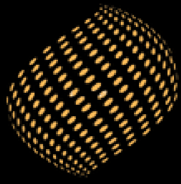

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16/12/2022

WarnerMedia Merges with Discovery for $43 Billion

SORTINOMAGROUP.COM

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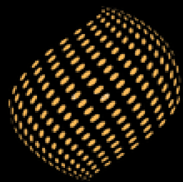
Source: Business Insider



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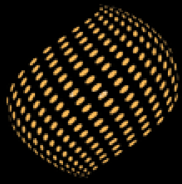

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DEAL INTRODUCTION

DETAILS ABOUT THE DEAL

On 8 April 2022, AT&T's WarnerMedia and Discovery finalised a $43 billion merger to create a mass media powerhouse, Warner Bros Discovery. The move was intended to pave the way for the new business to compete with media and streaming giants such as Netflix and Disney.

As part of the agreement, AT&T pulled out of its $85 billion acquisition of Time Warner. The new company, Warner Bros. Discovery, took on $43 billion of AT&T's debt, with AT&T shareholders retaining a 71% stake in the company.

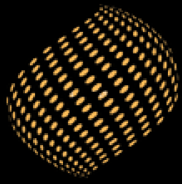
Advisers involved in the deal included boutique investment bank Allen & Co, along with bulge bracket banks such as JPMorgan and Goldman Sachs.

REASONS FOR M&A

The merger made WarnerBros Discovery the largest pure entertainment brand on the market, with a host of streaming platforms and cable channels under its umbrella.

The move will also provide an opportunity to cut costs, with reports suggesting that the merger could save over $3 billion.

Source: Fox Business



INDUSTRY OVERVIEW

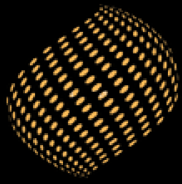
WHAT IS THE MASS MEDIA ENTERTAINMENT INDUSTRY?

The mass media entertainment industry is built upon three streams of distribution, cinema, terrestrial TV, and streaming. Many firms stretch across these mediums, and including content creation. Although, there has been one key difference in 2022. The profit margins for pay-TV have become considerably larger than for subscription streaming distributors, an inconvenient truth given the recent shift in consumer behaviour.

KEY HISTORICAL DEVELOPMENTS AND CHARACTERISTICS

Traditional media is struggling to keep up with changing content consumption. The pandemic has accelerated an existing trend in home entertainment, with new video-streaming competitors emerging and succeeding. The biggest winner of this evolution was Netflix, with an almost complete monopoly of the subscription-based market. Disney Plus, Paramount Plus, NBC Universal, Amazon Prime, and Apple TV, have since emerged, imitating Netflix's revolutionary model.

While the transition from legacy entertainment towards online streaming has provided strong revenue growth for many online distributors, the cost of content is increasing. With providers competing for subscribers, consumers have come to expect an unprecedented level of output, demanding heavy investment. In February, Morgan Stanley researchers expected a 12% increase in production spending between 2022 and 2025 "due to an insatiable need for new content".



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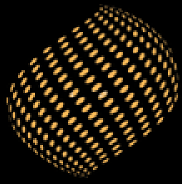
TRENDS FOR 2022 AND BEYOND

2022 signalled the end of an era. For the first time in a decade Netflix saw a fall in subscribers, 1.2 million to be precise. After this announcement, the share price fell almost 40%, bringing their value back to pre-pandemic levels. Raising prices to finance the ever-increasing cost of content, at time of significant pressure for consumers, indicated that growth is not inevitable.

For the wider industry, it has shown that the streaming market has a limit. Through the pandemic it was the revenue generating foundation, although with shrinking margins and opportunities to be profitable, streaming appears to be just one part of a wider content providing strategy. With several competitors launching advert supported subscriptions, consumers have reacted positively; Netflix saw an addition of 2.41million subscribers in Q3 of 2022. Interestingly, streaming is beginning to emulate the disrupted revenue model of legacy.

Source: Sportico



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ACQUIRER OVERVIEW

TICKER: WBD

WARNERMEDIA

WarnerMedia was founded in 1972 by Steve Ross under the name of Warner Communications. In 1990, it rebranded to Time Warner following the merger with Time Inc.

