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Formula One: Liberty-Supported Management Reinvesting in Brand

Nathaniel Leach of LBW Wealth Management presented his in-depth investment thesis on Formula One Group (Nasdaq: FWONK) at Wide-Moat Investing Summit 2018.

Thesis summary:

Formula One Group is a tracker stock of Liberty Media Corporation (one of three trackers) and comprises the Formula One (F1) operating group, some private assets, and a number of public equity holdings, including Live Nation, Time Warner Inc., and a quasi-interest in Liberty Braves. Liberty Media is controlled by John Malone and run by Greg Maffei.

The crown jewel of Formula One Group is F1, the race car organization that controls the brand's intellectual property rights via television programming, digital, merchandising, advertising, and sponsorship rights; hospitality; and the negotiation with circuit tracks worldwide to stage F1 races.

When Liberty Media purchased F1 via its tracker, named at the time "Liberty Media Group", F1 was an underinvested asset. Malone and Maffei brought in media veteran Chase Carey to reinvest in the brand and to grow it even more. They have already paid down $1+ billion in debt since their purchase in January 2017, and are looking for potential venues for additional races.

Potential investors have a hard time not only peeling back the other assets within Formula One Group, but also understanding what is needed to reinvest in the brand. Nathaniel believes that after "digging into the weeds", one will find F1 to be a valuable asset.

The following transcript has been edited for space and clarity.

The subject of this presentation is Formula One Group, which is a Liberty Media Corporation tracker stock.

This is a play on Formula One – the same Formula One with very fast cars that started in Europe. In part, it is also a play on Live Nation (LYV).

We have a classic Liberty story here, Liberty being the company associated with John Malone and Greg Maffei. It's the story of an under-utilized asset, and management is now taking active measures to re-invest in the business. It is what is known as a "sum of the parts" play. Being a tracker stock, it is non-indexed, and one could, therefore, call it an under-followed opportunity.

The economics of F1 include a predictable revenue stream and cash flows. This is a capex-light asset with fairly diversified revenues. There are newly created segments at play, and there is no reason why they shouldn't be monetized. It has a very efficient tax rate due to its UK location, plus it has most of its revenues and expenses in dollars, so it has that kind of currency arbitrage going on. Mention should also be made of the possibility of a new agreement coming online between the teams and Formula One in 2021.

To avoid any confusion and misunderstanding, it should clarify that F1 refers specifically to

the Formula One entity within the Formula One Group tracker. F1 Group or the ticker symbol, F1, reference the entire tracker.

One of the key figures, John Malone, was the CEO of Tele-Communications Inc from 1973 to 1996. The other Liberty Media pillar, Greg Maffei, was CFO of Microsoft before he came over to Liberty in 2005. Depending on how you look at it, he infamously, notoriously, or famously known for the Sirius XM transaction in early 2009. Liberty Media has taken many forms in the past – Liberty Interactive, DirecTV, Starz (now part of Lionsgate), and Liberty Broadband. The team now includes Chase Carey, who previously worked at Fox (now known as 21st Century Fox). Prior to joining Fox, he was also the CEO of DirecTV from, I believe, 2003 to 2009. He has a wealth of experience in the media game and was responsible for revving up Fox's global sports business.

Liberty announced the F1 transaction in September 2016. The value was $1.1 billion in cash plus 138 million Liberty Media Class C shares and $351 million in exchangeable notes. As time went on, Liberty did some things that minimized the equity dilution – something the company is well-known for. For example, it had three secondary equity offerings of $2 billion in the aggregate to facilitate the orderly liquidation of F1's old shareholders. One of these offerings raised $1.55 billion. Liberty utilized the spread between what the Liberty Media Class C shares (LMCK) had risen to – $25 a share – versus the reference price of $21.26, which was the price of the stock when the deal announcement came. Liberty used that spread and made approximately $230 million in cold cash from that secondary offering. It was then able to increase that original $1.1 billion cash payment and give that to the liquidating shareholders as part of the payment while also decreasing the equity dilution. I'm a huge fan of stuff like that because it saves us, the shareholders, money.

