Kings of Content

Several of the companies in our portfolios own and create unique intellectual property, be it in TV and movies (Disney and WWE), video games (Nintendo) or sports (Juventus, Celtic and International Speedway)[1]. In part these holdings derive from our belief in the escalating value of high quality media content fuelled by what we see as an unassuagable appetite for it across the globe. To illustrate, here are a few recent statistics that demonstrate just how healthy video content consumption is. Nielsen reported in 2012 that the average American is already consuming an incredible 4.6 hours of TV per day. In other words more than half of most people's spare time is now spent watching TV. Numbers from the web however suggest that even all this TV isn't enough, with Google in March announcing the milestone of one billion unique visitors per month to their YouTube site, together watching over four billion hours of video. Even cinemas are showing signs of life, with Disney's 'Avengers' grossing $1.5bn last summer, making it the third most successful film of all time, albeit in nominal terms.

To continue the theme, February saw us back on the west coast of the US, revisiting Morgan Stanley's excellent TMT conference. Given the above evidence, it's no surprise that many of the assembled media chief executives used the occasion to extol the virtues of content ownership. Comcast (the biggest cable company in the US) for example sent such a message, having finalised their $16.7bn deal with GE to buy out the remaining 49% stake in NBCUniversal. This completes the move begun in 2009, transforming them from a distributor of other people's content into one of the world's biggest TV and movie studios. Remember they also offered to buy Disney in 2004 for $54bn; Universal it seems was their second choice. Netflix, the online movie site, have also been paying up for streaming rights to the best shows and in December agreed to pay Disney a record $300m pa (estimated) for access to their Disney and Pixar films. A few months later they were outbid by their even deeper pocketed rivals Amazon for the US rights to ITV's hit 'Downton Abbey', so were understandably keen to point out the success of their first fully exclusive show. 'House of Cards' is already the most watched series they've ever hosted and is helping to differentiate the service from a company that would clearly rather be a content creator and owner than just an aggregator.

One advantage of being on the far side of America was the proximity to some of our key US media holdings, and we took advantage of this to visit Disney at their head offices in Burbank. In part this was to quiz/ congratulate them on their fantastic Lucasfilm acquisition announced towards the end of last year; their most significant content purchase since the $4.2bn Marvel deal in 2009. Amazingly, Disney managed to persuade George Lucas to part with his Star Wars franchise for just $4.05bn (less than 7.5x Lucasfilm's 2005 EBIT, the year the last Star Wars film was released), a feat we are sure only they could have achieved. Irrespective of the price, Lucas understood that Disney, with a track record proven during the prior acquisitions of Marvel and Pixar, would invest in his brands over the long term, allowing the valuable IP to flourish. From Disney's perspective, the acquisition makes perfect sense thanks to their unique ability to exploit a franchise's full potential through TV channels, movies, merchandising and theme parks. This makes bringing new intellectual property into the company's ecosystem extremely profitable and takes the model far beyond the traditional economics of the film industry.

Aside from the movie franchises, Disney own several other fantastic content rich properties, not least their cable channels. The Disney Channel counts 100m domestic subscribers and as many again overseas, allowing it to charge the US cable networks double the affiliate fees of its main competitor Nickelodeon. Arguably however the jewel in the crown is Disney's sports network, ESPN. By far the most expensive channel in the US, ESPN commands a 4x higher affiliate fee than the next dearest, having succeeded in raising prices at 15% pa over the past decade. Yet the draw of live sports - genuine content royalty - is so great that cable distributors have little choice but to offer it to ESPN's 98 million subscribers. Disney's cable networks now provide the company with 60% of its overall operating profit.

ESPN is a fantastic asset but at the end of the day doesn't directly own much of its core underlying content; the rights to the live games. These are owned by the leagues and teams that play in them and in most cases this will probably never change (e.g. the NFL's rules specifically prohibit teams from being owned by listed companies). This means that the ability to broadcast such premium content comes with a steep price tag. In return for being able to charge high affiliate fees, ESPN also has to spend big to secure its broadcast rights, investing around $6bn per year on programming. This is six times more than its nearest rival (Time Warner's TNT) and includes a

hefty $1.9bn annual payment to the NFL (up from the $1.2bn pa they were paying under the previous eight year contract) and $600m pa to Major League Baseball (double its previous cost).

