Yet another guide to media stocks, Part 6: Sports investing in a post-Covid world $MSGS $MSGN

Hi! Welcome to Part 6 of Yet Another Guide to media stocks. Today’s post will cover how I'm thinking about investing the publicly traded sports plays in the post-Covid world. 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. Note that I'm assuming you've read that piece for this post (some of the discussion of the bundle unwinding won't make much sense without that background), so I'd encourage you to go read that if you haven't! You can also find links to all of the pieces in this series here.

One of the areas I've spent the most time thinking about (and been asked questions on!) recently is Covid's impacts on sports teams. A big driver of these questions is likely due to how cheap publicly traded sports teams currently are. To pick two favorites (which I have written up extensively), MSGS (the sports spin off from the old MSG; MSGS owns the Knicks and Rangers while MSGE owns the Garden and other entertainment assets) trades for an EV <$4B, and BATRA (the Atlanta Braves plus the surrounding real estate) trades for ~$1B. Those are mammoth discounts to the private market value of the sports teams underlying those assets; the Knicks alone would likely go for ~$5B if they were put for sale (or more than MSGS's entire enterprise value, implying you get the Rangers thrown in for more than free!), and I would guess the Braves would be close to $2B in a sale (implying you get the very valuable real estate around the Braves' stadium plus a few other goodies for more than free). They are even discounts to the Forbes values of the teams (which tend to understate the private market value of the teams in a sale); the Knicks were value at $4.6B and the Braves for $1.8B.

Make no mistake: those are cheap prices, and they likely represent opportunity. However, I do see some clouds on the horizon. The impacts of Covid on sports teams are going to be felt for decades to come, and I would not be at all surprised if Covid creates some permanent impairment in sports team values. Probably not enough impairment to justify close to today's discount, but if you asked me if you offered me the exact same sports team at $2B pre-Covid or $1.5B post-Covid, I would almost certainly prefer to invest at the higher price in the pre-Covid world.

Investing at a higher price with a rosier outlook might sound a little hypocritical as a value investor. Isn't getting a discount due to a temporary factor what value investors dream of? And while stadiums will be empty for the near term future, it's difficult to imagine that Covid has a serious long term impact on the popularity of sports. Sports have lasted for centuries and survived wars, pandemics, and cocaine; surely their popularity will survive Covid. And, provided their popularity survives, isn't today's discount an opportunity?

Perhaps. Probably. But Covid has introduced serious tail risks and likely dramatically changed the economics of sports for the long term.

The biggest thing that likely has changed is Covid has accelerated cord-cutting. Remember: the cable bundle had increasingly become a "live" bundle. If you didn't watch Fox News and/or sports, there was really no reason to pay $80/month for a cable bundle; a Netflix subscription is far cheaper, offers far more variety, and doesn't include commercials. So when Corona shut down every sports league, it created a really weird cable TV offering: cable TV was effectively an overpriced sports bundle that no longer had sports. The results were pretty predictable: cord cutting accelerated. That acceleration is going to have repercussions for sports leagues years down the line. Consider the NBA: ESPN pays ~$1.4B/year to the NBA for their rights. Pre-Covid, there were ~85m people subscribing to the bundle, and that number was dropping by ~5%/year. If you spread that $1.4B across all 85m people subscribing to the bundle (just assuming all bundle subs were ESPN subs), ESPN effectively paid $16/sub/year for the NBA rights. With subs decreasing by 5%/year, when the NBA's ESPN contract came up in ~2025, ESPN would likely be bidding on a new contract with ~70m cable subs. Most people (including me) expected that the next round of NBA bidding would see another (significant) boost to their rights; here's a media consultant who thought the rights would double in the next round. Let's say that's right and ESPN started paying $2.8B/year in the next contract. With 70m subs in 2025 versus 85m today, the cost per sub for ESPN to have the NBA would go from ~$16/year today to $40/sub.

That's pre-covid. COVID has accelerated cord cutting. What happens if that acceleration means that there are only 65m subs to ESPN when they bid in 2025? 60m? The numbers start to get wacky real quick. If there are only 60m subs in 2025, bidding $2.8B for the NBA would mean ESPN is paying >$46/sub for the NBA versus the prior estimate of $40/sub. That's a huge increase.... and if cord cutting seemed set to continue at ~5%/year, it's entirely possible a long term contract for the NBA could see ESPN paying close to $60/sub/year for the NBA rights on the back end of that contract in the new world versus $16/year today.

Spread that increase in cost per sub across all sports, and that has a dramatic impact on the cable bundle. If the price/sub of all sports is tripling / quadrupling, the price of the cable bundle has to rise. As the price of the bundle rises, more subs will cancel, which leads to the price/sub of sports right to rise, which leads to more subs cancelling, which..... It's a vicious cycle that ultimately causes the cable bundle to break, and Covid has likely dramatically accelerated that breaking.

Bottom line here: cord cutting acceleration means that networks will have to be less aggressive in their bids for sports rights in the future. The economics of fewer subs simply demands it.