If you delve into the history of F1, you will see it began in its current form in 1950. Bernie Ecclestone, the man on the throne, started in the 1960s or the 1970s, but it was in the 1980s that he began started to consolidate his power.

He first started off as a team owner, but from the 1970s and into the 1980s, he began to negotiate on behalf of teams and drivers with the broadcasters, the promoters (the circuit owners or cities that offered up their locations for F1 to race in), the advertisers, and the sponsors. This, in turn, led to a series of organizations being launched.

First came FIA (Federation Internationale de l'Automobile), which then created a subsidiary called FISA (Fédération Internationale du Sport Automobile). FISA was meant to act as the negotiator for FIA with the drivers and the teams. The latter, in turn, established FOCA (F1 Constructors' Association) in 1974 to negotiate with FISA. In 1981, these two entities came up with what was called the first Concorde Agreement, named after Concorde in France, where FIA is headquartered. The Concorde Agreement guaranteed that all teams would show up for races, which was previously not the case if the races were held in far-flung areas because it would cost the teams an arm and a leg to travel there. Guaranteeing this would ensure consistent crowds, which, in turn, would act as leverage for broadcasting, promoter, and sponsorship negotiations. It also allowed the teams to pool resources and share the expenses of transportation to the races.

In 1987, an organization called FOPA (F1 Promotions and Administrations) was created and given the rights of the TV broadcast negotiations and the contracts, receiving the promotion fees on behalf of the teams and then passing on these revenues to the teams as prize money.

This is where Bernie Ecclestone started to take control. He was the organizer of FOPA, which he created to manage all this. Both he and the teams won out because all of this negotiating power was now centered into this one entity. FOPA made it possible for the teams to take their power as a whole instead of separately, whereas it was every team for themselves before that. Now it was settled in one organization where approximately 65% to 68% of the pre-team EBITDA was given out to the teams.

In 2000, the FIA sold to FOM the commercial rights to F1 for 100 years. FOM (F1 Management) was a successor to FOPA and a subsidiary of F1. This is the infamous 100-year agreement of 2011 that's probably one of the most amazing coups in the sports world because it essentially sold 100 years of all merchandising, racing, broadcasting, and IP rights for an upfront $360 million cash payment. That's $3.6 million a year F1 advertises on its income statement every year. Now, F1 controls all the IP.

The story can't be told without private equity firm CVC, which bought control of F1 together with a number of other private entities. Bernie had given away control previously because of some divorce proceedings, and it went downhill for him, but he did still retain control. When you pair CVC with Bernie's infamous eccentric management, you get an under-invested, under-monetized asset.

You have to consider CVC's incentives in this case. Because it's a PE firm, its F1 asset was locked up within a fund. These funds have tenure (with an extension) of up to 12 years in total, after which they have to be liquidated. This is where Liberty Media came into the picture, swooping in and picking the asset for what was probably deemed a reasonable price. Because CVC couldn't hold on to it, it was CVC's gain that Liberty Media came in.

The core business segments of F1 are Promotions, Broadcasting, Advertising/Sponsorships, and Hospitality, the last one principally comprising the Paddock Club, where ticketholders can go and enjoy the races at their leisure throughout the race weekend. The Promotions segment covers cities or racing circuits that pay F1 to host. It is paid in five to seven years, with five-year extension options which F1 can exercise. These contract details do not differ materially for each segment. We also have a number of new segments that can be categorized as subsets of the core segments. Examples include Digital and Merchandising. It's all IP-based. None of these had been monetized under Bernie and CVC, and now there is a great opportunity to do so.

Turning to the attributes of F1, we should start by noting this is a really unique opportunity to own an entire sport – I can't think of any other publicly traded opportunity for that! Yes, there's the Liberty Braves, but that is just a team within a sport. F1's revenue streams are heavily contracted. As of September 2016, $9.3 billion in revenues was contracted through 2026. About a year later, in August 2017, the number had shrunk to $7.7 billion through 2026. Something that speaks clearly to the quality and solidity of these revenues is the fact that F1 has the ability, through a debt covenant, to lever up to 8.75x OIBDA (operating income before depreciation and amortization). It has mentioned it is only aiming to do 5x to 6x and is paring back the debt right now because it was so high.

