HILLIARD LYONS

**Entertainment & Leisure**
Analyst: Jeffrey S. Thomison, CFA
502.588.9137 / JThomison@hilliard.com
Institutional Sales Desk: George Moorin
502.588.9141 / GMoorin@hilliard.com
J.J.B. Hilliard, W.L. Lyons, LLC
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COMPANY UPDATE / ESTIMATE CHANGE / PRICE TARGET CHANGE

# The Walt Disney Company

DIS — NYSE — Long-term Buy-1

## Updating Estimates and Price Target

| Key Metrics | | |
|---|---|---|
| DIS - NYSE (as of 9/12/17) | | $97.89 |
| 2 Year Price Target | | $125.00 |
| 52-Week Range | | $90.32 - $116.10 |
| Shares Outstanding (mil.) (basic) | | 1,562 |
| Market Cap. ($ mil.) | | $152,904 |
| 3-Mo. Average Daily Volume | | 7,720,000 |
| Institutional Ownership | | 63% |
| Total Debt/(Total Debt + S.Equity) (6/17) | | 33% |
| ROE (TTM ended 6/17) | | 19% |
| Book Value/Share (6/17) | | $29.48 |
| Price/Book Value | | 3.3x |
| Annual Dividend & Yield | $1.56 | 1.6% |
| EBITDA Margin (TTM ended 6/17) | | 30% |

**EPS FY 9/30** (excludes nonrecurring items)

| | 2016 | Prior 2017E | Curr. 2017E | | Prior 2018E | Curr. 2018E |
|---|---|---|---|---|---|---|
| 1Q | $1.63 | | $1.55 | A | $1.73 | $1.65 |
| 2Q | $1.36 | | $1.50 | A | $1.60 | $1.60 |
| 3Q | $1.62 | | $1.58 | A | $1.82 | $1.76 |
| 4Q | $1.10 | $1.24 | $1.11 | | $1.50 | $1.39 |
| Year | $5.72 | $5.87 | $5.74 | | $6.65 | $6.40 |
| P/E | 17.1x | | 17.1x | | | 15.3x |

Note: Quarterly EPS figures may not add to annual figure due to rounding.
Note: P/E multiples based on 8/9/17 intra-day price shown above.

**Revenue ($mm)**

| | 2016 | Prior 2017E | Curr. 2017E | | Prior 2018E | Curr. 2018E |
|---|---|---|---|---|---|---|
| 1Q | $15,244 | | $14,784 | A | $15,800 | $15,560 |
| 2Q | $12,969 | | $13,336 | A | $14,100 | $14,010 |
| 3Q | $14,277 | | $14,238 | A | $15,500 | $15,260 |
| 4Q | $13,142 | $13,842 | $13,242 | | $14,600 | $14,370 |
| Year | $55,632 | $56,200 | $55,600 | | $60,000 | $59,200 |

***Company Description:*** *The Walt Disney Company is a worldwide entertainment company engaged in animated and live-action film and television production, character merchandise licensing, consumer products retailing, book, magazine, and music publishing, television and radio broadcasting, cable television programming, and the operation of theme parks and resorts. Past acquisitions include ABC/ESPN (1995), Pixar (2006), Marvel Entertainment (2009) and Lucasfilm, Ltd (2012).*

### Investment Highlights

- **We are updating our financial estimates and price target to reflect several recent developments.** These include the company's lowered earnings expectation for the current 4Q and FY17 periods (with potential lingering effects from a few factors), and further details on the company's planned content streaming services.
- **CEO Bob Iger discussed numerous issues in a recent interview, including the expectation of near-term earnings pressure.** We have lowered our FY17 and FY18 estimates due to issues such as weather (FY17 only), sports programming costs (both years), and new business development costs (both years).
- **Development continues on the content streaming services announced last month.** The recent purchase of a majority stake in BAMTech, LLC (a direct-to-consumer content streaming company) was integral to the company's desire to build its own streaming services. Last month, the company announced two such services—an ESPN-branded service for spring 2018 and a Disney-branded service for late 2019. This strategy allows the company to take advantage of its unparalleled portfolio of brands, BAMTech's technological prowess, and changes in consumer preferences related to content consumption. In his recent interview, Iger announced that Marvel and *Star Wars* films would be added to the Disney-branded service, whereas the company was previously undecided on this issue.
- **We remain bullish on Disney's outlook and maintain our LT Buy rating.** We have lowered our price target by $5 to $125 per share to reflect our new earnings projections and valuation assumptions. Over the next few years, we expect each of the company's core business segments to show meaningful growth. We recommend purchase of DIS with the expectation of attractive returns over a two year holding period. Our Suitability rating remains 1.

