Yet another guide to media stocks, Part 5a: Corona impacts

Hi! Welcome to Part 5a of Yet Another Guide to media stocks. Today’s post will cover how COVID is impacting the media sector. Before diving in, I’d highly encourage you to check out the intro section to the guide, which goes over why I’m doing this and dives into the most important thing hitting the media sector today (well, aside from COVID): cord cutting. You can also find links to all of the pieces in this series here.

It feels like a lifetime, but we're only two months into the Corona crisis. Trite to say, but obviously huge sectors of the economy and every day life will be reshaped by Corona. I think anyone who tells you with 100% certainty that they know how long term trends will be shaped by Corona is lying, but I do think investing today requires a lot of deep thought about how trends are likely to change and shift in response to Corona. I also think some of these trends are likely to be materially different than the market currently expects / is pricing in, and if you can successfully identify a Corona response that will unfold differently than the market is pricing in, there's likely a significant amount of money to be made.

I've been thinking a lot about how Corona will impact a bunch of different corners of the media / telecom sector, so I wanted to throw some thoughts out there. Again, we're just two months into the Crisis, and no one truly knows how this will unfold, so if you agree / disagree with any of these points I'd love to hear your reasoning!

Movie theaters

- Corona impact: screwed

- Let me start with the most obvious: movie theaters companies are absolutely, totally destroyed. That's pretty obvious to just about anyone, but I don't think many people understand that there's absolutely no coming back for these companies. I know some people who think they can avoid bankruptcy, or that they have some future in restructuring. Nope, asbolutely not. Every movie theater company today deserves its own chapter in F'd companies, because they are done and not coming back.
- The short term is a disaster: movie theaters are closed. They are taking in zero revenue while they still have fixed costs (from both their lease and their debt service cost). Revenue lost today is lost forever, and while rent can be deferred, it still needs to be paid back at some point.
- The medium term is pretty obviously awful too: let's say movie theaters are allowed to reopen over the summer. Awesome for them. I'm sure states are going to put extreme limits on their capacity, but I'm not sure state limits on capacity is going to be necessary: who is going to want to go to movie theaters? You may be thinking, "some brave souls will certainly want to sit in a poorly ventilated box with a bunch of random strangers," and you're probably right (I mean, there are people who think bleach could be used to treat Corona, so anything is possible). But the better question is who is going to want to go to movie theaters to see whatever movies are playing? I can guarantee you every movie that has not yet been pushed to 2021 is going to get pushed. What movie studio is going to release a film during a pandemic while movie theater capacity is limited? Do you think Disney is about to have the headline "New Corona outbreak traced to 15 parents watching

Mulan?" Heck no, and that's ignoring that no studio is going to bother marketing / releasing a movie when theaters have limited capacity because there's no way the limited box office receipts are going to cover the movie's costs (remember, marketing costs for a blockbuster run into tens of millions of dollars, and if movie theaters are limited to 25% attendance then the box office receipts wouldn't begin to cover the marketing costs alone!). So, let's assume there's no major release happening this year. What are movie theaters going to show in September that is going to entice people to go see them? Old Marvel movies? Good luck with that.

- Now, you may be thinking that's a short term issue. There may not be new movies in 2020, but they'll come back at some point in 2021. Let's say your right, and let's even be generous and say that there's a vaccine in early 2021 so people feel comfortable going to movie theaters and filling them to capacity (again, I strongly doubt movie studios are going to release their movies in any type of "limited capacity" theater environment because the limited box office receipts will never cover their marketing / distribution costs). Great, early 2021 comes and people are going to see all of the delayed movies from 2020 (Mulan, Wonder Woman 1984, etc.). What happens after all of those movies have been released? Movie production has ground to an absolute halt right now. There's going to be a huge air pocket of movie releases once all of the current "delayed" backlog is released, and the longer this crisis goes on, the longer movie production will be halted and the bigger that air pocket is. Remember, a movie production is a big production: dozens of people in close interaction with each other often filming across the globe. Sure, you could avoid some of this with "smaller movies," but the things that really drives the box office is huge Marvel-esque spectacle movies. Those involve more people, more travel,more locations, and more time to produce. Big budget production is likely to come back much later than your average business, and the longer it takes for big budget production to come back, the bigger that movie release "air pocket" is and the worst for theaters.

- But again, you might argue that's a medium term issue. In the longer term movie goers will feel comfortable going to movies and the movie slate will look normal, and then theater companies' normalized earnings can shine through. And you're absolutely correct.... but what is normalized earnings going forward? The current pandemic has provided movie studios with the opportunity to experience releasing movies directly to consumers (either through an app like Disney+ or just releasing them into VOD immediately), and the results have been alright. For example, Universal released Trolls 2 to VOD, and it did more revenue in three weeks than the original did in five months in theaters. Universal's head said "the film exceeded our expectations and demonstrated the viability of premium video on demand." There are a bunch of issues with comparing Trolls 2's VOD income to the original's box office, but the key point here is that VOD has been proven viable. Remember that a movie theater takes a ~50% cut of any ticket revenue; going forward, every movie studio is going to have a huge sword hanging over the movie theaters in ticket cut negotiations ("take a smaller cut or we release this VOD and make just as much money without paying you a dime"). That negotiating leverage is going to be particularly brutal against the movie theaters for the first batch of movies that get released ("I don't know. Why should we release this in theaters; are we sure people are ready to go back? We're just going to release it on VOD..... unless you give us 99% of the ticket receipts." That negotiation may seem brutal but as a movie theater is mainly fixed cost and they would still get advertising and concession revenue, they may agree to some particularly brutal film splits).