Let's compare that 5x to 6x with other companies Liberty controls: Qurate, for example, has a 2.5x goal when it comes to its debt over OIBDA; Discovery has a range of 3x to 3.5x; Charter has a range of 4x to 4.5x. The highest I've seen is in Liberty Global and Liberty Latin America, where the range is 4x to 5x. When I see 5x or 6x, I get excited about how strong this business is.

The cost structure is also a classic tenet of Liberty investment. You could say it's similar to Sirius XM in that it is a low fixed cost and high variable. The low fixed is the administration of business, while the high variable is the team's payout, which is all based upon the revenue it's taking in and thus very advantageous to F1.

Regarding team payout, pre-team EBITDA is 76%- 77% of revenues. In 2013, ESPN released a report detailing how the team's payout is sliced and diced. I'm not 100% sure on some of the numbers, but it's supposedly 62.5% (I've also seen 60%) of the pre-team EBITDA that the team gets a share of. In recent years, however, this has reached as high as 67%-68% due to a one-time cost of approximately 5%.

I found some quite fascinating date on attendance and viewership. In 2016, F1 claimed 390 million unique viewers and 352 million in 2017. It looks as if it lost a good portion of its fan viewership, but what happened, in reality, was a change in the way it was measured, and 352 million is a far more accurate number. Now, when you compare the attendance at F1 Grand Prix in Britain to the NFL Super Bowl, F1 has nearly double the attendance. When you look at the unique viewers and compare the figure to the Super Bowl's numbers, it's over triple. That's quite fascinating for me because the NFL earned $1.32 billion from advertising in 2017, while F1 earned $273 million. That's a ridiculous divide that clearly indicates under-monetization.

As for how the core segments and teams work together, the sponsors pay teams based on the viewership (which is encapsulated in Broadcasting); the location and the number of events (Promotions) increase F1 negotiation Broadcasting leverage; and the Hospitality segment is more of an on-site value-add for fans. The under-utilized and under-invested segments are Digital/OTT (over the top), Merchandising/Licensing/Gaming, Social Media, and New Markets.

The opportunities we have here are quite numerous. There's a great opportunity to do promotion and marketing of the brand. In the Promotion section, F1 can add new races. I'm not quite sure of the number of sponsors today in the Ads and Sponsors category – I've seen about seven, but I've heard 17. Seven refers specifically to the engine manufacturers and parts suppliers.

A number of holes exist in the Advertising categories, where there are luxury providers in sectors such as telecom, financial, fuel, soft drink, hard spirits, apparel, hospitality, and tech. These are all mentioned in Liberty Media presentations on this subject and have not yet been filled with advertisers, so there's a huge opportunity for F1 here. Let's say there are 17 total advertisers and sponsors for F1. The Major League Baseball in the US has 75, which is an incredible difference.

In Broadcasting, F1's leverage and power to negotiate better contracts increases with the number of broadcastings. It's definitely under-monetized relative to other sports in that regard. The Paddock Club in Hospitality reminds me of what happened with the Atlanta Braves. They opened up a new stadium in 2017, shrinking the number of people that could fit inside. But what they were trying to do was curate higher-end clientele, and it worked because they were able to drastically increase their revenues while shrinking the audience. They were also able to create an atmosphere around the stadium. F1 might be able to replicate this kind of experience with the Paddock Club.

Within the new segments, there is a great chance to increase content distribution. Previously, there was 0% interest by Bernie and management to monetize IP beyond the core segments.

According to what I've heard, they just took what came their way; there was really no negotiating. With the Broadcasting negotiation, they probably didn't take advantage of the typical re-rating multiple in this business – 1.5x the original contract base amount is typical when these contracts are renegotiated. If they did take advantage, they probably didn't do it at very high multiples.

