Disney's Strategy Is Working

Disney+ is here, and it's already beating expectations. Analysts projected it would take the rest of 2019 – about seven weeks – for the new streaming service to reach 8 million subscribers.

It hit 10 million in one day.

The huge launch for Disney+ reaffirms what we've been saying for the past three years. Disney's unparalleled collection of IP, unique brand, and superior content monetization capabilities give it a significant competitive advantage over Netflix (NFLX) and every other content company. The Walt Disney Company (DIS: $148/share) is this week's Long Idea.

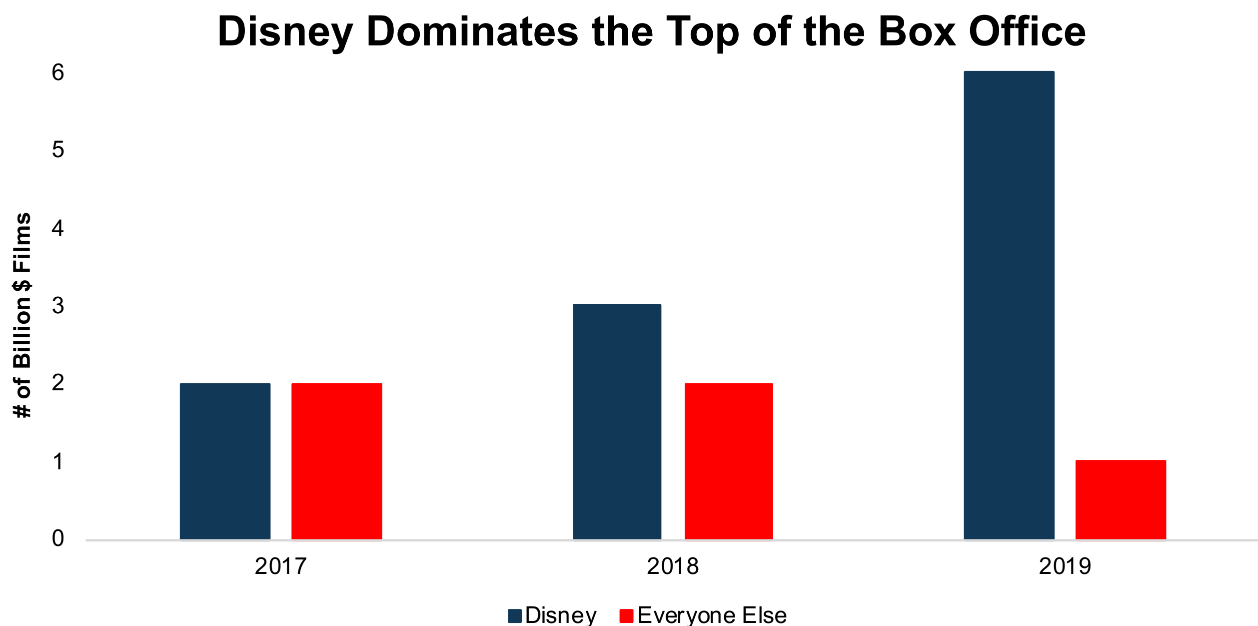
It's All About Franchise IP: Quality Over Quantity

495 scripted TV shows aired in 2018. The average consumer can't watch that much TV or even attempt to sort through it to figure out what's best. Anyone who has Netflix or any other streaming service knows the terrible feeling of scrolling through a seemingly endless list of shows and not being sure what to watch.

Research shows that when viewers are faced with so many options, they tend to retreat to the programs with which they're most familiar. That's why *The Office* and *Friends* consistently rank as the most-watched shows on Netflix, and why the loss of those shows is such a huge blow to the streaming service.

Disney stands to benefit as consumers become more overwhelmed by the amount of content and gravitate towards familiar characters and franchises. No other company can boast the familiarity or the same level of franchise IP. Figure 1 shows that Disney has produced[1] 11 billion dollar films over the past three years, more than double every other studio combined.

Figure 1: Number of Films With $1 Billion+ Worldwide Gross



Sources: New Constructs, LLC and company filings.