**Note Important Disclosures on Pages 7-8.**
**Note Analyst Certification on Page 7.**

***Lowered expectation for current quarter.*** In an interview on 9/7/2017, CEO Bob Iger made several announcements, including the expectation that fiscal 2017 (period ending 9/30/17) earnings would be "roughly in line with" fiscal 2016, which was $5.72 per share. Recent street consensus was $5.88 per share and our estimate was $5.87 per share. Factors cited by Iger in this final quarter of the fiscal year include the cost of NBA broadcast rights, expenses related to growth initiatives at BAMTech (see below), lower company-wide sales related to *Star Wars: Rogue One* versus *Star Wars: The Force Awakens* one year ago, and the impact of Hurricane Irma on the company's Orlando and cruise operations. We believe the revised near-term earnings outlook was the main reason for a sharp stock price decline after the interview, as investors likely wondered about these issues having possible lingering effects into fiscal 2018.

***More firepower to future streaming services.*** Another highlight of Iger's recent interview was an update on the company's planned streaming services—an ESPN-branded service set for a Spring 2018 launch and a Disney-branded one planned for late 2019. The company had previously announced the intention of having Disney and Pixar-branded movies as part of the Disney-branded service but Iger announced that Marvel and *Star Wars* movies will also be included. The respective major films from these studios would become part of the service after the customary initial theatrical window. Disney management has consistently expressed its support of, and dependence on, movie theatres as the initial distribution outlet for its major films.

In August 2017, Disney announced plans to boost its stake in BAMTech, LLC, a global leader in direct-to-consumer content streaming technology, from 33% to 75% and to change the way the company distributes its content with the creation of the two direct-to-consumer content streaming services. BAMTech has cutting-edge proprietary technology and acumen integral in the creation of "over the top" (OTT) networks. While the BAMTech majority stake purchase comes with near-term earnings dilution, we believe the long-term impact is significantly positive. Pricing and exact launch dates of the streaming services have not been announced.

The ESPN-branded, multi-sport, video streaming service will include regional, national, and international events across a wide spectrum of sports. In fact, management expects the service to offer nearly 10,000 events a year, including those from Major League Baseball, National Hockey League, Major League Soccer, Grand Slam tennis, and college sports. While the traditional ESPN networks (such as ESPN and ESPN 2) will continue to be offered on cable platforms under agreements with cable companies, paying subscribers to those networks will be able to stream those networks under the same ESPN app featured with the streaming service.

The future Disney-branded streaming service will include movies and shorter form content (new and library titles) from Disney and Pixar studios, as well as some content from The Disney Channel. In his recent interview, CEO Bob Iger announced Marvel and *Star Wars* films would also be included, ending some uncertainty that had existed about those popular brands. With the creation of its own streaming service, Disney will end its current distribution agreement with Netflix and control its own content distribution beginning with the 2019 theatrical slate.

These actions reflect the growing industry trend of forging direct relationships between content creators and consumers. The Walt Disney Co., with what we consider to be unparalleled content, seems to be at the forefront of this movement. This is consistent with our long-standing view that management is sharp, visionary, and a major positive investment factor.

***Some tweaks to Star Wars film plans.*** On September 9, 2017, the company made some major announcements regarding the ninth episode of the *Star Wars* movie franchise. *Episode IX* (working title only) was originally expected to be directed by Colin Trevorrow (*Jurassic World*) and be released on May 24, 2019. Now, the attached director is J.J. Abrams and the release date is December 20, 2019.

We like both of these changes. Not only do we have great respect for Abrams, we believe he is one of best directors in the business and has proven himself with his directorial work on *Star Wars: The Force Awakens* and numerous other major motion pictures and acclaimed television shows. The new release date for *Episode IX* is consistent with the franchise's recent history, including *The Force Awakens* (December 2015) and *The Last Jedi* (December 2017). Moreover, we believe the additional seven months of potential production and post-production work could have a meaningfully positive impact on product quality.