Given all I've said above about content *ownership*, ESPN's reliance on other people's IP raises an obvious concern for us as investors. What comfort can we have that Disney will continue to afford the rights to this 'must have' sports content over the long term and what's to stop a rival outbidding them at some stage? Well, we do see this as a risk, however we also have confidence in ESPN's strength as a franchise in its own right, thanks to its highly rated editorial content, positioning it as the natural home for US sports. ESPN's 33 year long relationships (SportsCenter aired its 50,000th episode in September last year), and the 24/7 exposure they give to each sport makes it as valuable a partner to the leagues as they are to it, allowing both parties to build their respective brands. We therefore think a new entrant would have to offer a really substantial premium to the already high prices ESPN is paying for content rights to persuade a league to gamble on its own long-term exposure. As an example of the faith the major leagues have in ESPN, it has already locked in lengthy contracts for the majority of the country's major sports, in most cases stretching into the 2020s. At the end of the last fiscal year, ESPN had $40bn worth of contractual sports rights commitments in hand, locking up the NFL, MLB and the important college sports until well into the next decade, bringing a certain degree of long term stability to the company. In recognition of this stranglehold, Fox when announcing their new sports network in March, explicitly warned that they were "not trying to beat ESPN", and would instead focus on more niche areas. In fact, ESPN's abject failure to dethrone BSkyB from its home sports market of the UK is a good example as any of just how difficult it is to compete with the established leader, already in possession of marquee content rights. Sky have remained the lead broadcaster for the English Premier League ever since its founding in 1992 and have achieved this despite the league's insistence on short, three year TV deals, underlining the importance of ESPN's long term US contracts.

Actually BSkyB is an interesting case in itself, as unlike ESPN it also operates its own satellite TV distribution business and does so rather successfully, claiming over 10m subscribers and 18% operating margins. So should we also consider investing in a similar cable or satellite company? Indeed, there are clear advantages to being a well established distributor with a lazy (if not quite loyal) subscriber base providing fantastically repeatable revenue streams. In addition, whilst we would still argue that in the end distributers will always be reliant on the content creators, a very large customer base should give them some clout when it comes to negotiating fees. Recent corporate activity demonstrates the desirability of such businesses, with Malone's Liberty Global currently embroiled in a €7.5bn bidding war for Kabel Deutschland (Germany's largest cable company), having already paid £15bn for Virgin Media earlier this year. Mr Murdoch's attempts to buy the 61% he doesn't already own of BSkyB also demonstrate his confidence in the model. However we think relying too heavily on distribution is a risky move as its legacy systems make the business vulnerable to technological change. The internet for example has already heralded a massive fragmentation of distribution and is busy disintermediating many a conventional model, be it newspapers, magazines or the radio. It is for precisely this reason that big name sporting content with its power to draw large, live audiences has become so valuable to the traditional distributors. As a result we think companies such as ESPN in control of much of this content provide us with the best prospects for the future.

At LT we supplement our exposure to ESPN led US sporting content with stakes in market leading clubs hailing from the rest of the world's great 'football' obsession; Italy's Juventus and Scotland's Celtic FC. Whilst constraints on market cap and free-float limit these to relatively small weightings within our portfolio we feel particularly optimistic about their prospects. For example, we note with ever increasing interest the dramatic escalation of the value of TV rights earned by the rival English Premier League over the last two decades. Between 1992 and 2012, the annual domestic TV fees collected by the EPL have grown from £43m to around £650m, compounding at 14.5% pa. More importantly, the international rights have also expanded beyond all recognition. In 1992, five years of overseas rights earned the Premier League just £40m, in 2011 their new three year contract drew in an almost £1.5 billion; a 60 fold increase in annual fees. Europe's other leagues have yet to capture the world's attention in quite the same way and Italy's Serie A, despite being the next highest earner for domestic TV rights (currently around €2.5bn over three years) earns a tenth of the overseas revenues of the EPL. However the Italians play some of world's best football (Italy have the second highest FIFA World Cup winning tally, just one behind Brazil's five titles) and we believe should be able to effectively promote the Serie A overseas. When this happens, the 28 times Italian champions Juventus will be at the forefront, with a new fully owned stadium, a rejuvenated squad and a quarterfinal placing in this year's UEFA Champions League competition.