[1] Or co-produced, in the case of *Spider-Man: Far From Home*

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Disney's 2019 box office dominance should increase after *Frozen 2* and *Star Wars: The Rise of Skywalker* – two movies all but guaranteed to top $1 billion – are released over the next two months.

These huge franchises give Disney a key advantage as it launches Disney+. Most of the promotion of the streaming service has tied into these franchises – whether it's the new Star Wars show *The Mandalorian*, the promise of future tie-ins to the Marvel Cinematic Universe, or just the company's vast library of classic films.

These tentpole franchises don't just help Disney attract new subscribers, their extraordinary popularity lowers subscriber acquisition costs, too. On the other hand, Netflix's more niche-focused content is getting increasingly expensive as the company produces 700+ projects a year. We think Disney+ subscriber growth will be plenty strong with just 45 movies and shows in its first year.

CEO Bob Iger forecasted 60 original projects per year over the long-term because he knows content quality is more important than content volume. Disney can offer fewer shows because the excellent reputation of its past content means that shows like *The Mandalorian* have a large, guaranteed audience. As a result, it can invest in fewer, higher-quality programs and offer its streaming service at a much lower price. More importantly, Disney+ might actually generate positive cash flow, a feat Netflix has never achieved.

Unique Brand Value

In addition to Disney's tentpole franchises, the company has the unique advantage of having its own distinct and popular brand, something no other content company can really claim.

Everyone knows what a Disney movie is (or a Pixar movie, for that matter). Even when the company tells a totally new story, people are interested because of Disney's excellent track record for high-quality content. This brand advantage allows the company to continually create new stories and worlds that become their own valuable franchises (like Frozen).

On the other hand, when you see a TV show labelled "Netflix Original", you're not as sure about the kind of show you'll see. The same goes for other movie studios such as Universal (CMCSA) or Warner Bros (T). None of these companies have built as strong a brand for consistent high-quality content as Disney. Other brands have to spend a lot more to sell audiences on original stories.

A superior brand also creates a marketing advantage for Disney+. If you're a parent of a young child, you know that Disney+ has a vast library of high-quality family-friendly entertainment.

Superior Content Monetization Capabilities

No other content firm monetizes content better than Disney. Iger referenced this advantage on the company's most recent earnings call, telling analysts:

"So as we look at these businesses (Marvel and Star Wars), they're film business and they're TV businesses, they are still big Consumer products drivers and more and more they have a greater presence in Parks and Resorts."

When Disney develops successful content, it can extract value across a wide array of businesses. A hit franchise like Star Wars doesn't just make billions at the box office, it also sells toys and merchandise, creates the potential for spin-off TV shows, forms the basis for attractions at theme parks, and now – with Disney+ – contributes to the library of a streaming service.

These multiple monetization channels give Disney a key advantage over Netflix. Disney+ represents just another link in the chain for Disney, one more way to extract value from IP that can also be monetized in several different ways. Netflix, on the other hand, has only one monetization channel: streaming subscription revenue.

As a result, Disney+ can price well below Netflix. Disney+ can even be a loss leader to get more customers into its other monetization channels. Disney does not have to rely solely relying on streaming income to earn an adequate return on invested capital (ROIC) in IP. By offering higher-quality content at a cheaper price, Disney+ should continue to grow rapidly and take subscribers away from Netflix.