***Hurricane Irma.*** Considered to be the most intense hurricane in over a decade, Irma moved northward from its eastern Atlantic Ocean path around Friday, September 8, and headed into U.S. mainland/Florida over that weekend. This prompted The Walt Disney Co. to close its four Orlando theme parks for the bulk of the weekend, representing only the fifth time the parks have closed since opening in 1971. The parks shut down at 9:00 PM Saturday, September 9, and remained closed through Monday, September 11. Normal operations resumed on Tuesday, September 12. The company's resort hotels remained open, though services and amenities were minimized. There have been no reports of property damage, to our knowledge. In some instances, planned vacations during the storm's existence may be re-booked for another time; however, in some instances, they will not due to logistical challenges of re-scheduling. The net impact on 4Q operations will be negative (as recently cited by CEO Bob Iger), though we remind investors of the company's large size and diverse operations. In addition, mid-September is typically one of the lower volume times of the year for Walt Disney World operations.

***Outlook.*** We are bullish on the company's outlook over the next several years. At Media Networks, we anticipate expanded and more efficient distribution for ESPN, including the future OTT streaming services and a more efficient cost structure for the traditional, or "linear," networks that are delivered through cable operators. We believe the Studio Entertainment has never been stronger, with growth potential from the Lucasfilm/*Star Wars,* Pixar, Marvel, and Disney brands. Over the next three years, we expect numerous films that could have a significant company-wide impact. These include, but are not limited to, new releases from popular franchises such as *Star Wars*, *The Avengers*, *Toy Story*, and *Frozen*. The Parks & Resorts segment could benefit from new attractions/lands at the domestic parks, hotel expansion at some locations, and growth at Shanghai Disney Resort beyond its debut year. We have been particularly enthused about recent expansion (attractions and operating hours) at Animal Kingdom in Orlando, including the well-designed *Pandora* section of the park and its marquee attractions.

We have updated our earnings model—not yet reflective of the future streaming services since many variables (such as specific content, launch date, and pricing) are unknown at this time, but reflective of 4Q expectations and the near-term business outlook. While this includes EPS estimate reductions for FY17 and FY18, we believe recent developments have significantly improved the company's long-term outlook. We expect improved earnings growth rates once the planned OTT streaming services gain a sizable core subscriber base and significant early stage expenses begin to moderate. During the next two years, we anticipate stabilization followed by resumption of growth from the ESPN brand in totality (streaming and cable distribution). In addition, we believe earnings can benefit from new or recent attractions at the theme parks, continued growth at Shanghai Disney Resort, and a powerful film slate. Share repurchases are likely to continue as well, in our opinion.

For the current FY17 year, our new revenue estimate for FY17 is lowered by $600 million to $55.6 billion, while our diluted EPS estimate is reduced by $0.13 to $5.74. We anticipate an operating margin decline of about 90 basis points, 10 basis points more than our previous assumption. We project an approximate 3% decline in net income, with share repurchases helping achieve a modest EPS gain from $5.72 in fiscal 2016.

We remain bullish on FY18 due to the favorable timing of several product/service introductions, as well as projected improvement at ESPN (ratings, ad rates, affiliate revenues, etc.). We believe *Star Wars: The Last Jedi*, scheduled for a December 2017 theatrical release, is likely to become the highest grossing movie of calendar 2017 and benefit many aspects of the company during FY18. We are mindful of continued "cord cutting" by consumers and the impact on subscribers to the existing ESPN "linear" channels, as well as CEO Bob Iger's recent commentary on growth-related expenses, particularly with BAMTech and the planned content streaming services. As a result, we are reducing our FY18 revenue estimate by $800 million to $59.2 billion. We assume an approximate 20 basis point improvement in operating margin and continued share repurchases, leading to an 11.5% gain in EPS to $6.40, a reduction of $0.25 from our previous estimate.

In the longer term, our basic financial model includes mid single-digit revenue gains, improving profit margins, operating leverage, and share repurchases. We believe this could result in upper single-digit growth in EBITDA and low double-digit growth in earnings per share.

***Valuation.*** Given solid company fundamentals and relatively clean earnings, we believe a price/earnings approach to valuation is most appropriate. DIS shares are currently trading at 17.1x and 15.3x our updated FY17 and FY18 EPS estimates, respectively. Given that the current 4Q period has nearly concluded and revised EPS expectations for the period have been disclosed, we use FY17 EPS as a bogey for trailing earnings and FY18 earnings for forward earnings. The 15.3x multiple on our FY18 EPS estimate compares to the stock's median forward multiple of 18.2x over the past fifteen years and 18.7x over a more recent five year period.