- **Variant possibility / how could the impact be different:** honestly it's tough to come up with a variant thesis for movie theaters.
    - Look, I'm not saying no one will ever go to movie theaters ever again. People still pay hundreds of dollars to see Lion King on Broadway even though you can see it for free on Disney+ (well, they don't go to Broadway currently, but you get the idea!). People will go to movies; people want to get out of their house and away from their phones and doing diner and a movie is one of the easiest and most cost effective was to do that. But, in their current design, all of these movie theaters are screwed. Their cost structures are way, way too high for both the near to medium term attendance picture and for how hard studios are going to be able to push them on ticket splits going forward. Theaters need a complete design, likely towards a more premium experience: smaller theaters, more comfort, more focus on higher margin food and drink items (I think trends towards selling alcohol / delivering items during the movie are obviously going to accelerate).

Cable (broadband specific)

- Corona-impact: slight positive
    - Long time readers will know that cable is my favorite sector, and Charter is my largest position. A huge part of the thesis has been their broadband internet offering had huge advantages (speed advantage against most competition, monopoly in many places) and was dramatically underpriced versus its utility. Corona has highlighted just how important cable is in every day life, and the need for fast, reliable internet has likely resulted in a small acceleration in cable demand (as suggested by both Charter's early disclosure and my anecdata). More people working from home means anyone who tried to live without home broadband is probably subscribing, and subs are likely looking to upgrade to higher speed tiers in order to stream video better.
    - So why only a slight positive? Three reasons
        - First, and most importantly, a hidden sneaky (well, sneaky to most observers; anyone who followed cable closely knew it) piece of the cable thesis was the growth on their business side. For example, in 2019, Charter's small business customer count grew ~7%, while enterprise grew ~8%. The growth here was driven by similar dynamics to the residential business: cable's infrastructure was simply better, and they were taking share as people switched from slower, legacy providers. That growth is going to be demolished by Corona: businesses are going to be going bankrupt left and right, and it's hard for me to imagine many businesses looking to switch providers when they are dealing with an existential issue of revenue dropping to zero. There is a small eventual silver lining: when businesses do restart, I

would guess any existing business is giving their current cost structure a hard look, while all of the new businesses replacing bankrupt businesses will evaluate providers with fresh eyes. Cable companies should be taking significant share from both customer groups given cable's superior infrastructure and (often) lower pricing.

    - Second, cable companies were investing hundreds of millions into building out their wireless services. This involved big marketing blitzes as well as building out fixed cost infrastructure (in particular, retail store fronts). I would guess (and early data seem to confirm this) that people have stopped switching wireless providers during the crisis; it's simply too much of a hassle and there's too many other things to do. That means all of that early investment / fixed cost that cable is making will drag on for much longer than expected.
    - Third, the economy is going to be an absolute disaster. Bad debt, non-pays, etc. are all going to go up.
- **Variant possibility / how could the impact be different:** the current crisis has shown just how important cable is to everyday life, and the government decides it needs to be significantly more regulated. Government mandated price caps or even a utility like allowed return environment.
    - Another possible variant, but on the positive side? I could be way off on wireless, and their wireless business is actually booming / adding huge subs right now. Remember, cable's big wireless selling point is "we have the same network as your current provider, but we're way cheaper." I think that pitch should ring

particularly true in the current environment: you're not leaving your house much, so how important is network anyway, and who doesn't want to save money in a GDP down 20%+ environment?

- Cable companies start reporting earnings later this week, so we'll have more on their trends and outlook then, but I'd be very surprised if anything they reports differs from what I said here!

Cable bundle / pay TV

- Corona-impact: big negative
    - At first blush, you could paint a picture of Corona being good for the old cable bundle. People's free time has gone up dramatically, and one of the only ways they can spend that free time is watching TV. Basically, the same forces that are driving Netflix would drive increased Pay-TV usage. Plus, cancellations could go down a bit; the largest source of cancellations are still people moving, and moves are going way down in the current environment.
    - But nope: that's all wrong. The cable bundle costs ~$100/month. Netflix and Hulu each costs $10-15/month, and each offers all of the general entertainment you could ever watch; substantially more options than the cable bundle, and you can watch it all whenever you want. The reason the cable bundle can charge more despite a far inferior product is because the cable bundle is anchored by "live" events (this clip sums it up well). The headliners here are sports and news (particularly sports), but there are other live things (the Oscars, Grammys, late night shows, etc.). Corona has wiped away basically all of the live events (outside of news). In effect, if you're subscribed to the cable bundle right now,

you're paying $100/month for news + a far inferior netflix product. People are going to be cancelling in droves on the awful value proposition alone, and that's before factoring in that the current economic environment will result in plenty of people' taking an ax to their monthly budget / subscriptions.