But that's just one small effect. There are plenty of other knock-on effects. Consider baseball; who the heck knows what the baseball season is going to look like this year? It's entirely possible we have a lost season. What does that do to any baseball RSNs that have the cable contract running out this year? If I was a cable company, I would absolutely be looking to blackout the RSN. Why am I going to be given them $5/sub/month when they aren't providing a product? Sure, the RSN could offer to take no or seriously reduced fees until baseball returns.... but, again, if I'm a cable distributor, I'm looking to tighten the screws on the RSN right now. If I blackout an RSN during a lockout, basically no one will care. But the RSN will suffer enormously. Most of the RSNs are owned in pretty levered formats; suddenly having their cable fees (which they basically thought of as an annuity) drop to zero is going to cause massive debt service issues for them. Cable companies can start the process of resetting their video cost curve by turning the screws to RSNs while they're weakest. And that screw turning has huge knock on effects for sports leagues: lower RSN rights fee = less revenue = less profits.

There are plenty of other places where economics are going to be lost. Obviously the near term loss of gate fees is going to hurt, and given the economy will likely be brutal for a while I'd guess sponsorship revenue and such is going to be awful. But those are more near term issues: I feel pretty confident that five years from now stadiums will be backed and sponsors will be locking to enjoy the sports brand halo once the economy turns around.

So the economic concerns are serious. But what's more serious is the tail risk that reduced revenues introduce to sports teams.

Look at baseball right now: there's the possibility the whole season is cancelled because owners and players can't agree on a revenue split. There's likely to be a lot more labor disputes to come in the near future, as players and owners adjust to a new reality that revenues are going to be a heck of a lot lower than anyone thought possible.

Consider basketball: there's near no doubt that the revenues and the salary cap will be dramatically lower than expected in the next few years. The NBA gets ~22% of their revenue from gate receipts; those are almost certainly trending towards zero for next season. The NBA's salary cap (and most other sports) are set on a revenue share, so the NBA effectively losing 22% of their revenue means that salary cap will have to go down by 22%. How many unions do you know who would take a 22% haircut for their members without going ballistic? It has the potential to get ugly fast: unions claiming that their billionaire owners are more concerned about keeping their profits high in a crisis than the well being of their players, owners leaking that players are overpaid and entitled, etc.

Or you could have strife within the player community. Consider Chris Paul: he's set to make ~$40m next season. The cap for the 2021 season was supposed to be ~$115m; what happens if the cap drops to $95m? Suddenly, Chris Paul went from making ~35% of the salary cap to ~43%. That's a pretty big increase; does that create resentment among other players who are free agents in the summer and will get significantly less because they timed into an unfortunate cap drop? Or consider the teams: if they had a roster signed for next season for $110m, suddenly their team went from under the salary cap to way over. You could see waves of free agents unsigned simply because teams are locked into contracts from a completely different time.

I'm not saying it will, but all of these financial consequences have the potential to set off some really weird dominoes. And when weird dominoes get set off, you don't know where they end up. Lebron James is already making more per year in endorsements than he is in NBA salary; if the league tries to cut salaries 20% across the board, could James and a few other super stars band up and create their own league (Kyrie Irving already floated the idea, though Irving can be a little wacky....)? In normal times, I'd consider that laughable. But with the whole world on pause, a fresh league could have some advantages: there are plenty of suboptimal things about the NBA that could be improved with fresh thinking, and obviously the players could cut out the owners (who don't really provide much) and keep the equity capital for themselves. I'm not saying it's at all likely; I'm just saying that there's a really good chance that we see a lot of labor strife on the back end of this and that the players (particularly the superstars) have never been in a better position to try to reset the power dynamics of the league. 40 years ago, Michael Jordan didn't make enough money off the court to threaten to fund a new league, and even if he did it would have been incredibly difficult for him to go get all the TV contracts, media deals, etc. he'd need to fund a league. Today, the NBA's top players have reach rivaled by only a select few (the Kardashians, K-Pop band BTS, and maybe POTUS); between their reach and sponsorship deals, I could certainly envision a path to starting a player owned league.

Again, it's very unlikely.... but if things get bitter enough it's a threat that will certainly get made. I expect to see several lockouts and strikes through different sports as teams and players adjust to the new economic realities, and while I doubt a player owned league is happening, I wouldn't be surprised if the threat of one gets made and I wouldn't be surprised to see players ultimately striking deals that see them get a much larger piece of a much smaller pie and results in teams and franchises becoming less profitable. So, best case, teams are a lot less profitable going forward given lower revenues and probably needing to give players a larger cut. Worse case, you see constant strikes / lockouts (and remember, missed seasons and long lockouts are awful for sports leagues; both hockey and baseball still haven't recovered fully from strikes/lockouts that happened decades ago) as players and owners fight over a smaller pie. Absolute black swan scenario, you see some players figure out how to band together and start a new league / cut out the owners entirely.