The 15.3x multiple on our FY18 EPS estimate represents roughly 0.8x the forward multiple on the S&P 500. More often than not, the stock has traded at a premium to the market multiple throughout its history. Over the past five and fifteen years, the median relative multiple has been approximately 1.1x.

As with many media companies, cash flow and related valuation measures can be useful. Enterprise Value divided by EBITDA (earnings before interest, taxes, depreciation & amortization) focuses on the implied total value of a company (market capitalization plus net debt) relative to its cash flow generating ability and is commonly used in analysis of media companies. On this measure, and based on today's intra-day price, DIS currently trades at 9.3x our projection of FY18 EBITDA. Over roughly the past decade, we believe DIS shares have typically traded at forward EBITDA multiples in the 8x-12x range.

***Opinion.*** We believe DIS shares can move higher in the coming years on the basis of overall higher revenues, cash flows, and earnings. We have attempted to make conservative assumptions regarding the main business segments, including the ESPN brand and related metrics such as ad revenues, subscription levels, and the planned content distribution initiatives.

We believe the long-term outlook at the company is favorable, more so now (following the company's recent announcements and investments in technology) than we did at the beginning of the year. We believe this outlook and the current stock valuation make our Long-term Buy rating most appropriate. This rating is based on a recommended investment time frame of two years. Not only does this give the company time to implement new strategies and address challenges, it also captures a period that should include growth projects from all of the company's major businesses.

Our two-year price target is $125 per share, $5 below our previous target. This decrease reflects our updated earnings forecast, which we believe is based on conservative assumptions with revenues and margins. The projected outlook supporting our price target includes improved EPS growth beyond the challenged FY17 year. Our price target reflects a P/E multiple of 16.5x applied to our estimate of forward earnings two years from now.

Our valuation assumption is slightly below our prior figure, a reflection of the challenges affecting current earnings and some uncertainty regarding the level of early stage expenses with BAMTech and the planned streaming services. Our multiple assumption is above the current forward multiple of 15.3x (which we consider depressed) but well below historical averages. We believe our projected valuation is reasonable, if not conservative, given the company's growth plans, earnings outlook, solid fundamentals, and potential uses of free cash flow.

Additionally, our two-year price target represents an EV/EBITDA multiple of 9.6x based on our estimate of forward EBITDA in two years. This compares to the 9.3x multiple on our projection of FY18 EBITDA. Annualized total return potential based on our target, the current dividend, and today's intra-day stock price is in the 14%-15% range. We typically require expected double-digit returns on investments in DIS, with consideration given to the company's blue-chip nature and our view of the stock as a core holding.

***Suitability.*** Our Suitability rating on DIS is 1 on a 1-to-4 scale (1=most conservative, 4=most aggressive). This is based on factors such as the company's size, diversification, operating history, and financial strength. We consider DIS a core holding in equity portfolios.

***Risks.*** Factors that could impact business conditions and operating results, and therefore impede achievement of our price objective, include adoption of new business models such as the planned content streaming services, adverse geopolitical events, contraction in leisure travel, a soft advertising market, weak domestic or international economies, low demand for the company's products and services, potentially dilutive acquisitions or strategic investments, and various other factors that could impact consumers' discretionary spending habits. In addition, CEO succession in mid-2019 following the planned retirement of Bob Iger represents a major event and therefore represents a unique risk factor, in our view.