  - An easier way to think about this: the monthly cable bundle costs ~$100/month. Of that cost, roughly half of it goes towards sports (ESPN, RSNs, plus part of the network fees clearly covers their sports rights). Basically all of that cost is worthless right now. When half your value proposition goes to zero value over night, of course you're going to have cancellations!

- Are there ways to solve this problem? Sure! The easiest would be a "pause" on sports fees while sports aren't happening. But that's not likely to happen fast enough because the value chain is complex. Consider ESPN and a consumer: the consumer pays $8/month for ESPN. That $8 goes to the cable company, who gives it to ESPN, who uses it to pay for their rights fees to the sports leagues. If you're a cable channel sub, you're probably going to cancel if you keep getting charged $8/month for an ESPN that delivers no value. So say you call your cable company to cancel. Maybe you stay if they offer to waive that $8/month until sports comes back. Awesome.... but now the cable company is eating the $8/month/sub until they get that revenue from you. They should go to ESPN and ask for a rate cute.... but ESPN has huge fixed costs in the form of rights fees they owe to the sports leagues. They can't take a fee cut unless the sports leagues agree to a rate cut rates until sports comes back. All of that should be doable.... but it's a complex value chain, and it needs to be repeated across dozens of combinations of cable channels / cable companies / sports leagues. Until all those negotiations happens, consumers are getting overcharged for a product that delivers limited value, and churn is likely to dramatically accelerate until the value proposition comes back in line.

- So the near term is both complex and negative. But it's not (just) the near term I'm worried about: it's the longer term. Remember, the cable bundle is built on sports rights, and those rights are generally fixed. Say you're ESPN and you pay the NFL $1B/year for their rights. If you spread that across 100m subs, that's just $10/sub/year. But if Corona causes a mammoth acceleration in cord cutting and suddenly there are only 50m subs, your cost per sub has effectively doubled. Yes, in the short term, you can probably negotiate your NFL rights down if the NFL isn't playing games, but my worry here is what happens in the next negotiation. Instead of negotiating from a starting place of 100m subs, you're starting with 50m subs. Your cost/sub is way higher. Doesn't that open the door for a streaming player (like Amazon) to come in?
    - Let me frame this another way: when the NFL's next round of bids comes up, ESPN and Amazon both may have bid $1B for streaming rights to Monday Night football. The NFL would probably have gone with ESPN because of ESPN's greater reach. But now ESPN is likely to be bidding with a dramatically smaller base. Can the new base even support that potential $1b bid? And, even if it could, ESPN's argument "we reach more people

than Amazon" is now substantially weakened. In fact, Amazon might reach more people than ESPN does by the time all of this is over!

    - Also, remember that a lot of cable revenue still comes from advertising. We're absolutely in the middle of a mammoth recession; ad rates are going down bigly literally overnight and they aren't coming back anytime soon (also, a big piece of advertising is driven by live events, which aren't coming back anytime soon!).

- **Variant possibility / how could the impact be different:** everyone will be desperate, and this presents the opportunity to make cuts that the bundle would never have been able to do in normal times
    - Everyone has known the cable bundle was a bloated / broken product for years, but the collective action problem meant that no one could do anything about it. Every company is going to be absolutely desperate on the heels of Corona: ESPN knows their value proposition is shot. Sports leagues have seen their revenues drop to 0 overnight, and the possibility of being forced to play games in empty stadiums means their media rights are their only saving grace / form of potential income (plus their athletes have unexpectedly seen their income dry up, and leagues will be facing pressure from their athletes to get some revenues in the door). That desperation might give cable companies some temporary power to come in and reset the bundle: hold the sword of a blackout or using force majeur over every channel's head and force every company to come to the table and renegotiate fees in a way that resets the bundle's cost more in line with its value proposition, while calling up the sports leagues and offering a lifeline if they agree to pause their fees while they're delivering no value. Do that across a bunch of channels, and use

> the crisis to cut a bunch of excess channels, and you could bring the bundle's pricing back in line with its value and substantially stem cord cutting going forward. I don't think it's likely / think it's too much of a bank shot and that all of these companies are too busy worrying about surviving the near term to pull off an industry wide solution like this in a very short time frame, but the cable industry is relatively consolidated and generally run by long term strategic thinkers, so I guess anything is possible!

Ok, that's enough for today. Tomorrow I'm going to try to dive a little further into Corona's impacts on the networks, broadcasters, and free radicals. Again, if you have any thoughts on these (or areas you'd like to see covered), I'd love to hear from you!