While there are definitely a lot of risks to F1, whether they are that material is a question for each investor to answer. When it comes to the Concorde Agreement, which runs through 2020, one risk is that the terms may lead to deterioration in the sports quality, that is, lower investment in the engine technology due to a proposed spending cap. There may be no agreement formed, and perhaps a competing league might be formed. I should note this happened in the past, in the 1980s, and did not succeed because they would have had to build new tracks and find new cities willing to host these tracks. They would have had to find broadcasters and create contracts with them to view their product, which is very hard to do if they don't have a product to begin with. And they would also have had to find advertisers and sponsors. It's all very hard to do to get off the ground.

There could be negative terms for F1, perhaps a similar or a higher percentage team payout. Currently, it's approximately 68% with one-time costs added in. When you strip out the costs, it should be 62.5% to 63%. There were rumors saying F1 wanted to include the engine manufacturers within the revenue share. Those engine manufacturers currently include, I believe, Mercedes, Ferrari, Renault, and Honda.

Ferrari is a team, and that's going to come into play here because the current Concorde terms state that Ferrari gets a 5% payout just for being the longest-running team in F1 racing. However, if the engine manufacturers are paid a share of the team payout, then perhaps it might encourage Ferrari to sign on the dotted line with this new Concorde Agreement because it will still be getting a higher payment than most. But instead of it being based upon its track record of decades ago, it's now going to be based on what it does with its engines. I think this will go over very well with the teams and could perhaps play into a lower amount overall that F1 has to pay the teams. It could, therefore, work to F1's benefit.

Another risk within the Concorde Agreement is that there might be too many races, which could potentially lead to driver burnout, although that's a very small risk – more year-round racing versus the current nine-month timeframe. It could be like for one-time events, and it isn't inclusive of what is currently a 25-race limitation stated in the Concorde Agreement.

There's also the risk of dilution, meaning commoditization of F1's brand due to sponsors being on board for what I would describe as low- to mid-end brands, but there is definitely room for other luxury to mid-end brands within that category.

Regarding monetization, F1 may fail to re-rate the Broadcasting contract at a decent multiple from the prior contract. There could be OTT product difficulties and/or little penetration. That OTT product launched in 2018, and there were some difficulties with it. It was geared towards the hardcore fan and is now going through growing pains but should have some benefit in the future.

In new markets, principally in the US and China, F1 may not be able to successfully promote itself and/or grow into those new territories. It might not be able to find the viewers and fan followings it is craving, and that could then trickle down into all the core segments, as well as the new ones.

Then there's the debt – Liberty is well-known for leveraging up. In the timeframe of 2023 to 2024, there is a $4.5 billion amount due. A combination of variable and fixed rate issues could make F1 unable to roll over its debt and refinance, which could seriously affect the company.

With regard to valuation, the question is what the best way to value F1 is. When I say F1, it means specifically the operating company within F1 Group. One could look at F1 only within the operating group, so by subtracting the market caps of Live Nation and the other public equities, private assets, and cash on F1 Group's balance sheet and then dividing that by F1's free cash flow, you get a very low, appetizing 11x multiple.

However, it isn't fair to look at it that way because you're not including the debt on F1 Group's balance sheet. I'm not referencing F1's operating group debt, which is approximately $3.2 billion but the $2.3 billion or so assigned to Formula One Group's corporate balance sheet. I would argue that you need to take the MC F1-only minus the net asset value and divide it by the F1 FCF, which produces a 19.6 multiple. This is the one to use because I took all F1 Group assets, which included Live Nation, Time Warner, and Liberty Braves intergroup interest, other public holdings, private assets, and also the corporate cash flow. When you take all that and subtract the debt load of approximately $2.3 billion, you're left with approximately $2 billion in net assets. If you take today's market cap, subtract from that the net asset amount of approximately $2 billion, you get $5.4 billion to $5.5 billion in market cap applicable to F1, and that's how I get that multiple of 19.6.

I have come up with a number of different scenarios where I take into account Race Promotion fees, Broadcasting, Broadcasting re-rate multiple, Advertising/Sponsorships, Hospitality/Other services, Digital/OTT Penetration, Team Allocation, Debt Payment, and absolute FCF growth. The differentiation between the growth rates for Race Promotion fees, Broadcasting, Advertising/Sponsorships, Hospitality, and Other Services could be viewed as either inflation or growth, depending on the scenario.