(The counter to all this is I'm talking about the NBA mega-stars with enormous endorsement deals; the rank and file make a lot less and may need the NBA paycheck too much to threaten to miss a year and work for little to start a player owned league. Traditionally, owners win strikes and lockouts because owners have outside wealth and players do not, and owners can manage a strike with a view towards owning a team for decades while every year a player misses due to a strike represents a huge percentage of their playing career. It's possible I'm overestimating the players here, but social media and the ability to monetize fame in different ways will likely continue to tip the balance of power from owners to players going forward).

Ok, I realize I hit a lot of things there, but here's my bottom line: Covid is going to mammothly alter the economic landscape for sports. The acceleration of cord cutting means the next TV deals are likely to be for a lot less than leagues had been planning, and the loss of other revenues like ticketing and decreased sponsorships could lead to years of labor strife and, in some super tail scenarios, the possibility of new challenger leagues popping up.

A few other random thoughts while I'm here

- Another longer term risk that has emerged from Covid? I think the "sports product" in the near to medium term is likely to be a lot worse, and combine a worse product with no in person fans, and I think leagues will lose incremental fans, particularly kids. That type of stuff doesn't show up in the near term numbers but in the long term it can have really negative implications for a league and its economics.
    - A big part of being a fan as a kid is going to a stadium and experiencing a game. Kids aren't going to get that for the next few years. Sure, they can watch the game on TV.... but they could also just go play fortnite. I would bet a significant number of kids chose fortnite over watching games on TV, and that can break the lifelong fandom bond.
        - Somewhat related: Covid likely significantly accelerated and increased the adoption of eSports.
    - The sports product is also likely to be a lot worse in the near to medium term. Watching sports without fans is really strange. Consider maybe the craziest shot I've ever seen: Kawhi Leonard's game winner against Philly last year. Part of the thrill of the play (and I still get chills when I watch it) is listening to the whole stadium go quiet as the ball hangs on the rim and then erupt once the shot goes through. Without the crowd, watching sports losses a little bit of the drama. At some point, a lessor product will result in less fans, lower ratings, etc.
        - This is something I missed with WWE. In the midst of Covid, I thought WWE would be a winner as they were the only "sports" product on television, and ratings would spike as people were desperate for live sports. But it turns out watching strong men running around in their underwear is really

weird if they're doing it by themselves instead of in front of 20k fans, and that's resulted in some really poor ratings for the WWE since Covid struck.

- I think Covid is going to reveal the importance of leadership for the sports leagues. Look at the NBA versus the MLB: the NBA got near unanimous buy in for resuming the season, while the MLB has been unable to come to terms with its players and could see a cancelled season. Leadership matters during a crisis.
    - It's impossible to state that without discussing MSG: it's controlled by James Dolan, and he is probably the worst owner in all of sports at this point (well, maybe Dan Snyder is worse). That is a big concern I have about all of the MSG entities at this point. In normal times, it was suboptimal but ultimately ok to have Dolan in charge. The tailwinds behind sports was just too strong, and as long as the value of the NBA and NHL were growing, Dolan's team values would get dragged higher even though it sometimes appeared like he was doing everything in his power to hurt his teams. In Covid times, that "league creates value despite Dolan's best effort" probably holds..... but there's growing risk that Dolan does something stupid (like being the only owner the wants the NBA to continue its season when Covid is spreading through the league) that causes serious damage to the Knicks / Rangers intrinsic value.
- Some quick hits on specific investment themes
    - RSNs: there are only two real plays on RSNs in the public markets: MSGN (which owns MSG Network) and SBGI (which owns Fox's old RSNs; I've made my thoughts on how untrustworthy SBGI is well known). Pre-Covid, I was very bullish on MSGN. It was very cheap, it would benefit massively from sports betting getting legalized in NY, and I thought it

was an obvious acquisition target with meaningful synergies to a buyer. Post Covid, I'm much more cautious on RSNs in general and MSGN in particular. As mentioned above, given no games ongoing, I think cable operators have enormous incentive to pressure / blackout RSNs in the near term. In the medium term, accelerated cord cutting and a worse sports product likely mean hugely decreased ratings. A very tough combo.

- Sports betting: if there's one thing the pandemic has proved, it's that people want to bet on sports (with most sports shut down, sports books saw huge increases in bets on table tennis). I think the sports betting trend is real and likely to accelerate. I'm not sure the best way to play this though; day traders have run up the most obvious plays (casinos, draft kings, etc.) to prices that make little sense to me. I have looked at most of the popular tech style plays on it, and unfortunately passed on most of them right before they tripled. MSGN used to be my favorite backdoor betting legalization play, but as mentioned above I'm really cautious on MSGN currently.
- MSGE: not a sports property exactly, but figured I'd throw some thoughts down here quickly. This is the other half of the MSG / MSGS spin; MSGS got the sports teams, MSGE got everything else (mainly the stadiums and lots of cash). There's no doubt MSGE trades way below the value of its assets, but pre-Covid I worried the companies plan for a Las Vegas Sphere were equivalent to lighting money on fire. In today's environment, it's borderline reckless that they're moving forward with relatively the same plan.