A Perspective on Twenty-First Century Fox

by Drew Weitz

Twenty-First Century Fox ("Fox") is a global, diversified media company. Its primary operations are film and television production; a collection of global entertainment; sports and news cable networks; the Fox broadcast network and local TV broadcast stations.

The Best Laid Plans

In June of 2013, the "old" News Corporation split itself into two companies: the "new" News Corp housed the more mature print media businesses, while the faster-growing television and film businesses were organized as Twenty-First Century Fox. Soon thereafter, Fox held an investor event highlighting the company's growth potential and informed Wall Street of their expectation in the fiscal year ending June 2016 to generate $9 billion of EBITDA (earnings before interest, taxes, depreciation and amortization – a proxy measure for a business' ability to generate cash from operations). (Fox subsequently sold its satellite pay-TV businesses. After the divestment, the guidance was adjusted to $8.1 billion to reflect the sale.) Wall Street cheered what seemed to be highly-visible, double-digit growth.

Unfortunately, after describing this three-year roadmap, Fox's results almost immediately took a detour. In the United States, a weak ad market and poor performance at the Fox broadcast network hit domestic earnings. Internationally, results remained strong in local currencies, but a rising US dollar increasingly dampened the contribution of overseas earnings, when translated into dollars for Fox's financial statements. In light of these circumstances, management was forced to reduce their 2016 earnings target–twice (once in February 2015, then again in August). Wall Street never looks favorably on downward revisions to guidance, landing Fox in the penalty box. Recent results have underwhelmed, and the industry is more competitive than ever, but we don't believe disappointment is a new permanent state of the world.

Cord Cutting Arrives

More recently, the entire media industry has come under additional investor scrutiny, as 2015 may be best remembered as the year that "cord cutting" (or, the act of cancelling one's pay-TV subscription in favor of internet-delivered video options) became reality. We acknowledge subscriber rolls have shrunk, but we believe the current loss of 1-2% of customers per year is manageable, and the "big bundle" will persist longer than many have suggested. In fact, Fox's most recent quarterly results included more than 1% increase in the aggregate number of subscribers, having won greater distribution for recently reformatted networks like Fox Sports 1 and FXX. Combined with brands like FX, Fox News and National Geographic, these networks comprise a compelling collection of content. Finally, live sports have only increased in value as viewers generally watch games live (and consequently, the ads too). Fox is uniquely positioned with "must have" sports content, thanks to its portfolio of 22 regional sports networks that have long-term broadcast agreements with 85% of the MLB, NBA and NHL teams in their markets (representing nearly half of all the US-based teams in these three leagues).

Lost in Translation

Fox is truly a global company, generating nearly 40% of its revenues outside the United States, and unlike the mature US market, pay-TV is still in "growth mode" in many countries around the world. In the past, investors pointed to Fox's enviable international position as a fundamental strength. However, the strong US dollar has muted growth, and many investors have soured on exposure to foreign currencies. Over the long term, however, we remain enthusiastic about Fox's overseas opportunities. For example, at STAR India, management made the decision to reinvest profits into key sports rights (principally cricket) to strengthen their position in the Indian market. The bulk of these stepped up investments are now behind them, and as expense growth moderates, the company forecasts STAR will progress from being a breakeven operation last year to generating $300 million of EBITDA this year, growing to nearly $1 billion in EBITDA by 2020. (For context, in the last fiscal year Fox earned $4.6 billion of EBITDA from all its cable channels combined.) Even under more conservative forecasts, STAR represents a tremendous growth opportunity, and Fox is well poised to capitalize on it.

Underappreciated Assets

The above discussions have centered on operations that Fox controls and consolidates in its financial results. Fox also has potential upside in the form of two, non-consolidated and underappreciated assets: a 39% stake in European satellite broadcast company Sky plc, and a 33% stake in Hulu. Sky's shares are publicly traded, implying a $10.6 billion value for Fox's stake, or roughly $5.25 for each Fox share (as of 1/8/2016). Management has consistently indicated that owning 39% of the company isn't likely to be a permanent state, and we consider a sale or spin-off to shareholders as the most likely outcome.

Valuing Hulu is a more difficult exercise, as its financial statements are not available. Various Wall Street research reports have estimated Fox's stake could be worth $2-5 billion (admittedly, a wide range), or roughly $1.80 per Fox share at the midpoint. We view Hulu as a strategic investment and a partial hedge, should the traditional pay-TV business break down more quickly than anticipated. We view these assets as options that create value for Fox, but our investment thesis doesn't require they be sold.

Valuation

We have long been attracted to media businesses for their subscription-based cash flows and relatively low reinvestment needs. Coupled with the under-appreciated assets, and a very strong balance sheet featuring nearly $6 billion of cash on hand, we believe Fox's shares are trading at very attractive levels. With the stock priced near $26 compared with our estimation of business value in the low $40s, we believe Fox provides a compelling investment opportunity for the Portfolios.

Drew Weitz, research analyst and co-portfolio manager, joined Weitz Investment Management in 2008. He has been co-portfolio manager of Research Fund since January 2010 and co-portfolio manager of the Small/Mid-Cap Value Strategy (Hickory Fund) since December 30, 2011. Drew holds a BA in computer science from Carleton College in Northfield, MN. While earning his degree, he spent his summers at Weitz working in various capacities. From 2004-2008 he was a research associate and research analyst with Ariel Investments, a Chicago-based investment firm.

As of December 31, 2015: Twenty-First Century Fox CL A represented 3.5%, 1.5%, 3.6% and 2.2% of the Partners Value, Partners III Opportunity, Research and Balanced Funds' net assets, respectively. Twenty-First Century Fox CL B represented 5.0% of the Value Fund's net assets, respectively.