Long-Term View on Profits

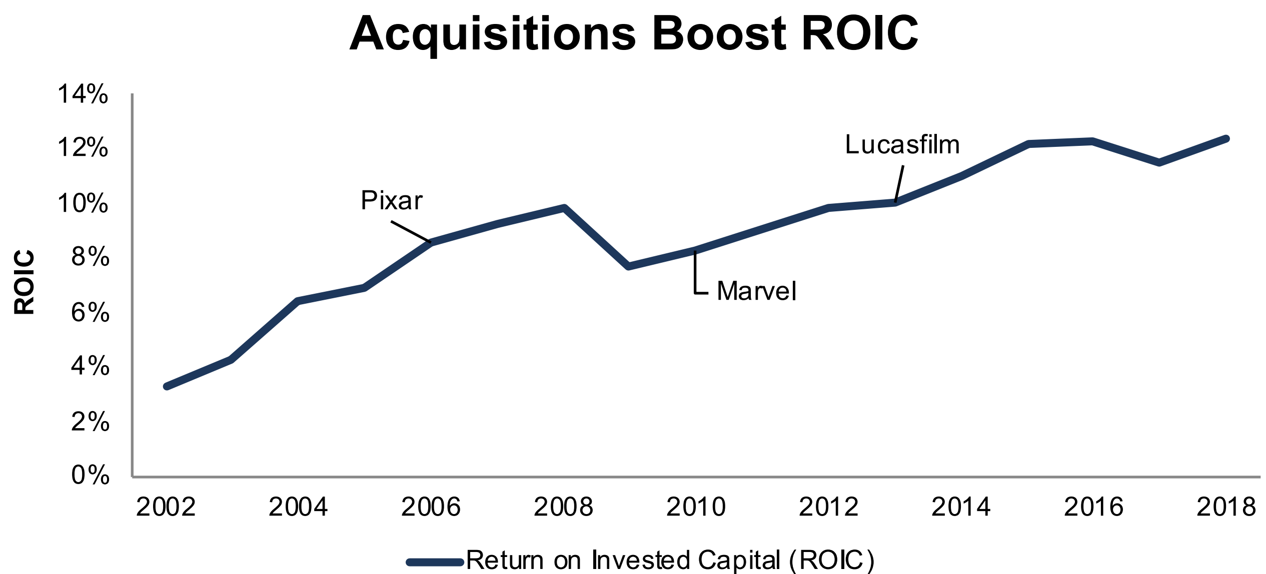
All the unique advantages above, combined with Disney's excellent corporate governance, make us bullish about the 21st Century Fox acquisition. We believe that over the long-term, Disney will be able to create an extraordinary amount of value out of the content it acquired from Fox, not to mention its control of Hulu.

However, in the short-term, Disney's free cash flow takes a big hit from the Fox acquisition. Further, an acquisition on this scale – $71 billion – can take a while to integrate and creates a number of unusual expenses. Many of these expenses – such as $1.2 billion (2% of revenue) in restructuring and impairment charges and $1.6 billion (2% of revenue) in fair value step up costs – will be accounted for in our model once the company files its 10-K in the coming weeks. Properly categorizing these unusual items creates a more predictive measure of core earnings, as demonstrated by research from Harvard Business School and MIT Sloan.

No model, though can account for all the various frictions and inefficiencies that happen in the first year of an acquisition of this size.

Nevertheless, we do have confidence that, over the long run, Disney will earn an ROIC on this acquisition in keeping with its track record. As Figure 2 shows, past acquisitions have consistently had a positive impact on the company's ROIC.

Figure 2: DIS ROIC: 2002-2018



Sources: New Constructs, LLC and company filings.