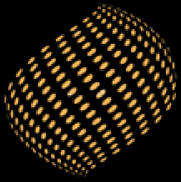
WarnerMedia is a leading media entertainment company that distributed premium content to a global audience through brands such as HBO, HBO Max, CNN, Cartoon Network, and Warner Bros.

BUSINESS MODEL

WarnerMedia splits its operations up into three segments:

- Turner – operates multichannel basic television networks and digital properties
- Home Box Office – operates multichannel premium pay television services
- Warner Bros. – produces and distributes television shows, feature films, and games

Source: WarnerMedia



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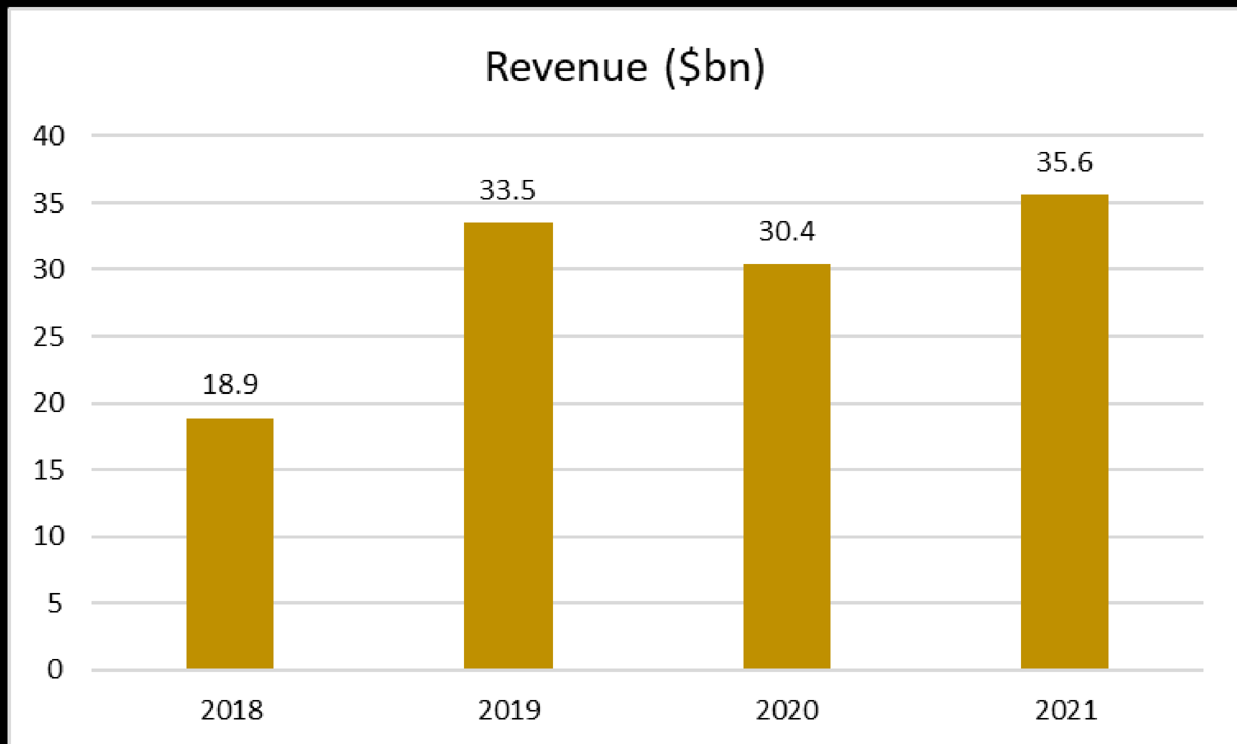
ESG PRACTICES

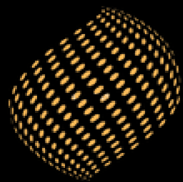
WarnerMedia is a founding member of the Sustainable Production Alliance (SPA). The Alliance is a consortium of global leaders in film, television, and streaming, who are dedicated to advancing sustainability initiatives.

The business also has its Encore programme, which supports local community partners by donating surplus items from its food service groups, productions, and departments.

In 2021, WarnerMedia donated over 75,000 items of clothing, furniture, and household items to 92 nonprofits across the 17 cities where it worked and filmed.

