



DISNEY | FOX

THE RED WEDDING OF MAJOR STUDIOS – BY SYLVIA TORSELLINI



The much awaited Deal of the Year, The Walt Disney Company (NYSE:DIS) buys Twenty-First Century Fox (NasdaqGS:FOXA), does not seem to be standing on solid grounds. In a time where the entertainment industry is dramatically changing, Disney has decided it is time to finally regain the initiative at the expense of what has become its biggest rival: Netflix. Disney has entered into a definitive agreement to acquire FOX, in a deal valued at over \$55 billion; under the terms of this agreement, FOX's shareholders will receive 0.2745 Disney shares for each FOX share held. What can FOX offer that could potentially offset the mighty power of the new media giant, Netflix? We believe, not much. If Disney really needs to compete in the streaming arena, why amplifying its pre-internet legacy structure while carrying the burden of more satellite TV and broadcasting channels from FOX?

The real deal should have been Disney buying Netflix. Well, that had to happen a few years ago when Netflix was still “buyable” and yet during that period we were debating about the “uncertain”

future of Netflix without realizing that there was only one possible outcome for this promising company: to become the new standard in entertainment. Disney had its chance to enter the streaming market, and gain an insane footprint that would have changed the entertainment sector forever. At the beginning of 2013, with respectively a market cap of \$92 billion and \$5 billion, Disney-Netflix could have been a winning joint reality with implications for decades to come. Now that the window of opportunity has closed, Disney's lack of vision is cornering the company into a deal with FOX that appears to be tardy and dull.

About a century ago, the entertainment industry used to be fully vertically integrated. Who would have thought that could happen again? Against all odds Netflix has proven that a change of direction was not only possible but rather inevitable: the movie industry with its twists and turns has evolved and in so doing has gone back to its origins when in 1915 FOX Film Company was founded on a vertically integrated basis or when Players-Lasky became the first modern studio achieving vertically integrated



status in 1919. Today, Netflix can seamlessly produce and distribute, and consumers' homes have become the new movie theaters. This model brings challenges to the old modus operandi where demand was pushed from the top down rather than pulled by audience preferences as it happens today. In this new scenario, can Disney and other big studios still produce \$100 million budget-movies expecting to lure audience away from streamed content, while Netflix (and Amazon) is so fast moving with original content that mostly comprises of low-budget films? Research shows that

major studios, with a high budget movies philosophy, have very high volatility on their returns, with huge negative spikes and not very exciting profit margins; on the other hand, independent production companies, with lower movie budgets, show lower profit volatility counting on smaller losses when a film fails to perform. Hence, it seems clear there is a weak correlation between movie budgets and box office. So, higher budgets no longer translate into selling more tickets; even worse, data shows that the more a studio spends on production, the less likely it is the movie will recoup the initial investment. This proves that the entertainment market is definitely jam-packed and ready for consolidation in a do-or-die type of scenario.



Although, the movie industry is now mature enough to spun new transactions, we wonder whether Disney is battling with the right weapons. For example, by acquiring

the FOX library, which includes franchises like X-Men and Alien with mainly male characters driven content, it will not be easy for Disney to pull audience away from Netflix – which skews female audience with 53 to 47% women to men ratio – primarily due to the influential power of women subscribers. Based on simple audience preferences, FOX's content, as Die Hard would not only hardly entice consumers to switch from Netflix to Disney's new streaming platform, but also it will fail to convince Hulu's existing subscribers to stick with the platform, where the female-male ratio is 63 to 37%.

The main drivers of streaming content perception changes are represented by female audience; not only do women have tremendous entertainment footprint, but also watch more video content than men on average and drive the conversation online. For example, the new Netflix hit show "Stranger

Things” has seen a very significant split in audience talking about the show online; only 37% of men indeed were sharing opinions and critics, compared to the astounding 63% of female audience driving the conversation and popular preferences.

Disney thinks that it will be able to enter into the streamed entertainment, counting on either FOX’s stake in Hulu or building a new platform from scratch, combining their own franchises and FOX’s.

But due to lack of vision in what a post-internet audience wants, Disney will eventually get slaughtered by huge competition from Netflix, Amazon, Apple, and Google, if it does not come up with a revolutionary plan as soon as possible.



From a merger arbitrage standpoint, the Disney-FOX deal made little sense at the time of the announcement; why would you buy FOX at \$32.42 per share after shorting Disney for just \$29.45

leaving \$3 on the table? But this clearly signals that the market was desperately asking for a change and expecting a wave of consolidation within studios that are trying to cater to streamed entertainment audiences. Today’s FOX’s price (January 10th) of \$35.60 implies

“Disney thinks that it will be able to enter into the streamed entertainment ... but will eventually get slaughtered.”

approximately a target spread of -15% – given an offer price of \$30.35 (exchange ratio of 0.2745 multiplied by Disney’s price of \$110.57 at the announcement day) – which represents an annualized return of -30%, counting on the deal closing in the second half of this year. This entails

that the value added to FOX's shareholders is not consistent in this situation; in other words, FOX's shareholders could simply sell shares in the marketplace and gain a better deal compared to Disney's. This can occur when perhaps there could be other suitors in play, although we do not think this will be the case.

The industry is going through a profound transformation; as such, deals like Disney-FOX are more likely to happen in order to streamline resources and find more effective ways of providing content to an increasingly finicky audience. Netflix is likely to lead this transformational change while the giants of the past will have to find ways to adapt quickly to the post internet reality.

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