If contracts for the promoters, broadcasting, and sponsorships were to increase simply by inflation, then the upside increase is drastic. The Broadcasting re-rate multiple of 1.5x rises to 1.8x. The typical re-rating multiple can vary depending on the sport. To give you some frame of reference here, NFL has historically re-rated at 1.6x. At the higher end of the scale, you have the MBA with 2.8x. I wanted to keep it as conservative as possible, so I stuck mainly to 1.5x throughout, which I think is very good odds, especially with what Liberty is doing to re-invest in the F1 business. I go only as high as 1.8x.

For Digital/OTT penetration, I assume 0% in 2008 and have it growing by 0.5% increments from 2109 to 2022 in some scenarios. With 352 million unique viewers, 2% is just seven million fans worldwide that would have to buy this product. I have conservatively put the cost at $8 a month worldwide, so there's surely a lot of upside with regard to that.

Team Allocation in 2017 was 67.2%. If we assume it's 68% going forward, decreasing to 65% and 63% in 2021 as a result of the negotiation terms, then it's one more factor that can lead to almost a hockey stick in earnings in the very extreme case. Remember there are one-off charges of 5% of pre-team EBITDA paid in the past couple of years. Those may flow off. But even conservatively, assuming it goes 68% until 2021, I think it's a very safe assumption.

As regards debt payment, I have assumed the average interest rate paid on the debt increases by 0.5% increments through 2019 and 2022. The biggest debt amount is based on a variable rate on LIBOR, which is a risk, but with the exception of the worst-case scenario, I

have assumed there is debt repayment going forward.

I've also assumed that share repurchases occur, except in the worst-case scenario. Everything left over after debt payments would be used to repurchase shares, the assumption being they would be bought at today's Formula 1 Class C prices. From 2024 on, I assume the absolute free cash flow dollar amount does not increase, so growth after that would be from share repurchases alone.

Let me go through these scenarios in some more detail. Scenario 1, or the worst-case scenario, has 0% growth, a 1.5x re-rating multiple, and zero debt repayment. A 10-year multiple would be 11.1.

In scenario 2, or the conservative case, there is 3% growth (1% in Hospitality) and 68% team allocation, but F1 would also start repaying debt in 2019. We have here a conservative 10-year multiple of 15.3.

The base case scenario (scenario 3) would require Digital/OTT penetration to occur and the team allocation to go to 65% in 2021. Remember, there may be a lot of one-time costs at play. The base payout is at least 62.5% right now, so assuming 65% starting in 2021 – to either allow for no more one-time cost or to allow for a lower team payout percentage – will drastically increase the multiple to 28.2.

Then we go to scenario 5 and scenario 6, the optimistic and extremely optimistic ones. This is where everything would be firing on all cylinders: high percentage increases per year for the promoters, broadcasting and sponsorship contracts, Hospitality stays at 1% throughout, same penetration by 2022. The big part here would be team allocation dropping to 63% in scenario 5 and 60% in scenario 6 in 2021. I'm not going to bet on that happening, especially the 60% figure, which is extremely optimistic. I think scenario 5 is more likely, with assumed increases of 5% for Race Promotion and Broadcasting being quite realistic in the long term given what Liberty has been doing to re-invest in the business.

I think most likely is something in between scenario 2 and 3. It's more likely to be 3% growth for Race Promotion, Broadcasting, and Advertising, and 1% for Hospitality, with team allocation dropping down to 65% starting in 2021. Share repurchase and debt repayment occur, and the multiple becomes 18x. If you compare scenario 5 versus scenario 1, you get a 3:1 return, while scenario 5 versus scenario 2 gives you a 6:1 return.

According to my estimates, at today's prices, you are starting to purchase the stock at a minimum 30% margin of safety. When you consider the more optimistic scenarios, you're delving into a margin of safety territory of anywhere from 50% to almost 70%, which is an extremely high buy-in price.

