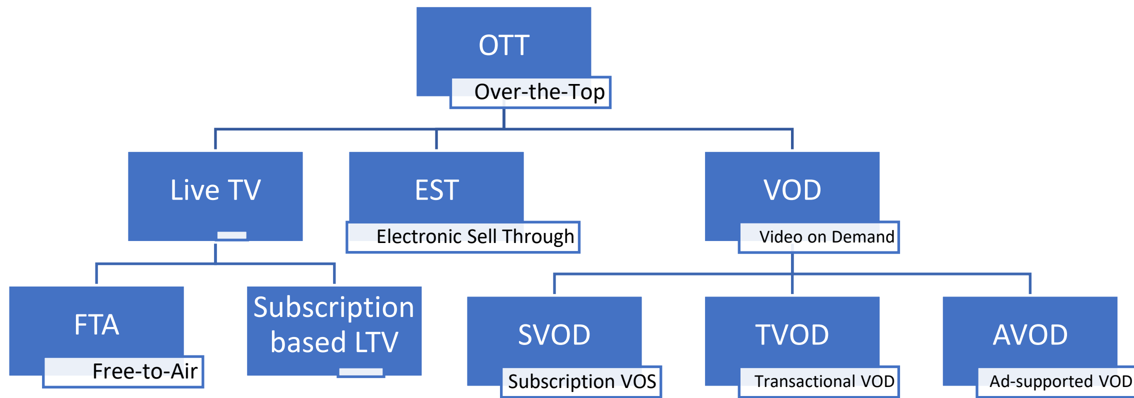
Hulu gives Disney a significant and growing installed base, but whether it intends to run parallel offerings or to merge BAMtech into Hulu is unclear; the latter is unlikely unless it has control over the service. Another option would be for Disney to sell its stake in the loss-making Hulu and use the proceeds to invest further in BAMtech. However, with Comcast now facing debts of over $100bn (3.6x debt/EBITDA) the most likely bidder is unlikely to be in the position to acquire it; although with no comparable Video on Demand (VOD) service in the US, it would appear Comcast needs Hulu more than Disney. We expect that although Comcast has always maintained that it will not sell its stake in Hulu, that position may have changed given its current financial position especially as Disney is willing to part with their Sky stake. We expect that AT&T will wait to see how the situation plays out before revealing their hand because they already own DirecTV, which has 21 million subscribers and is a similar offering to Sky with additional VOD and EST options

As evidenced by the charts above and below, the reason behind all this manoeuvring and shifting of assets is the fundamental change in subscriber preference for consuming audio-visual content, and that the realisation that the traditional subscription based live TV is in decline. Currently more than 50% of US homes subscribe to streaming services and on average they sign up to three different SVOD products, consequently Netflix, Hulu and BAMTech and are not mutually exclusive products. We believe that with the Asian opportunity opening up through Star and the popularity of the Disney franchise in China the company is well positioned to be at the forefront of any move to streaming in these markets. Walt Disney was right that there are lots of interesting things to do, and in Bob Iger they have an experienced veteran of the industry who is ambitious and capable enough to navigate the ship through these tides of change.



Source: TIM/Statista

Demystifying the acronyms



OTT: Delivery of audio-visual content over the internet where the customer rather than the internet service provider controls what access they receive and by which medium. Includes the delivery of content through smart phones, tables, games consoles, internet connected TVs, streaming media players and set-top boxes.

EST: Customer purchases content on a perpetual licence and it is downloaded to a connected device or hard drive.

VOD: Streamed or downloaded content through an internet connected device.

SVOD: Customer pays fixed, recurring fee for unlimited streaming of provider's catalogue.

TVOD: Customer pays for each individual movie of show that they watch on a single licence policy.

AVOD: Ad-supported content made available on an on-demand basis, primarily at no charge.

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