**Exhibit 1**
**Income from Continuing Operations** (figures in millions except percentages and per share data)

| | *FY18E* | *% chg.* | *FY17E* | *% chg.* | FY16 | % chg. | FY15 | % chg. |
|---|---|---|---|---|---|---|---|---|
| **Revenues:** | | | | | | | | |
| Cable Networks | *$17,000* | *3.7%* | *$16,400* | *(1.4%)* | $16,632 | 0.3% | $16,581 | 9.7% |
| Broadcasting | *7,200* | *1.4%* | *7,100* | *0.6%* | 7,057 | 5.6% | 6,683 | 10.6% |
| Media Networks | *24,200* | *3.0%* | *23,500* | *(0.8%)* | 23,689 | 1.8% | 23,264 | 10.0% |
| Parks & Resorts | *19,775* | *7.5%* | *18,400* | *8.4%* | 16,974 | 5.0% | 16,162 | 7.0% |
| Studio Entertainment | *9,800* | *12.6%* | *8,700* | *(7.8%)* | 9,441 | 28.2% | 7,366 | 1.2% |
| Cons. Prod. & I'active Media | *5,425* | *8.5%* | *5,000* | *(9.6%)* | 5,528 | (2.6%) | 5,673 | 7.4% |
| | *59,200* | *6.5%* | *55,600* | *(0.1%)* | 55,632 | 6.0% | 52,465 | 7.5% |
| **Operating Income:** | | | | | | | | |
| Cable Networks | *6,445* | *5.2%* | *6,125* | *(9.2%)* | 6,748 | (0.6%) | 6,787 | 4.9% |
| Broadcasting | *1,080* | *3.8%* | *1,040* | *3.3%* | 1,007 | 0.1% | 1,006 | 17.8% |
| Media Networks | *7,525* | *5.0%* | *7,165* | *(7.6%)* | 7,755 | (0.5%) | 7,793 | 6.4% |
| Parks & Resorts | *4,050* | *8.7%* | *3,725* | *12.9%* | 3,298 | 8.8% | 3,031 | 13.8% |
| Studio Entertainment | *2,775* | *10.3%* | *2,515* | *(7.0%)* | 2,703 | 37.0% | 1,973 | 27.4% |
| Cons. Prod. & I'active Media | *1,970* | *9.4%* | *1,800* | *(8.4%)* | 1,965 | 4.3% | 1,884 | 28.0% |
| | *16,320* | *7.3%* | *15,205* | *(3.3%)* | 15,721 | 7.1% | 14,681 | 12.9% |
| Corporate & Other Activities | *(660)* | *4.8%* | *(630)* | *(1.6%)* | (640) | (0.5%) | (643) | 5.2% |
| Nonrecurring Charges | *0* | | *0* | | (156) | | (53) | |
| Other Income (Expense) | *(80)* | *14.3%* | *(70)* | | (129) | | 0 | |
| Interest Inc. (Exp.), net | *(515)* | *8.4%* | *(475)* | *N/A* | 72 | | (117) | N/A |
| Pre-tax Earnings Excluding Nonrecurring Items | *15,065* | *7.4%* | *14,030* | *(5.6%)* | 14,868 | 7.2% | 13,868 | 13.2% |
| Less: Taxes | *4,821* | *5.7%* | *4,560* | *(10.2%)* | 5,078 | 1.2% | 5,016 | 18.2% |
| Less: Minority Interests | *420* | *5.0%* | *400* | *0.3%* | 399 | (15.1%) | 470 | (6.6%) |
| Net Income | *$9,824* | *8.3%* | *$9,070* | *(3.4%)* | $9,391 | 12.0% | *$8,382* | 11.7% |
| **Diluted EPS:** | | | | | | | | |
| As Reported | *$6.40* | *11.5%* | *$5.74* | *0.2%* | $5.73 | 16.8% | $4.90 | 15.0% |
| **Excluding Nonrecur. Items** | ***$6.40*** | ***11.5%*** | ***$5.74*** | ***0.4%*** | **$5.72** | **11.1%** | **$5.15** | **19.2%** |
| Avg. Diluted Shares Outst. | *1,535* | *(2.8%)* | *1,580* | *(3.6%)* | 1,639 | (4.1%) | 1,709 | (2.8%) |
| EBITDA | *$18,410* | *7.0%* | *$17,200* | *(1.2%)* | $17,401 | 7.6% | $16,170 | 11.8% |
| **Operating Margins:** | | | | | | | | |
| Cable Networks | *37.91%* | | *37.35%* | | 40.57% | | 40.93% | |
| Broadcasting | *15.00%* | | *14.65%* | | 14.27% | | 15.05% | |
| Media Networks | *31.10%* | | *30.49%* | | 32.74% | | 33.50% | |
| Parks & Resorts | *20.48%* | | *20.24%* | | 19.43% | | 18.75% | |
| Studio Entertainment | *28.32%* | | *28.91%* | | 28.63% | | 26.79% | |
| Cons. Prod. & I'active Media | *36.31%* | | *36.00%* | | 35.55% | | 33.21% | |
| Total | *27.57%* | | *27.35%* | | 28.26% | | 27.98% | |
| **As a % of Total Revenues:** | | | | | | | | |
| EBITDA | *31.10%* | | *30.94%* | | 31.28% | | 30.82% | |
| Corporate & Other Activities | *1.11%* | | *1.13%* | | 1.15% | | 1.23% | |
| Tax Rate | *32.00%* | | *32.50%* | | 34.15% | | 36.17% | |