Because of our business model (wealth management), we're investing with individually managed accounts, so I'm starting to nibble on it for our clients' accounts, but I'm not doing so in a whole hog position. I would recommend the business if you're looking for ideas to put into your portfolio, but I don't think it's a good one to do all out quite yet.

If I was in a partnership business model, where I can really wait or had clients that are looking 10, 20, or 30 years out and can afford to lose money, it's quite a different mindset. Most good partnerships out there have the kind of clients that would warrant such mode of thinking. These investment managers can wait for lower prices.

When this deal was announced, it was at $21-$22 per share, and it quickly skyrocketed from

there. Perhaps there are lower prices ahead due to the Concorde Agreements possibly not going the way F1 would like, some teams threatening to break away, or execution risks. There are a number of risks that would make an investment manager wait. I, for one, would start to buy in small positions today, perhaps a quarter or half position, which can differ from manager to manager.

To sum up, this is an opportunity to own an entire sport. The cost structure leads to a very high, very well contracted, revenue-based FCF amount. There are multiple opportunities to grow revenues through either ramping up the core segments or investing in new ones, specifically the distribution of IP, which was not well done under the prior management.

The current management has shown throughout its track record it has excellent capital allocators in John Malone and Greg Maffei, and highly experienced executives in the person of Chase Carey, as well as Malone and Maffei. They have shown they're always looking for the best place to re-invest their capital, and I have great confidence in
their management style.

The following are excerpts of the Q&A session with Nathaniel Leach:

Q: For those interested in doing more work and tracking this idea over time, what might be some data points to monitor to either validate or challenge your thesis?

A: There are a couple of key points one can follow. Going down the core segment line, you've got the Race Promotion segment. You could count the number of races and then divide it by the race promotion fee amount, which can be found under revenue in the income statement. You can calculate the fee per race and the growth of that number as time goes on.

You can also calculate the growth in Broadcasting revenue. It's not going to be even every single year. For example, from 2015 to 2014, it only grew 0.6%, but from 2015 to 2016, it grew by 7.1%. It's going to be lumpy.

With regard to Advertising and Sponsors, you have to find out how many sponsors are currently with F1, which can be hard to dig up. But once you do that, you can divide the number by the segment revenue, find the revenue per sponsor, and start to track the growth for that. With Hospitality, you can just assume it stays flat or maybe grows 1% or 2%. It's hard to know for all the new areas because these are all new revenue segments.

One of probably the two biggest factors is the percentage of team allocation – watching what happens with contract negotiations, keeping your ear to the ground, seeing what's happening with that because the engine manufacturers might start to get a piece of it. Allocation may either increase to compensate them, or F1 might be able to negotiate a lower payout amount to the teams and car engine manufacturers because it is trying to encourage them to think long term and be willing to accept a smaller portion of the pie. But the pie will hopefully expand over time.

The second biggest factor is the debt load. It's going to be critical for Liberty to pay down the debt load. It is well on its way to doing that – it restructured a lot of the debt in 2017 and managed to lower its interest rate payout. Estimates suggest it saved anywhere from $90 million to $115 million in interest rate expense.

What it failed to tell you though is that was just for F1 Operating Group because Liberty Media, the tracker Formula One Group, the corporate side of the balance sheet, compensated for that debt load by taking up more debt onto its balance sheet by monetizing its Time

Warner stock. Those are probably the biggest things to look for.

About the instructor:

Nathaniel Leach grew up in western Wisconsin and has been investing in the stock market since high school. In 2003, he attended Kalamazoo College and graduated with a B.A. in History. His degree encouraged him to conduct diligent research in a disciplined and efficient manner of any concept. In 2008, he enlisted in the U.S. Marine Corps. After completing active duty in 2012, with honorable character, he entered the RIA industry as a Securities Analyst at a local wealth management firm. He spearheaded multiple initiatives in operations, compliance, and trading as he steadily educated himself further as a value investor. Nathaniel has rigorously studied the great value investors, including, but not limited to: Benjamin Graham, David Dodd, Warren Buffett, Charles Munger, Philip Fisher, Mohnish Pabrai, Seth Klarman, and Joel Greenblatt. Nathaniel resides in Madison with his wife Chaoying.