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The Friday Filter

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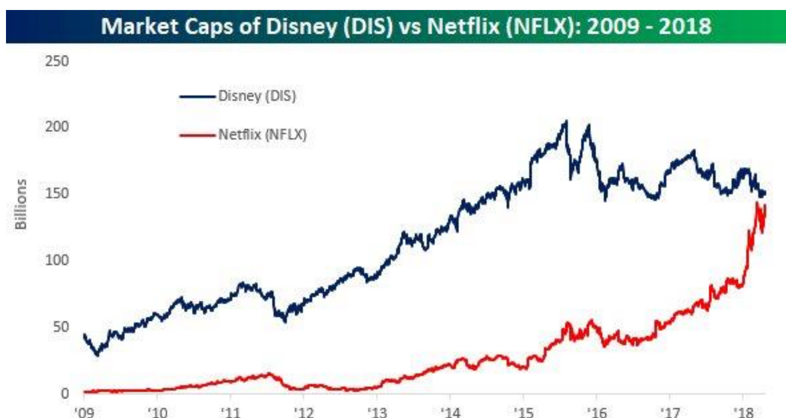
15 June 2018

Cable, content and opportunity

The global media and entertainment industry is undergoing a period of dramatic change as new, technology enabled entrants set out to disrupt the incumbents. The chart below shows the market cap of newcomer Netflix versus that of old stalwart Disney. It illustrates just how dramatic recent changes have been and industry participants continue to scramble to position themselves for an evolving future. This changing landscape has created both uncertainty and opportunity.

Netflix is now worth more than Disney, even though Disney is more than 20 times more profitable (net income of $4.4 billion versus $185 million).



Our global portfolios have been active participants amongst this rapidly changing media landscape. Time Warner was the first opportunity that we took advantage of for global portfolios when the uncertain industry outlook provided an excellent entry point into a very good company with some excellent media and entertainment assets. We sold our shares at a very healthy (50%) profit last year when they neared the levels of the take-out offer by AT&T that has just been approved.

Our second entry point, Twenty First Century Fox, had a similar, and simple underlying investment thesis that great content would retain a value, regardless of how this content was distributed and viewed. Content may well be viewed via different channels and on different devices, but ultimately the demand for good content will continue to grow, particularly in under-penetrated international markets. We were again able to purchase world class media/content assets at a very good price. 21st Century Fox has since also seen strong demand for its portfolio of assets and just as we were getting our heads around the potential of a merged Disney and Fox, Comcast has made a counter-bid for certain Fox assets.

Late last year we made another purchase in the sector when Discovery Communications was on sale. Discovery provides a different kind of content - non-fiction viewing such as the Discovery Channel, Animal Planet and more recently after acquiring Scripps Network, the Food Network and Travel Channel. The market was again undervaluing the strong cash flow generation of the company and we were led to the investment by an ownership stake of John Malone of the Liberty Media Group. Malone has a long track-record of success in the media industry and is exactly the type of owner operator that we seek to partner with.

Thus far we have achieved good results in an industry that is facing a very cloudy future. Our simple recipe has been to take advantage of the uncertainty when high quality assets, overseen by very capable owner managers are being offered to us at a very good price by short-term focused investors. While this approach may not be as exciting as following everyone else into the companies that are disrupting the industry (Netflix, Amazon etc), given the discrepancy in valuations we believe it is the lower risk approach.

Just last week we invested in another Malone owned company that sits at the heart of the industry, Liberty Broadband. Liberty Broadband is a holding company of Charter Communications, the second largest US cable operator behind Comcast. The opportunity was created by a disappointing quarterly result and market fear over declining video subscribers due to increased competition from the likes of Netflix.

While Comcast is looking to buy content by making an offer to purchase 21st Century Fox, Charter Communications has a very different strategy. The investment proposition and business strategy rests on an incredible infrastructure of fiber-rich cable assets that passes to 50 million American homes. While there will be some competition from other providers and alternative technologies (5G being an example), this high capacity network provides a strong competitive advantage in the areas that Charter covers and is difficult, if not impossible, to replicate. It is for this reason that Charter received four bids during the course of 2017, but having good visibility of the cash flow potential in the years ahead Malone is not a seller at anywhere near current prices.

The business model of Charter is to focus on growing new customer relationships and increasing their penetration in the 50 million homes that their cable passes to. Current penetration is about 50%, thus there is ample room for growth in customer numbers. While they will continue to offer various video bundles, the primary service that they offer to all their customers is high speed internet connectivity (starting internet speeds of 100 Mbps). Given that there is no cost associated with content in this part of their service, it is a much higher margin business than video. Their customer focused investment seeks to grow revenue through new customer relationships as opposed to price, providing simpler, better packages and improved service. Once this investment tapers off in the next year or two, free cash flow should accelerate. Based on the free cash flow that we think they will be able to produce in the years ahead the shares are very cheap.

We are watching the corporate activity in the sector with interest, but it does not form the basis of our investment in Liberty/Charter. We view their unique cable assets as very well placed to deal with an increasing demand for high speed internet access. Whether you are watching Netflix, Apple TV or Youtube, your internet connection is critical. While there will be increased competition in the years ahead, we are of the view that Charter has a superior infrastructure that will provide an advantage for years to come in the footprint that it covers.

Our ownership of Charter is via Liberty Broadband, where we gain access at a discount and alongside John Malone, who is the major shareholder.

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