View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Repositório da Universidade Nova de Lisboa

A Work Project, presented as part of the requirements for the Award of a Master Degree in Finance from the NOVA – School of Business and Economics.

The Time Warner effect

Guilherme da Cunha Morgado Cacela da Silva
25720

A Project carried out on the Master in Finance Program, under the supervision of:

Nuno Vasconcelos e Sá

3rd of January, 2020

Abstract

Acquired in 2018, Time Warner (renamed WarnerMedia), is expected to be one of the main growth drivers for AT&T, through its subsegments and by providing content data for digital targeted advertising. However, some important risks may oppose to the $85 billion acquisition, such as the possibility of HBO Max not being able conquer its space in the SVoD market, or AT&T fail to reimburse its debt.
After computing a valuation on the telecom firm without WarnerMedia, it was possible to conclude that AT&T is still being undervalued but would be worse off without the media and entertainment segment.
Nevertheless, the firm as incurred in higher risks, which, ultimately, are reflected in its cost of capital. Hence, AT&T is now more vulnerable, meaning that, if the firm's operations do not follow with what was predicted, it might enter in a difficult situation where it will struggle to meet its financial obligations.

AT&T, WarnerMedia, Scenario analysis

This work used infrastructure and resources funded by Fundação para a Ciência e a Tecnologia (UID/ECO/00124/2013, UID/ECO/00124/2019 and Social Sciences DataLab, Project 22209), POR Lisboa (LISBOA-01-0145-FEDER-007722 and Social Sciences DataLab, Project 22209) and POR Norte (Social Sciences DataLab, Project 22209).

The acquisition

By June 2018, AT&T completed the acquisition of Time Warner, one of the biggest players in the media and entertainment industry. For a total value of $84.5 billion[1], the telecom company now owned Turner, the international multichannel owner and operator, Home Box Office, a premium paid television services, and WarnerBros., producer and distributer of television shows, films and games.

Regarding this acquisition, it is expected to provide new streams of revenue, outside AT&T's traditional segments like the U.S. wireless business. Furthermore, the main expected value-added driver is the development of AT&T's digital targeted advertising structure. The acquisition allowed the firm to gain access to a broad set of viewership and data analytics, which are crucial for the targeted advertising market. Hence, the firm can now enable advertisers to target TV ads, and so develop its position in a market where these ads can be sold by three time the price of regular ads[2]. Such market is almost fully dominated by Google and Facebook.

The other expected main growth driver is Time Warner (renamed WarnerMedia) itself. The media and entertainment company has proven to be a profitable company throughout its three segments and prospects are that it keeps such trend. More specifically, the segments of Turner and Home Box Office are the ones with higher expectations[3].

Turner comprises a set of channels like TNT, TBS, Adult Swim, TruTV, Cartoon Network, CNN, among others, and produces and distributes successful contents such as 'Rick & Morty' and Conan O'Brien's show. This successful performance in the broadcasting TV market is expected to be maintained, thus resulting in significant growths for the next few years.

Home Box Office, by 2020 will be launching HBO Max, its new streaming on demand video (SVoD) service, which will comprise a diversified set of contents, including originally produced and other WarnerMedia contents (from Turner and WarnerBros.). Coupling the extensive set of successful

[1] AT&T's website
[2] FierceVideo: "AT&T: Addressable advertising CPMs up to $40, 3x traditional ads"
[3] Variety: "WarnerMedia Drives AT&T Growth in Q2, as HBO and DirecTV Lose Subscribers"; Analyst estimates

contents that will be available in the platform with the expectations for the SVoD market, it is projected that HBO will end up highly benefiting from this and drive growth for the company.

Associated risks

In 2015, AT&T acquired DirecTv for $67 billion[4], a paying TV service company. With Time Warner's acquisition, the company also intended to add support and boost the 2015's acquisition. Additionally, the telecom firm means to become able to compete with giant tech companies such as Netflix, YouTube and Amazon prime.

Nevertheless, there is the risk that AT&T is already late to enter in this market, and having made two significant acquisition aggravates the loss risk of the company if its mergers' strategies do not work.

As referred, HBO Now is predicted to be one of the main growth drivers for WarnerMedia, and producing original contents is one of the key actions to boost it. Nonetheless, it is important to highlight that HBO does not standalone. In 2018, Netflix spent $12 billion in original content[5], Apple committed to spend $4.2 billion until 2022[6] and YouTube is also betting more and more on original content, launching new YouTube's originals. Hence, there is the risk that HBO may be late on entering this market and investing in original contents may not be enough to get near to its competitors.

Finally, to finance another acquisition, the firm had to get new debt. As so, its net debt increased from around $125 billion to more than $175 billion, increasing the net debt to EBITDA multiple from 2.5x to 3.3x[7]. Thus, despite tax shield benefits that arose with more debt, in a scenario where the acquisition's strategy fails, AT&T may be in big trouble to turnaround the situation and meet its financial obligations.