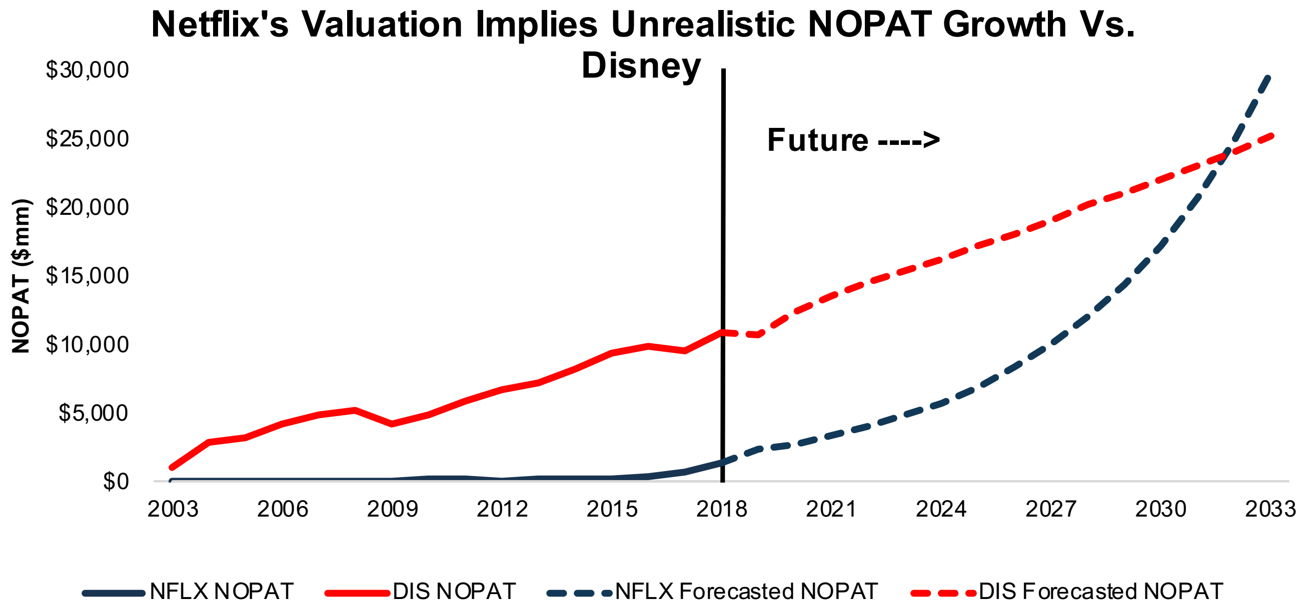
If Disney earns a 12% ROIC (in-line with its 2018 ROIC) on the $71 billion Fox acquisition, the company will earn an additional $8.5 billion in after-tax operating profit (NOPAT), a 78% increase from its 2018 NOPAT.

Micro-Bubble Winner

Disney currently looks expensive in our rating system with a price to economic book value (PEBV) of 2.6, but that's only because the valuation accounts for all the extra shares and debt from the Fox acquisition, while the company has only just begun to earn the extra profit from the deal. Our systematic Risk/Reward rating on the stock is suspended while it integrates the acquisition. Our Long Idea and Danger Zone picks always begin with reviewing our risk/reward ratings on stocks, ETFs and mutual funds, but those reviews do not prevent us from making calls that may not align with that rating.

While Disney may look expensive based on current profits, we think the stock remains undervalued based on the expected cash flows from the Fox acquisition, and it looks downright cheap compared to Netflix. As Figure 3 shows, the market still expects Netflix to earn a higher NOPAT than Disney over the long-term.

Figure 3: NFLX Vs. DIS: Historical Vs. Market-Implied NOPAT



Sources: New Constructs, LLC and company filings.

It might seem odd to say that the market has higher expectations for Netflix when Disney has the higher market cap, but there are two factors investors need to consider when valuing these companies:

1. **The Time Value of Money:** Disney generates significant cash flow right now, while Netflix has a much lower NOPAT and loses billions on a free cash flow basis. Since money today is worth more than money in the future, Netflix needs to earn an even higher profit in the future to make up for its losses now.
2. **Cost of Capital:** Our reverse DCF model uses the weighted average cost of capital (WACC) as the discount rate for future cash flows. Netflix, with its more volatile stock and higher credit risk, has a much higher WACC than Disney. As a result, it must clear a higher hurdle to meet the expected return for investors.

When you combine these factors, Disney still looks significantly undervalued, both in its own right and especially compared to Netflix.

If Disney can grow NOPAT by 9% compounded annually over the next decade (the default forecast in our model right now based on historical margins and analyst revenue projections) the stock has a fair value of $181/share, a 23% upside to the current stock price. See the math behind this dynamic DCF scenario.

9% annual growth might seem ambitious, but it's only slightly higher than the 8% annual growth for Disney over the past decade, a period when it didn't have any acquisition on the scale of Fox.

As the market grows more skeptical of the growth expectations embedded in Netflix's stock price – and as Disney+ continues to gain market share – we expect to see more of the capital invested in Netflix to flow to Disney.

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Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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