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21 Century Fox acquisition impacting Disney's Studios

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Abstract:

The 21CF acquisition was revolutionary, not only for both companies, but also for the overall Film Entertainment market, since two of the biggest players in it have been combining their strengths in the past months. Acquisitions are highly complex processes, that if executed correctly, can bring tremendous synergies for businesses, but if not, can result in operational and organizational losses. The purpose of this report is to look deeply into the factors that have a greater probability of increasing the performance of Disney’s Studio Entertainment segment in the years that follow the acquisition of Fox’s Studios.

Key words:

Synergies; Acquisition; Enterprise Value

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How acquisitions can have a positive or negative impact on businesses

An acquisition is a process where one company takes control of another, typically requiring Debt issuance or new shares issuance or in some cases both (it is possible to observe in Disney case, that it issued $32.5 Billion debt and also issue 307 million shares).

Applying an acquisition strategy is a very complex problem, mainly because there are not patterns from other acquisition because of different objectives, firms of variable sizes, all resulting in diverse outcomes from this process. Understanding what drives a company to acquire another is the first step to comprehend how the company can succeed and for that, it is important to illustrate six different possible reasons: To improve the acquired company performance, mainly by reducing costs and taking measures for revenue growth; Combine businesses with competitor to avoid over capacitation on matured industries; Increase the market penetration of innovative services/ products; Acquire knowhow, skills and technology on a faster and sometimes cheaper way; Target market scalability, by operating businesses with close necessities and therefore reducing costs; Purchase companies that show promising futures at a time where it is less expensive to do so. For Disney, it is noticeable the case of acquiring for reducing excess offer in the industries and also for achieving market scalability and negotiation strength.

By 2017, up to 83%[1] of acquisitions ended by destroying value for the acquirer and this elimination of value can come from organizational factors, such as cultural issues and management disagreements from different leadership polities of managing the human and financial capital of the company. Value can also be destroyed from difficulties in executing the acquisition, by issuing to much debt or shares to pursue with the purchase or by not knowing how to manage it. Finally, it can even result in customer cannibalization or confusion, leading to an overall market share loss.

In some cases, acquisitions are hugely successful, because both companies are capable of reaching to more customers, with better solutions and at lower costs, there is space for large cost reductions, trough the combination of different business units and corporate offices, debt issuance that leads to substantial tax gaining’s and cultural diversion that can create stronger and more complete teams, with innovative ways to performed for the other.

[1] https://www.forbes.com/sites/georgebradt/2015/01/27/83-mergers-fail-leverage-a-100-day-value-acceleration-plan-for-success-instead/#4315a3f95b86

To measure the success of an acquisition, the key is to analyse the synergies that come from it and Disney's is no different case.

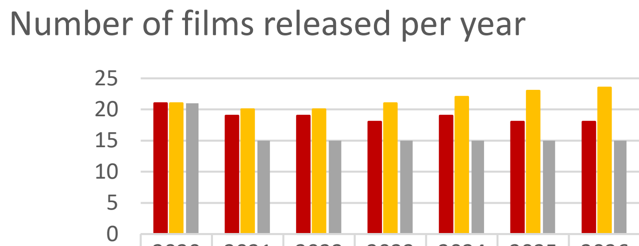
Disney and Fox possible synergies value after acquisition

To conduct this analysis it was took into consideration three different scenarios (expected, optimistic and pessimistic) for which were applied three possible impacts for the Studio Entertainment segment performance, being the first factor that impact of the acquisition on the film releasing capacity, the second the effect on customers, distributors and talent providers agreements, which will impact directly the operational result of the segment and the third being the impact of cultural differences on the overall performance of the sector. This analysis will start by looking at the factor in each specific scenario and then doing an overall look on the Enterprise Value impact.

Factor 1: Film releasing capacity

As announced by Disney's CEO after Fox acquisition, it is expected that Fox will produce half of the movies it was capable of, mainly because of synergies that will be created between the different studios owned by Disney, but also to avoid schedule releasing cannibalization. Fox is expected to produce an average of 8 films each year, from its usual capacity of around 15 movies a year and assuming Disney will keep the same production capacity, the combination of Disney's studios is expected to release an average of 19 films each year.

On a more positive perspective, it is believable that at some point in the future, Fox will be able to slowly return its releasing capacity without cannibalizing the other studios and because of that, on the optimistic scenario it was computed a recovery of Fox's capacity starting 2021. Forecasting for a more negative scenario, the level of production of Disney in this segment has become greater than its competitors, creating a potential scenario where Disney Studios will also reduce its capacity, focusing on releasing less movies, but with a better performance on the market, which will be seen on the pessimistic scenario (figure 1).