No acquisition scenario

---

[4] AT&T's website
[5] Variety: "Netflix Spent $12 Billion on Content in 2018. Analysts Expect That to Grow to $15 Billion This Year"
[6] CNBC: "Four reasons why losing Time Warner would be good for AT&T"
[7] Analyst estimates

The acquisition exhibits the main expected benefits of the development of AT&T's digital targeted advertising structure and Turner's and HBO's outstanding performing. However, it also displays important risks, like the failure on the strategy where HBO would not be able to gain enough market share and AT&T would get stuck with a significant amount of debt. Henceforth, to measure the impact of these situations it was developed a valuation in a scenario where Time Warner was not acquired, to infer how much would AT&T be worth in this case.

Hence, the whole WarnerMedia segment performance and the respective balance sheet captions were not considered for the cash flows. Moreover, with not having access to the valuable viewership and data analytics that WarnerMedia would provide, revenue forecast growth exhibited more modest growths, specially in the segment of Xandr. Finally, the debt amount was adjusted, reflecting a value that is more in line with the firm's target, resulting in a net debt to EBITDA multiple of 2.6x[7].

Furthermore, AT&T's cost of capital was also adjusted. The telecom market displays a lower associated risk than the media and entertainment one. Thus, return on debt decreased by 0.1 p.p., since now the firm is not liable to the riskier debt that WarnerMedia had (while the weighted average YTM of AT&T's bonds was 2.8%, WarnerMedia's was 3.5%), exhibiting a value of 2.9%. Additionally, return on equity decreased from 5.8% to 5.6%, as beta equity of AT&T was 0.6 and WarnerMedia's 0.9, reflecting a less volatile and exposed to market's fluctuations[7].

As a result, the WACC also decreased. While with WarnerMedia the WACC was predicted to be 4.5%, now it decreased to 4.2%[7]. Hence, by not being exposed to a more volatile market that is media and entertainment coupled with no significant increase in its debt values, AT&T's cost of capital decreased. The implied growth rates of the firm, as expected, were more modest, since operational ROIC and reinvestment rate are generally lower, resulting in a terminal growth of 0.76%, 0.1 p.p. lower when compared to the scenario with WarnerMedia.

For the valuation it was used the Discounted Free Cash model (DCF). According to this model, and considering the referred inputs, the implied EV is predicted to be $521 billion and the financial debt $262 billion. Thus, implied equity value is projected to be $259 billion, $73 billion below the alternative scenario[7].

Afterwards, to compute the share price it was considered the number of shares outstanding at the date before Time Warner's acquisition, since after that shares outstanding increased, since part of the $85 billion were paid with shares. Thus, with $6.2 billion outstanding shares, the share price for end 2020 is expected to be $41.85, reflecting a decrease of 8%, compared to the alternative scenario[7].

Final conclusions

After computing the DCF valuation, it is possible to realize that, when analysing the predicted share price for the telecom firm, shareholders would be better off with the acquisition of Time Warner.

In this scenario, despite slower growths, it is still predicted that the firm, overall, grows throughout the analysed period. The main growth driver, in this situation, is the implementation of 5G.

The Mobility subsegment, included in the segment of Communications and where 5G will have the most impact on, alone, accounts for around 40% of total AT&T revenue.

The firm is currently the leader in the US telecom market and has been preparing to be one of the first to launch the 5G technology in the country. Additionally, just like 3G and 4G, this new tech is expected to disrupt the market, as it will facilitate digital communications among users, due to a faster and higher quality connection. Moreover, 5G will enable devices, like routers, to become even more wireless[8].

AT&T, being a market leader and a pioneer in a new technology that will be launched and expected to drive growth for the industry, is predicted that will improve its performance throughout the forecast period. Hence, the valuation computed suggests that, up to today and even without WarnerMedia's

[8] Deustche Bank: "How 5G will change your life"

effect, the firm's share price is undervalued, providing a HOLD recommendation, as the 12-month expected return, including capital gains and dividend yield, is around 6.9%[7].

In addition, a sensitivity analysis was conducted to the predicted share price for end 2020. The variables chosen were the WACC and perpetual growth, to measure how changes in these inputs could impact the firm's stock price. On the variable growth, its inputs - ROIC and reinvestment rate - were the ones changed, ultimately changing growth. Overall, it is possible to conclude that the analysis supports the previously given recommendation, since nine out of the 25 results suggest a HOLD recommendation, while the same goes for the BUY recommendation and the remaining seven providing a SELL recommendation[7].

In conclusion, it is possible to realize that acquiring Time Warner was/will be beneficial for AT&T. Despite still being undervalued, when analysing the firm without WarnerMedia (according to the valuation conducted), the referred segment is predicted to provide higher growths through new streams of revenue, either by its own segments or by digital targeted advertising. Hence, one can say that the expected benefits of the acquisition outcome the associated risks.

Notwithstanding, it is important to highlight that, if the actual performance of the segment is not in line with forecast, lowering the firm's expected growth significantly, AT&T may struggle to reimburse its debt. Hence, such risk should be reflected in the predicted share price, mainly through a higher cost of capital.