Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | JULY 2, 2018

The Art Of The Deal — "Benny Hill" Style

WRITTEN AND PRODUCED BY

FRONTWATER CAPITAL

Smacking the young Justin Trudeau upside the head may not be the traditional way of conducting trade policy, but it is on par with some of the best pie-in-the-face slapstick negotiations. Of course, when the U.S. troupe running the most powerful economy in the world looks like "The Benny Hill Show," it can be hard to tell what is theatre and what is the art of the deal.

One day, there's a trade war with China. The next — not so much. One day, global trading partners like Canada, Mexico and Europe are reassured that they are safe from harm. The next — they are hit with smack talk and are accused of being 'security risks.'

Like most things Trump does, there is duality — logic and insanity. President Trump is probably 100% correct in standing up to China and its closed markets. Chinese companies are allowed to set up shop in foreign markets such as Canada and the US but the reciprocal does not hold. Foreign companies cannot easily establish themselves in China — not without forfeiting some of their intellectual property or having to joint venture with a Chinese company.

On the other hand, it seems like absolute insanity to go after Canada and Mexico. The free trade zone has been a win-win for all countries involved. Without question, removing NAFTA will hurt employees in all three countries. We can only imagine the damage it will do specifically to the US auto sector, a key industry that Trump wants to protect. Right now, so many auto parts flow freely between the three North American countries. Eliminating a tax free zone seriously complicates the supply chain and adds a layer of cost. Where did this auto part originate from? And where did the parts that went into the auto part originate from? The impact will be clear. The auto sector and many other manufacturers will have to add costly tax departments to determine 'duty classifications' and identify 'countries of origin' in their 'bills of materials'.

PHOTO: JIM WATSON/AFP/GETTY IMAGES

No doubt, the Trump administration's decision to slap tariffs on foreign countries has created tension in the financial markets. The implications of those tariffs are still unclear. The aggressive rhetoric used by Trump has become commonplace and recognized as a bargaining tool in negotiations between nations rather than a clear-cut policy. The talk of trade wars has created volatility in the markets, but we still do not see any concrete decision taken by any nation. Of course, Trump may yet pull out a cushy deal that benefits the US and others.

As questions remain: Is Trump overplaying his hand with traditional U.S. allies and trading partners? Will his tariff proposals sour decades of goodwill? Will his NAFTA-busting talk lead to untenable policies and declining markets for U.S. products? Will he start a trade war with China, the EU, Canada, and Mexico? Or will he just see how much benefit he can secure for his "America First" brand of economic and political diplomacy and settle for a sweet spot in the middle? The impact to the stock market is real — a return of volatility.

The S&P 500 has moved up or down at least 1% on 28 trading days already in 2018. To put that into context, there were only eight swings of 1% in all of 2017. Moreover, a Polar Bear plunge in February sent the Dow Jones down more than 1000 points. Finally, we are no longer seeing "a rising market lifting all tides" like we saw in 2017 where the broad market as a whole performed in the green.

Performance in 2018 is much less broad based and varies significantly by sector. Those investors who have shunned the technology sector have really missed out on some large gains. On the flip side, many defensive and conservative stocks lost ground this past quarter.

For example, technology stocks like Facebook and Amazon performed very well, up 10% and 43% respectively. Adobe which we wrote about in our Q1 2017 newsletter was also up 40% in 2018. Meanwhile, consumer staple companies as a group were pounded — down 8.3% on average

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The Walt Disney Company

PHOTO: THE DISNEY COMPANY

Disney is positioning itself to regain its dominance within the world of movies and media.

Over the last 3 years, Disney stock has been near "Frozen" while other stocks have been on the fast track to "Treasure Island." On June 30th 2015, Disney shares topped out at $120. Today, the shares trade 12% lower at $105 and have drastically underperformed the S&P 500's 31% gain. But Disney's no dud, and now is the perfect time to own shares in the house built by the mouse.

In order to fully grasp the enormous upside potential in Disney, we first need to understand why it has been such a disappointment over the last 36 months – despite the fact that it runs one of the best movie studios in the world.

It boils down to three things:

- The ESPN cash cow has slipped a bit.
- Mickey has been behind the curve in offering super-lucrative streaming services.
- And, the company spent $15 billion in acquisitions over the last 12 years.

But all is poised to change for the better and Disney is positioning itself to regain its dominance within the world of movies and media.

