This article by Francisco Olivera is excerpted from a letter of Arevilo Capital Management, based in San Juan, Puerto Rico.

Francisco was an instructor at Best Ideas 2018 (replay the session).

Read about the key pillars of Francisco's investment approach.

We initiated an investment in Disney, which complements the Twenty-First Century Fox ("21CF") investment initiated last quarter. As described in our previous letter, Disney is acquiring most of 21CF's assets and 21CF shareholders will receive shares of Disney and "New Fox" when the deal closes. We decided to increase our exposure to Disney as the share price became more attractive and we grew more confident in Disney's long-term business opportunities.

Disney has four (4) business segments[1]: Media Networks, such as ABC, ESPN and Disney Channel; Studio Entertainment, including Disney Animation, Disney Studios, Pixar, Marvel Studios, and Lucasfilm; Parks and Resorts, such as Disneyland and Disney World; and Consumer Products & Interactive Media, the licensing division for merchandise and games.

The heart of Disney

The studio business is the heart of Disney and creates momentum across most of the company's business segments. Disney's studios produce high-quality films and television programming, many which turn into valuable franchises. In addition to driving theatre box office sales, physical/digital video purchases and video licensing fees, these franchises also generate demand for consumer products and can be leveraged across the company's theme parks and resorts.

As an example, Disney Animation's Frozen, a 2013 film, generated nearly $1.3 billion in global theatre ticket sales, a very financially successful film (not to mention hundreds of millions of dollars in home video sales as well). For any other studio, Frozen would be a major hit (and it was for Disney), but only Disney – with its scale, entertainments assets, and marketing expertise – was able to further monetize the film. Disney's Consumer Products & Interactive Media segment licensed Frozen content for dolls, toys, clothing, and other merchandise, providing high margin profits for the company (sales of Frozen dolls alone reportedly exceeded $500 million). Disney has also incorporated Frozen content in its theme parks and recently launched a Frozen Broadway show. A Frozen sequel is expected to be released next year.

Disney continuously executes this strategy: leveraging its high-quality content making capabilities with its scale, entertainments assets (including Parks and Resorts), and marketing expertise to monetize content at an unmatched level. Other examples of Disney franchises include: Pixar's Toy Story, a new "Toy Story Land" in Disney World will open this summer and Disney will release a fourth film next year; Marvel's Blank Panther, which has generated over $1.3 billion in global theatre ticket sales this year (in late February, the line

to “meet” Black Panther at Disneyland was an hour long); and Lucasfilm’s Star Wars films, a Star Wars themed “land” and hotel will open in Disney World next year. Disney’s studio, parks and consumer products segments have continued to excel in spite of the changing media landscape.

Media Networks concerns

Concerns over Disney’s value as a company have grown over the past few years as new internet-based content creators and distributors (mainly Netflix, Amazon, Hulu and YouTube) have changed consumer behavior and disrupted the pay television content bundle, the main profit generator for Disney’s largest division, Media Networks. A decline in pay TV households in the U.S. is likely to continue, as quality content is cheaper and easier to access on Netflix (and other streaming services) versus the traditional +100 channel cable bundles. This does not mean Disney’s media networks (the largest and most important being ESPN) are doomed towards extinction.

According to 21CF’s Chief Financial Officer, 83 of the top 100 shows on television[2] in 2017 were sports or news. In 2007, 90 of the top 100 shows were scripted entertainment shows, such as Lost and Two and a Half Men. Consumer habits have dramatically shifted. Consumers prefer to watch live content when tuning to linear television and turn to streaming apps to watch their favorite television shows and movies on their own schedule. Disney knows these trends will continue to accelerate and began to implement a two pronged strategy: 1) Maintain ESPN’s place in the cable bundle, as the premier destination for live sports; and 2) shift the majority of its scripted entertainment to a new Disney direct-to-consumer streaming product to be introduced next year.

ESPN

The traditional cable bundle is still the best mechanism to distribute ESPN’s live sports content rights. Live sports are very expensive and therefore ESPN needs to be distributed as widely as possible. Television advertisements for sports events are the most valuable due to the live nature of the content, and sports transmission on cable has less technical issues relative to online live streaming. Given that the most watched programming on television is live and the most valuable portfolio of live sports is licensed by ESPN[3], we expect ESPN’s ability to extract value from the cable bundle to continue.