KEY FINANCIALS





TARGET OVERVIEW

DISCOVERY, INC

Discovery, Inc. was an American multinational mass media factual television conglomerate based in New York City. Established in 1985, the company operated a group of factual and lifestyle television brands, such as the namesake Discovery Channel, Animal Planet, Science Channel, and TLC.

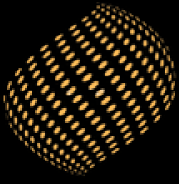
BUSINESS MODEL

Discovery aimed to generate revenues principally from the sale of advertising on its various networks and digital products

They also generated revenues from fees charged to distributors that carried its network brands and content, primarily including cable, direct-to-home ("DTH") satellite, telecommunication and digital service providers, as well as through DTC subscription services.

Other revenue-generating transactions include affiliate and advertising sales representation services, production studios content development and services content licences, and the licensing of its brands for consumer products.

During 2021, advertising, distribution and other revenues were 51%, 44% and 5%, respectively, of consolidated revenues.



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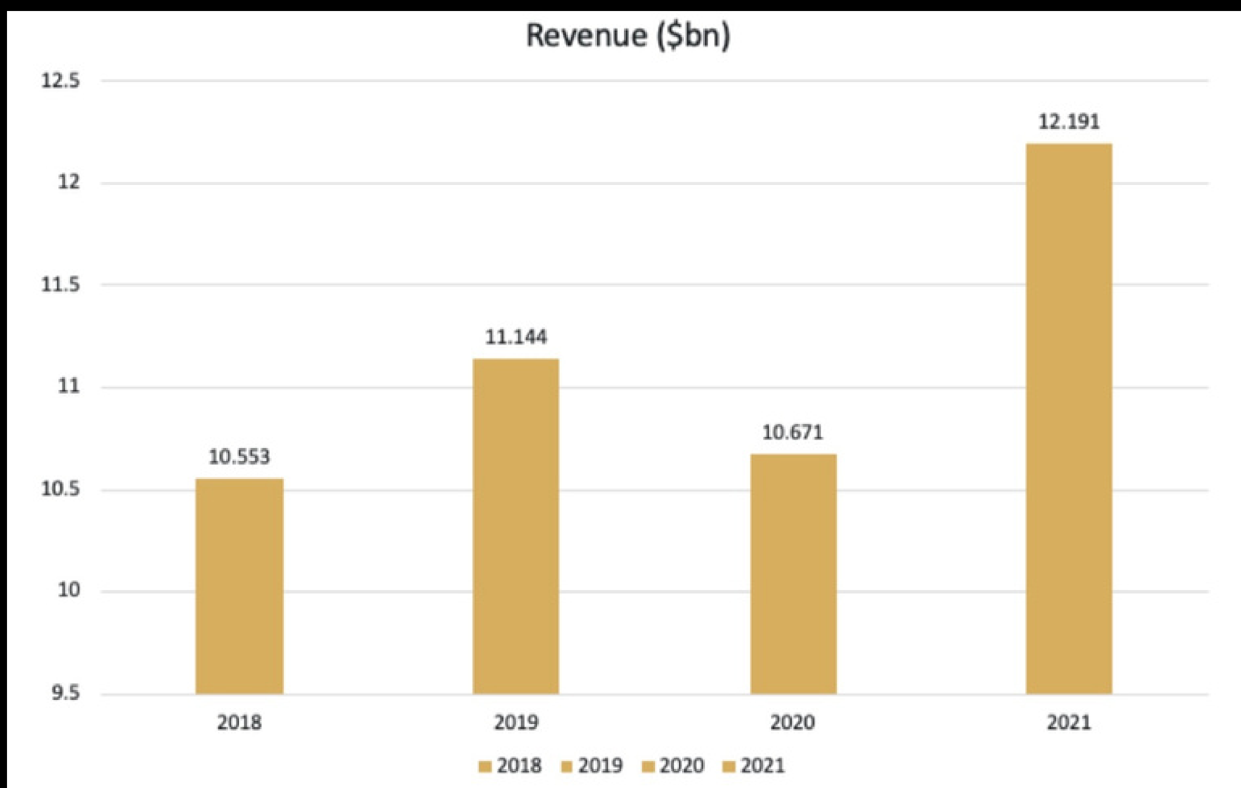
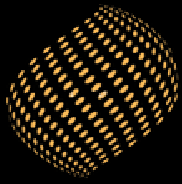
ESG PRACTICES