We all like to think of Disney as a conglomerate of family magic from movies to theme parks and boat line cruises. But what most of us fail to grasp is that, over the last ten years, a disproportionate amount of Disney's profits has come from one division – ESPN, its sports broadcasting arm.

ESPN is part of Disney's media division, which remains the company's largest source of revenue, with revenues increasing 5%, to $20.4 billion, in fiscal 2017. ESPN's rights to various professional and college sports programming and live-sports

coverage attract millions of pay-TV providers and higher ad rates. It has a large, established subscriber base and a clear competitive advantage over other sports channels.

Accounting for nearly 57% of all of Disney's profits in 2011, ESPN was by far and away the cash cow of the business. But that was at its peak, with a subscriber base at the time of 100 million customers. Today, that subscriber base has dwindled to 87 million. While ESPN still accounts for the lion's share of the income for Disney, it is now closer to 40%

Additionally, the households that remain connected to ESPN are spending fewer hours watching. The early-evening edition of SportsCenter, ESPN's flagship show, has lost almost half of its audience in the highly coveted demographic group of men aged 18 to 49.

Some blame the new millennial generation, which seems to enjoy social media and computer games more than live sports. Others say the NFL's anthem turmoil drove viewers away. But the real bottom line is that more viewers are cutting the cord – the cable cord, that is. So, perhaps the millennials are not lost, but just turning to internet and streaming services for their sports and entertainment needs.

Finally, in a perfect storm scenario, licensing costs have shot up. That is because more and more viewers at home are watching their favourite shows on catch-up instead of when they air originally. Networks and advertisers see live sports as one of the few areas that can still draw substantial audiences.

Aside from ESPN, Disney's slow and lethargic foray into digital streaming has been cause for concern. Disney has shown sheer ineptitude in online streaming, missing out completely on this opportunity. Disney, with its treasure trove of movies, should have been one of the first movers in terms of online streaming. But not only did Disney fail to monetize its massive vault of video content, it actually provided Netflix with Disney content.

By renting out its library to Netflix, Disney enabled Netflix to rise from near-ashes. (See our Q1 2013 Newsletter for our call on Netflix). We forget that Netflix was once a disc-by-mail service that nearly followed Blockbuster's death march to an ignominious end.

NETFLIX

Now it's king of the hill. This past quarter, Netflix achieved the status of "largest broadcaster in the world", with a market cap of $178 billion versus Disney's $158 billion — an incredible feat for a company that only started producing its own original content about 6 years ago.

But Disney could take that hill. It has a trove of movies and entertainment, not to mention ABC and ESPN programs, at its fingertips. In addition, over the last 12 years, Disney's management made three very shrewd acquisitions that have paid out multiple times over: Pixar, Marvel Comics, and Lucasfilms. Pixar was acquired for $7.4B USD in 2006 in an all-share deal. Marvel and its library of 5000 characters were acquired for $4.0B USD in 2009. Lucasfilms and the "Star

Adding Fox is a great longterm move with franchises like X-Men and SKY Sports.

Wars" franchise were acquired for $4.05B USD in 2012.

Now consider the following:

- As of December 2017, the three new Disney '"Star Wars"' movies had already made more than the $4.05 billion Disney paid for the franchise in 2012.
- Over the last eight months, ticket sales for Disney's three Marvel movies: "Thor Ragnarok," "Black Panther," and "Avengers Infinity War," combined for more than the $4 billion purchase price for Marvel.
- Keep in mind that these revenue figures are from box office tickets alone and exclude the money Disney made from merchandising and theme parks, both of which are more lucrative than what the studio gets from ticket sales.

Today, Disney is battling Comcast for Twentieth Century Fox. Adding Fox is a great long-term move with franchises like "X-Men" and SKY Sports. It gives an incredible boost to Disney's content portfolio, both on TV and in studio. Initially, it looked like Disney might get Fox on the cheap with its initial $52.4B all-stock offer but then Comcast entered the fray with its own $62B all-cash offer. Disney has subsequently bumped its offer to $71B between cash and stock.

PIXAR
ANIMATION STUDIOS

PHOTO: THE DISNEY COMPANY

TICKER: DIS; PRICE: $104.81 AS OF JUNE 30, 2018

Aside from ESPN, Disney's slow and lethargic foray into digital streaming has been cause for concern.