Note: EBITDA represents segment operating income less corporate expenses plus depreciation & amortization
Operating income from Cable Networks segment includes equity in income of investees

Source: Company reports and Hilliard Lyons estimates Note: September fiscal year

*Additional information is available upon request.*

Prices of other stocks mentioned: Netflix Inc. - NFLX - $185.15

## Analyst Certification

I, Jeffrey S. Thomison, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

## Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

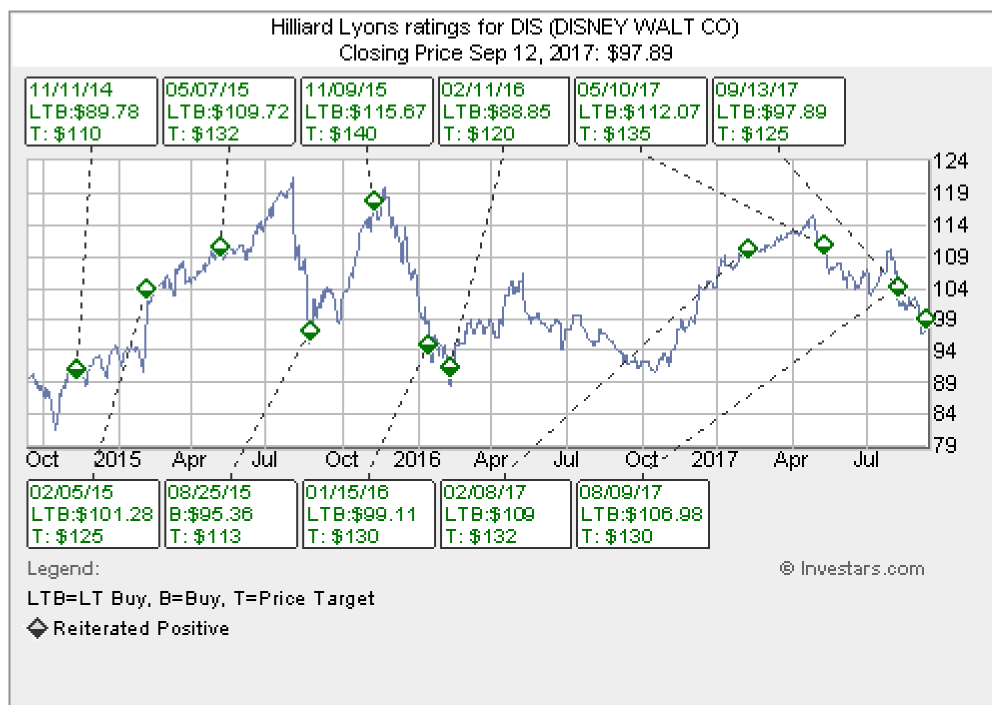
The author of this report or members of his household have a long position in the common stock of The Walt Disney Company, but may not engage in buying or selling contrary to the recommendation.

**Investment Ratings**
**Buy** - We believe the stock has significant total return potential in the coming 12 months.
**Long-term Buy** - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.
**Neutral** - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
**Underperform** - We believe the stock is vulnerable to a price set back in the next 12 months.

**Suitability Ratings**
**1** - A large cap, core holding with a solid history
**2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
**3** - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
**4** - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base

| | Hilliard Lyons Recommended Issues | | Investment Banking Provided in Past 12 Mo. | |
|---|---|---|---|---|
| Rating | # of Stocks Covered | % of Stocks Covered | Banking | No Banking |
| Buy | 40 | 32% | 10% | 90% |
| Hold/Neutral | 77 | 62% | 8% | 92% |
| Sell | 8 | 6% | 0% | 100% |

*As of 6 September 2017*




Note: Price targets accompanying Buy ratings reflect a one year time period while price targets accompanying Long-term Buy ratings reflect a two to three year time period.

## Other Disclosures

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