	2020	2021	2022	2023	2024	2025	2026
Expected Scenario	21	19	19	18	19	18	18
Optimistic Scenario	21	20	20	21	22	23	24
Pessimistic Scenario	21	15	15	15	15	15	15

Figure 1- Source: Nova SBE equity research

Factor 2: Losses from renegotiation of agreement with customers and suppliers

Negotiating with suppliers and customers is a long-term process even for market leaders like Fox and Disney, that need to be carefully managed overtime. With an acquisition of this size, is expected that Disney will gain some market strengthens that can lead to operational cost reduction and even higher quality movies, by having access to a larger set of actors, directors and movie producers. This is the most expected outcome from this acquisition and so it was inputted both on the expected scenario and the optimistic scenario.

When analysing possible losses in this factor from the acquisition process, it is possible that with some customers, distributors and talent vendors the process does not go so smoothly for a different range of possibility (e.g. previous bad experience from a Disney supplier, with Fox Studios), that on a greater level can lead to visible profitability losses and therefore reduction on EBITDA margins.

Factor 3: Cultural differences creating impacts

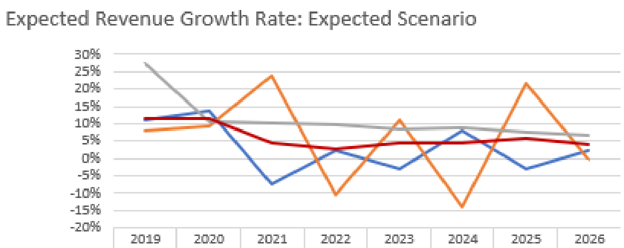
One of the biggest challenges when conducting an acquisition is assuring that both human capital can relate with each other business culture, managing policies and business overview, and in many cases there are gains/losses in product and service innovation from disparities, increases/decreases on operational margins. Looking into Disney and Fox cultural statements, it is reasonable that no major impact will come from this acquisition and therefore, under the expected scenario there was no impact coming from this factor.

Since the Studio Entertainment segment is much dependable on workers capacity to innovate and create new concepts, it trustworthy to believe that a positive impact on the performance of the movies can come from this acquisition. This impact was computed on the optimistic scenario.

On top of these analysis, there is also the possibility that cultural differences from the companies create incapacity on capitalizing some expected studio's synergies, leading to losses in terms of film releasing capacity and EBIT margins, which were reflected on the pessimistic scenario.

Scenario 1: Performance analysis

On the expected scenario, it was computed a CARG of 3.98% (1.75% in real terms) for this segment, divided in three different business units, theatrical distribution (0.61%), home entertainment (2.59%) and TV-SVOD and others (7.67%) (figure 2). In this scenario the factor with a greater impact was the film releasing capacity of Fox and taking that into consideration it was computed an Enterprise value of $63,307 million (figure 3) resulting on a target price for 2020 of $162.23 and an expected capital gain for investors of 11.9%.



	2019	2020	2021	2022	2023	2024	2025	2026
Theatrical distribution	11%	14%	-7%	2%	-3%	8%	-3%	2%
Home entertainment	8%	9%	24%	-11%	11%	-14%	21%	0%
TV/SVOD distribution and other	27%	11%	10%	10%	9%	9%	8%	7%
Total Studio Entertainment	11%	12%	5%	3%	4%	4%	6%	4%

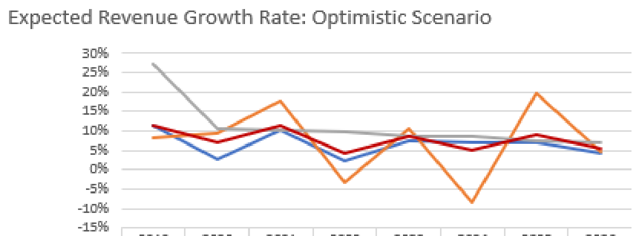
Figure 2- Source: Nova SBE equity research

Media	$	127 128
Parks&Resorts	$	136 077
Studio	$	63 307
Consumer Products	$	29 636
DTC	$	3 959
Corporate	$	(10 088.41)
Enterprise Value (million)	$	350 019
Debt (million)	$	50 550
Non core assets/liabilities	$	(7 124)
Equity value	$	292 344.83
# Shares ((million)	$	1 802.00
Price per share	$	162.23
EPS	$	6.62
Expected Capital gain		
Price taget 2020	$	162.23
Current share price	$	146.88
Expected Capital gain		10.5%
Expected cash gain		
Dividend yield		1.44%
Expected cash gain		1%
Expected capital gain+ cash gain		11.9%
		BUY