No question — it is a massive deal for Disney but one that positions the company for a competitive online streaming service due to come online in 2019. There are few companies these days that can take on the behemoth, Netflix, but Disney is looking more attractive as the lone exception.

Netflix closed 2017 with 53 million subscribers in the United States and 110 million subscribers across the globe. Strip away the Disney content from Netflix and its value proposition goes down significantly.

Meanwhile, Disney's archive alone is a strong draw for families. Furthermore, its ability to use branding to create shows that force people to subscribe is even stronger. Heck, Disney took the "Guardians of the Galaxy," an obscure group of Marvel characters, and turned it into two hit films. Disney's ability to create characters and then wring every last dime out of them is the best magic trick of them all.

Another powerful option in the online space is for Disney to bundle its streaming service with an online ESPN version. Even though ESPN is losing subscribers — many of whom were not watching ESPN to begin with — demand for the network still appears to be quite strong.

ESPN's subscriber fees, the amount cable and satellite providers pay to ESPN per subscriber, continue to rise. ESPN now charges over $8.00 per subscriber, by far the most expensive cable network, and up 54% from what they were charging in 2011, when it cost $4.69 per subscriber.

Disney currently trades for 13.9 times forward earnings and an EBITDA of 10.6. We believe anyone would be hard pressed to find a similar company that trades at this level while generating 20% in profit margin and a 24.6% in return on equity. Debt levels are extremely manageable at $46 billion. The company pays a small dividend of 1.7% but has grown it by more than 10% over the last five years.

At this point in time, Disney may no longer be the market darling that it once was. However, Disney offers an interesting payoff for investors with a 1-5 year time horizon. Mickey Mouse has several crown jewels in his vault, including ESPN, ABC, the "Star Wars" franchise, the Marvel Comic Universe, Pixar, fairytales galore, the original scripted Disney characters, and a century full of movie content.

When we look at all of the stocks in the Dow and the S&P that have shared in the 31% boom over the past 3 years, you don't have to have a "Sixth Sense" to see that Disney is available at a pre-boom price, teed up and ready for a long drive.

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- Corporate Accounts
- Small and Medium Sized Businesses
- Holding Companies
- Trusts
- Endowments

THE ART OF THE DEAL

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for the year. Likewise, we saw global mining and resource based companies suffer — down 4% year to date. Finally, the TSX continued to flatline showing little to no sign of vitality as commodity stocks with the exception of oil and uranium experienced a slowdown.

The good news is that a solid foundation of confidence and real growth has been built. The roaring US and Canadian economies are in place. Both Stephen Poloz and the US Feds seem comfortable in raising interest rates. Unemployment in the US has dropped to "full employment" levels not seen in years, with job openings outstripping the number of job seekers. Moreover, tax cuts are starting to put real dollars in the pockets of both workers and employers.

All the crystal balls of the market pundits are a bit foggy right now. But we like the fact that central bankers in Canada and the US seem to have confidence that their economies will grow, as seen by their inclination toward tightening short term monetary policy. And the market, though volatile, has not panicked amid the confusing signals created by a possible global trade conundrum. Many investment firms have been wrongly betting on a bear market over the last two years and their returns have suffered. All signals say it's a little premature to send the bull to the slaughter house just yet.

Guaranteed Investment Certificates (GICs)

WHY INVEST IN GICS?

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	ANNUAL PAY	RRSP	RRIF	TFSA
1yr GIC	2.72%	2.50%	2.40%	2.40%
2yr GIC	3.08%	2.70%	2.70%	2.55%
3yr GIC	3.15%	2.80%	2.77%	2.80%
4yr GIC	3.19%	3.05%	2.91%	2.91%
5yr GIC	3.32%	3.20%	3.13%	3.13%

* Rates subject to change

[1] Frontwater does not issue GICs. GICs are issued through independent, third-party financial institutions.

[2] Based on comparable posted rates as of June 30, 2018 at Canada's five largest financial institutions.

JEFF KAMINKER, MBA, CFA founded Frontwater Capital in 2009 and is a licensed Portfolio Manager. He is a member of the CFA Institute and holds an MBA and Engineering Degree (with Honours). He has more than 15 years capital markets experience.

Frontwater Capital offers an array of private wealth management services including investment management, insurance, financial planning, tax and retirement planning.

Frontwater Capital is licensed as Portfolio Manager, Commodity Trading Adviser, and Exempt Market Dealer.

FRONTWATER CAPITAL

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