Discovery has a department dedicated to social good that builds and oversees consumer and employee-facing initiatives and campaigns. They leverage their platforms, resources, and employee base to make an impact in communities and with key nonprofit partners around the world. Discovery also have corporate partnerships aimed at addressing childhood hunger, inequality, civic engagement and wildlife preservation. Their employee-facing initiatives include matching gift and “dollars for doers” programs and sponsoring Impact Day, a global day of employee volunteerism that gives back to the communities where they live and work around the world. Discovery are also committed to using its voice to advocate for action around the issues of our time that are important to our employees.

KEY FINANCIALS





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DEAL ANALYSIS

STRENGTHS

By combining their streaming service together, WarnerMedia and Discovery will be at a position to reduce competition in the industry, As a result, companies that sell content, such as ITV Studios or BBC Studios, will only need to sell content to one buyer, as opposed to two before the merger. Reduction in competition could allow the new company to have a bargaining power over prices, which would reduce the cost and increase profits for the merged firm.

WEAKNESSES

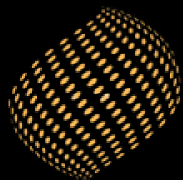
As a result of the merger, Warner Bros. Discovery currently has a net leverage multiple of 5.0x, implying that the company holds an extensive amount of debt given the size of the merger. The company has mentioned this issue by stating that their goal is to reduce their net leverage to 2.5-3.0x, however due to the current economic state of rising interest rates, achieving this goal may take longer than initially anticipated for Warner Bros. Discovery

OPPORTUNITIES

Merging with Discovery gives great opportunities to WarnerMedia since Discovery has been the top low-budget, unscripted TV provider. Therefore, the merger of the two companies can enhance the reach of the target audience of Warner Bros. Media. As a result, the world-class premiums scripted TV service in combination with Discovery's low-budget, unscripted stream can allow the company to be a direct competitor of any direct-to-consumer (DTC) offering that exists.

THREATS

Although the use of WarnerMedia and Discovery is common in the US, Canada and the Nordics, Sky still remains to be the popular choice for European countries, such as UK, Germany and Italy. In these European countries, there are existing content distribution agreements that are thought to continue until 2024/25. Therefore, Warner Bros. Discovery should strategically consider their actions for the post-agreement period after 2024/25 in order to improve their presence over the European market.



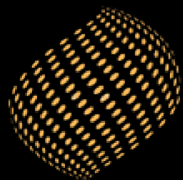
VALUATION ANALYSIS

MERGER MODEL

Post-merger EPS Calculation	
Revenues	181,055
(Operating Expenses)	(155,696)
EBIT	25,359
(Interest On Debt)	(900)
(Interest Foregone [on cash])	(468)
(Net Interest [besides on new debt & foregone]**)	(2)
PBT	23,989
(Income Tax)	(5,997)
Net Income attributable to Noncontrolling Interest	17,992
(Net Noncontrolling Interest)	(1,589)
Net income	16,402.75
Outstanding Diluted shares of combined company	7,864
EPS of combined company	2.0858
EPS of acquirer standalone	1.5151
Accretive/Dilutive	Accretive
Accretive/Dilutive	0.5707
Accretive/Dilutive (%)	38%

Please click on the table to access full model.

Based on the merger model and the accretion/dilution analysis shown above, the merger between Discovery and WarnerMedia can be expected it to be accretive, having the possibility of increasing the EPS of the acquirer by 38%. However, it should be noted that the analysis is based on the financials between Discovery and AT&T since the WarnerMedia's specific financials were not obtained. The analysis shown suggests that Discovery's interest in merging with WarnerMedia is highly justifiable, and has the potential to bring in significant financial benefits for the company, although the share price has reacted oppositely since the announcement of the merger.



VALUATION ANALYSIS

COMPARABLE COMPANIES ANALYSIS (CCA)

Media company	Low	High
Selected EBITDA Multiple:	8.8x	10.9x
Implied Enterprise Value	69,803	86,204
Net Debt	(43,000)	(43,000)
Implied Equity Value	26,803	43,204
Equity Value per share	$ 3.75	$ 6.05
Premium / (Discount) %	60.43%	(0.47%)

Please click on the table to access full model.