Recognizing the decline in U.S. pay television households, ESPN launched a new branded direct-to-consumer streaming service called “ESPN+.” The focus for ESPN+ is on niche sports, daily MLB and NHL games, and ESPN’s original programming, including the award-winning 30 for 30 series. We expect ESPN to acquire more significant sports rights for ESPN+ over the next few years, which could serve as a hedge to ESPN’s cable bundle risk. In our view, the risks to ESPN’s long-term business model are vastly overstated.

Disney Direct-to-Consumer

Disney’s studio business was built on movie theatres selling tickets, retailers selling home movies, and other media companies licensing Disney’s content library. These third parties

mark-up Disney's products considerably and do not provide Disney with significant data on its customers. Disney does not know who watched Frozen in theatres, purchased Frozen merchandise, or bought Frozen Blu-Ray for home viewing. To position Disney for the future, the company has announced a Disney branded direct-to-consumer streaming service that will launch next year. Disney will cease to license its content to Netflix (and other streaming providers) and go "all-in" on its new service.

We believe the larger goal of the Disney streaming service will be to create a sustained Disney experience for consumers. With the new service, Disney will know what movies and television shows consumers watch most and will be able to adjust its content spend accordingly. The service could eventually offer exclusive deals for Disney merchandise, theme park discounts, cruise line discounts, and/or exclusive Disney Broadway tickets. Shifting the content monetization from primarily third party revenue streams (individual movie tickets and home movie purchases) to a subscription model will create enormous value for Disney over the long-term. Owning the most valuable family-oriented content in the world has its perks!

Twenty-First Century Fox Transaction

The above description does not include the assets Disney is acquiring from 21CF, but it is worth commenting on, given the size of the transaction. We believe the 21CF acquisition materially enhances Disney's long-term opportunities. On the Media Networks side, Disney will be adding a large portfolio of regional sports networks ("RSNs") that matches well with ESPN and could provide valuable content for ESPN+. Disney will also be acquiring FX Networks and the National Geographic Channel. Both channels own noteworthy content that Disney will be able to monetize through its own streaming services, including Hulu.

The 21CF deal will raise Disney's ownership in Hulu to a controlling 60% stake. Disney will be able to supply Hulu with quality adult-oriented content that does not fit well with the Disney branded streaming service. With over 20 million subscribers, Hulu is a growing force in content streaming and will fit perfectly with Disney.

The Twentieth Century Fox Film and Television studios add enormous content and content-making capabilities for Disney, including the Avatar, X-Men, Fantastic Four, Deadpool, and Planet of the Apes franchises. Monetizing franchises has been Disney's "bread and butter".

21CF's Marvel film franchises (X-Men, Fantastic Four and Deadpool) will integrate seamlessly into Disney, but the Avatar franchise is also a great fit[4]. Lastly, Disney agreed to acquire 21CF's 39% stake in Sky Plc and Fox's international television businesses, which provide additional direct-to-consumer services and increases Disney's international scale. Growing internationally has been one of Disney's long-time goals; 21CF provides the perfect assets to grow Disney's content awareness globally.

It is important to note that Comcast is trying to disrupt Disney's 21CF deal. Comcast announced a formal bid to buy Sky Plc, and is currently outbidding 21CF[5]. The Wall Street Journal also reported that Comcast may be interested in publicly bidding for the 21CF assets Disney agreed to acquire. We believe Disney will still manage to close its 21CF deal

with Sky Plc, however, if the deal does not happen, Disney remains an attractive investment.

Valuation

Disney currently trades at approximately 15x LTM earnings[6], a very cheap multiple when considering Disney's future growth opportunities and earnings accretion from the 21CF deal. Disney has also committed to repurchasing $10 billion worth of its own stock by the time the 21CF deal closes and an additional $10 billion within two years post-closing. At today's cheap stock price, Disney would create additional value by repurchasing shares.

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[1] Earlier this year, Disney announced a reorganization of its business segments to align the company with its future growth opportunities, such as its direct-to-consumer streaming services. Given that Disney does not yet report its financial statements under the new reorganization, we did not discuss the reorganized segments in this letter.
[2] Includes both broadcast and cable television shows.
[3] ESPN's live sports portfolio includes, NFL's Monday Night Football, NBA (including playoff games and the NBA finals), college football (including playoffs), college basketball, MLB, Grand Slam tennis and Formula 1.
[4] Last year, Disney opened the Pandora – The World of Avatar "land" at Animal Kingdom.
[5] 21CF is in the middle of receiving regulatory approval to acquire the 61% of Sky it does not own. Upon receiving regulatory approval, 21CF is expected to raise its bid for Sky to prevent Comcast from acquiring the company.
[6] LTM = last twelve months. We adjusted earnings for the impact of tax reform.