Figure 3- Source: Nova SBE equity research

Scenario 2: Performance analysis

Analysing the optimistic scenario, it was computed a CAGR of 7.25% (5.02% in real terms), conducted by the productivity increase both from the recovery of Fox's capacity and also trough synergies from cultural diversion on workers (figure 4). This scenario led to an Enterprise value of $88,468 million, what reflected on a price target increase of $13.3 and a new expected capital and cash gain for shareholders of 20.9% (figure 5). It is expected a probability of this scenario occurrence of 15%, based on already announced films and from statements made by the company executive board during FY19 financial results presentation.



	2019	2020	2021	2022	2023	2024	2025	2026
Theatrical distribution	11%	3%	10%	2%	7%	7%	7%	4%
Home entertainment	8%	9%	18%	-3%	11%	-8%	20%	5%
TV/SVOD distribution and other	27%	11%	10%	10%	9%	9%	8%	7%
Total Studio Entertainment	11%	7%	11%	4%	8%	5%	9%	6%

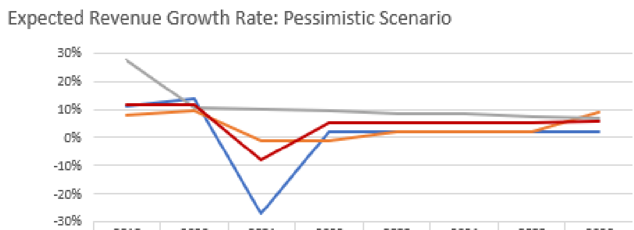
Figure 4- Source: Nova SBE equity research

Media	$	127 085
Parks&Resorts	$	135 903
Studio	$	88 468
Consumer Products	$	28 609
DTC	$	3 954
Corporate	$	(10 075.63)
Enterprise Value (millior	$	373 942
Debt (million)	$	50 518
Non core assets/liabiliti	$	(7 126)
Equity value	$	316 298.55
# Shares ((million)	$	1 802.00
Price per share	$	175.53
EPS	$	6.56
Expected Capital gain		
Price taget 2020	$	175.53
Current share price	$	146.88
Expected Capital gain		19.5%
Expected cash gain		
Dividend yield		1.44%
Expected cash gain		1%
Expected capital gain+ cash		20.9%
		BUY

Figure 5- Source: Nova SBE equity research

Scenario 3: Performance analysis

On the pessimistic scenario, it is expected impact of cultural differences and agreement renegotiation losses on operational expenses from 43% of revenues to an average 47% of revenues. On top of this, a lower releasing capacity results in lower revenue increases (figure 6) that combined with the previous mentioned leads to an Enterprise Value for this segment of $51,394 million, a new investment decision (hold) because of expected capital gains of 7.3% and a target share price of $155.46. From historical analysis on the probability of acquisitions resulting in costumers and supplying losses, this scenario has a probability of occurrence between 2% to 5%[2].



	2019	2020	2021	2022	2023	2024	2025	2026
Theatrical distribution	11%	14%	-27%	2%	2%	2%	2%	2%
Home entertainment	8%	9%	-1%	-1%	2%	2%	2%	9%
TV/SVOD distribution and other	27%	11%	10%	10%	9%	9%	8%	7%
Total Studio Entertainment	11%	12%	-8%	5%	5%	6%	5%	6%

Figure 6- Source: Nova SBE equity research

Media	$	127 120
Parks&Resorts	$	136 034
Studio	$	51 394
Consumer Products	$	29 301
DTC	$	3 961
Corporate	$	(10 090.91)
Enterprise Value (million)	$	337 719
Debt (million)	$	50 458
Non core assets/liabilities	$	(7 124)
Equity value	$	280 135.81
# Shares ((million)	$	1 802.00
Price per share	$	155.46
EPS	$	6.44
Expected Capital gain		
Price taget 2020	$	155.46
Current share price	$	146.88
Expected Capital gain		5.8%
Expected cash gain		
Dividend yield		1.44%
Expected cash gain		1%
Expected capital gain+ cash gain		7.3%
		HOLD

Figure 7- Source: Nova SBE equity research

[2] https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/where-mergers-go-wrong