An offhand quip from James Murdoch (who also presented at Morgan Stanley's TMT conference) that perhaps the only real way to profit from football was to "open Ferrari dealerships near the big clubs", highlights a perennial concern that in the business of football, the players are the only winners. Of the 22 clubs to list in the UK (most during the 1990s), only Celtic still retains its original listing, most of the rest having drifted into serious financial difficulties, generally citing wage inflation as a key source of their troubles. However there are exceptions, and the really top clubs have in fact been taken over at sizeable premiums. The Glazers paid £800m for Manchester United in 2005, whilst Liverpool though not listed at the time was bought by John Henry in 2010 for a non-trivial £300m. These are not trophy assets, but genuine business investments. Both were already owners of existing, successful sports franchises (the NFL's Tampa Bay Buccaneers and Major League Baseball's Boston Red Sox) and both we believe intend to make a return on their investments. Manchester United for example has subsequently relisted in New York at an even steeper valuation, and with its current $2.8bn market capitalisation has already made the Glazers a 130% return. Baseball franchise the LA Dodgers broke all records last year when a consortium (led by Lakers star Magic Johnson) outbid News Corp to purchase the team for $2bn dollars (around 8.6 times revenues), again demonstrating just how highly valued these assets can be. Even James Murdoch was keen to stress how important Sky's investments in domestic rights for the English Premier League (BSkyB, £760m pa) and German Bundesliga (Sky Deutschland, €486m pa) have been for News Corp. The deals were driven by "economic sense", have all turned out to be extremely profitable and have helped them maintain their dominant positions in two very important pay-TV markets.

To end, here are some figures from an event we follow every year; the NFL's annual Super Bowl competition. As America's flagship live sporting event, it seems to us a good way to measure the demand for such big name crowd-uniting occasions, and this year's final didn't disappoint. On February 3rd, an average 108.4m people tuned in to watch the Ravens beat the 49ers in the New Orleans final, which whilst slightly shy of last year's record, still ranks it as one of the most watched broadcasts in US television history. In fact out of the top ten US shows of all time, eight are now Super Bowls, with each of the last four events claiming over 100m viewers. These are must-watch, live broadcasts that reverse the fragmentation trend brought on by internet distribution and DVRs and consequently advertisers love them. Even if the viewing figures didn't quite top last year's record, the average cost of a 30 second ad spot again jumped double digits up to $3.8m. This represents a 100 fold increase in price over the first Super Bowl in 1967 (where 30 seconds cost just $37,500) which adjusting for inflation gives an annualised real growth of 5.8%. Not a bad record for 46 years, and to us as good an example as any as to just how valuable this kind of content really is.

James Bullock
July 2013

[1]LT also invests in a number of business facing content owners, which whilst not discussed here, we feel equally bullish towards. These include Pearson and Reed Elsevier, the world's largest educational and academic publishers respectively. Building from its position of strength in textbook content, Pearson is leading the charge in its efforts to digitise North American learning, increasing both the functionality and efficiency of their educational tools. This helps schools and colleges cut costs in the face of ongoing budgetary pressures, yet at the same time produces demonstrably better results (Pearson also operates much of the testing infrastructure). Reed Elsevier, thanks to its unmatched portfolio of top-ranking academic journals and its LexisNexis legal database (operating in a duopoly with Thompson Reuter's Westlaw), is uniquely able to provide mission-critical data to two of the world's most important industries, whilst representing less than 1% of their overall cost bases.

Sources: Lindsell Train, Bloomberg, Financial Times, LA Times, the Economist, Nielsen, JP Morgan, Forbes, Sporting Intelligence, Fox and ESPN.

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