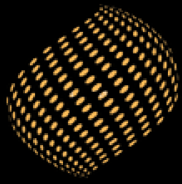
Based on the comparable company analysis (CCA), WarnerMedia's valuation multiples appear to be very close to the mean of the comparable group of companies. Out of the 4 comparable companies, there were a wide range of media companies in terms of equity value and EV/EBITDA multiples. All comparable companies appeared to have positive EV/EBITDA valuation multiples. As a result of the multiples, the low and high EBITDA multiples were chosen to be 8.8x and 10.9x, giving the implied enterprise values of $69,803 and $86,204, respectively. At the end of the valuation, the implied share price was found to be at least $3.75 and at most $6.05. When compared to the price offered by Discovery based on AT&T's total shares outstanding, the merger can be concluded to be fairly priced due to the premium range of %60.43 and -%0.47. This implies that %60.43 was the maximum amount of premium that Discovery paid based on the CCA analysis.

CONCLUSION

IMPACT ON KEY COMPETITORS

A contributing factor to the large-scale subscriber declines for firms such as Netflix is the availability of competitors. The Warner Bros Discovery merger combines a variety of content offerings to rival key players with large existing portfolios. Alongside that, with greater scale and operational synergies, such mergers are a more cost-efficient way of providing an alternative for consumers. As outlined by CFRA Research, this is a unification of “WarnerMedia's premier news and entertainment assets with Discovery's industry-leading cache of non-scripted programming networks”, a combination difficult to achieve organically. With a greater number of competitors, consumers are given greater freedom to switch between providers, when dissatisfied or searching for an alternative.

According to Deloitte, in the more mature US market, “the rate at which people add and cancel paid streaming services averages around 35%”. This is only likely to increase, with more firms providing the level of content variety and quantity as the industry giants like Netflix and Disney+. The implication for incumbents is a cap on subscriber demand. There are simply not enough consumers to sustain the level of growth seen in the last 10 years. As already clear, these firms will begin to consider whether streaming should remain the sole pillar of revenue.

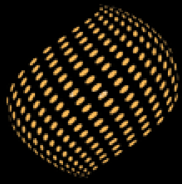


CONCLUSION

IMPACT ON INDUSTRY

The immediate implications of this merger, for the wider industry, is a reduction in investment. WarnerBros Discovery led the charge of content austerity by axing CNN Plus, the almost complete 'Batgirl' film and the HBO series 'Demimonde'. This is a part of a wider strategy to make a 3.5 billion spending cut in two years. With underlying revenue falling 8% from 2021 and shares falling by a half, it isn't surprising that the firm is reviewing its spending. CEO David Zaslav has defended this approach, stating that "spending money with abandon while making a fraction in return has ultimately proven, in our view, to be deeply flawed". While this may benefit the firm and its shareholders, the implications for the content production industry are certainly adverse.

For Warner Bros Pictures, the film unit of the firm, a 5% to 10% workforce reduction has been announced, with home entertainment cuts also planned. If this attitude towards investment spreads to the balance sheets of other competitors, third-party creators would face a serious problem. As not all streaming services make their own content, many are just distributers; the creators face the pay cut. Since the expansion in production in recent years has been uncovered unsustainable, revaluating the revenue streams for both distributors and creators is very likely consider whether streaming should remain the sole pillar of revenue.



GLOSSARY

Accretive: *Accretive in finance refers to the positive change in value after a transaction*

Bargaining Power : *The power that allows an entity to reach an outcome in their favour during an economic interaction*

Enterprise Value: *The total market value of a company that considers debt in the valuation*

EPS: *Earnings per share show the company's net profit divided by the total number of outstanding shares, which is used as a profitability measure*

Equity Value: *Total value of the company based on the activity of equity investors, found by multiplying share price with the number of shares outstanding*

EV/EBITDA: *Enterprise Value 'Multiple', gives insight into the value of companies against their cash earnings less their non-cash expenses.*

Net Leverage: *Net leverage is a ratio that compares the company's total debt in regards to its earnings before interest, tax, depreciation and amortisation*

Profit Margin: *The ratio between revenue and cost used to convey relative profitability*

Synergies: *An increased net effect as a result of the interaction of two organisations compared to the sum of two individual effects*