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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Warner Bros. Discovery (WBD) Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of WBD with a 3+ (Minor Concern) rating. When we get audited figures for the combined entity and can check for accounting assumption changes, we will update this coverage with more EQ items.

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

We see some value in WBD at these levels. The stock has declined from $25 to $14 in three months driven largely by weakness at Netflix. AT&T shareholders are more income-oriented and it was not surprising to see many sell their shares in Warner Bros. Discovery. But, the sell-off looks excessive for a merger that has:

- Confirmed its first full year's guidance of $14 billion in EBITDA
- Will have the final leverage figure come in at 4.6x EBITDA not 5.0x as forecast and should make it easier to hit leverage targets of 2.5-3.0x by 2024
- And is trading for about 6.0-6.4x EBITDA vs. the forecast 10x that was already lower than the group and assumes no EBITDA gains via higher revenue.

Merger Background

WBD was formed when WarnerMedia was spun-off from AT&T and merged with Discovery on April 8, 2022. That was after 1Q22 results so there are no published financials for the combined company yet. We expected many AT&T shareholders to sell their positions in WBD but we have been surprised how much the stock price has declined. WBD guided to a messy 2022 as it combines the two companies but affirmed the two-year guidance it gave when the deal was announced. We are relying on some proforma figures and some published figures from the past for both companies being separate entities and are focusing more on the big picture potential.

The initial guidance had WBD trading for 10x EBITDA with $60 billion in debt and $60 billion in equity value. Debt is likely to be closer to $55 billion. If management hits their EBITDA forecast of $14 million in 2023, even if they don't retire a nickel of debt – at 10x EBITDA, WBD would be over $35 a share vs. today's $14.

The Original Guidance

The initial guidance when the merger was announced in May of 2021 was a simple story:

Merger starting point:

- The merger would begin with Warner and Discovery's combined EBITDA of $12 billion
- The combined company would have debt/EBITDA of 5x
- This worked out to a market cap of $60 billion of stock ($25 per share) and $60 billion of debt which implies an EBITDA multiple of 10x.

By the end of 2023 (six months after the merger):

- WBD would find $3 billion of cost synergies
- WBD's combined EBITDA would be $14 billion for 2023 – which assumes some of the synergies have not annualized completely – thus EBITDA rises $2 billion vs. $3 billion annualized.

- Revenue would rise from the $39 billion that the two companies were starting with to $52 billion by the end of 2023 largely from the streaming services growing.

- 24 months after the merger (summer of 2024) Debt/EBITDA would decline to 3x.

What Has Changed Since that Initial Plan?

The merger was finalized on April 8, 2022. WBD released its earnings on April 26 to discuss 1Q22. Those results did not include anything related to WarnerMedia as it wasn't part of Discovery at the end of the 1Q22. However, WBD did discuss what it saw in WarnerMedia's results from AT&T. While they had not even completed the allocation of the merger on the official financial statements, WBD spoke in the bigger picture of current issues vs. initial guidance. The meaningful updates to the forecast were:

1) ***Initial EBITDA forecasts were lowered by $300 million…***

- While still a part of AT&T, WarnerMedia's operating income declined to $1.3 billion in 1Q22 vs. $2.0 billion for 1Q21. WBD estimates that it is starting about $500 million below its forecast for WarnerMedia. As we will explore later, we believe much of this was due to a huge increase in marketing which is likely to be reversed.

- WBD sees Discovery running about $200 million above forecasts – meaning WBD's total EBITDA is light by about $300 million from starting guidance of $12 billion.

- Debt to EBITDA was expected to come in at 5x. They still didn't have their working capital completely set for the merged entity that will impact this ratio, but they see their debt figure starting at 4.6x. Thus, debt should be about $5 billion below guidance too, given a lower EBITDA and lower debt figure.

WBD summed up 2022 by saying: *"Net-net, being the first year of our integration and as we've explained all along, 2022 will undoubtedly be a messy here, so a lot of moving pieces and now a somewhat less favorable starting position in Q1."*

2) ***…but WBD is more confident in hitting its cost-saving synergy goals of $3 billion.***

*"The good news, on the other hand is that, I also see more opportunity as I work through the numbers. There are certain investment initiatives underway in plain sight that I don't think have attractive enough return profiles. As such, and with our new combined leadership team in place out of the gate**, I feel very confident in our ability to rectify some of the drivers behind the business case deviations and some very quickly,** with the CNN+ decision last week being Exhibit A."*

"And while we're still early in our integration process and are still at the beginning stages of initiating our synergy as well as strategic and financial planning, **we feel more confident than ever about achieving our $3 billion cost synergy target, and believe there is a much greater opportunity** off of the current baseline and that target will ultimately prove conservative."

3) And 2023 guidance was confirmed.

That is centered on $14 billion in EBITDA that will be driven by synergies. Plus, they affirmed guidance to reduce the debt ratio too:

*"And to be clear, **we remain fully committed and reiterate our financial targets for 2023**, and **I remain very confident that we are on track to achieve our target gross leverage of 2.5 times to 3 times at the latest 24 months after closing**. We are refining a more detailed bottoms-up combined budget and long-range plan, the key insight of which we look forward to sharing in the months ahead."*

EBITDA Forecasts Look Very Reasonable

Both Discovery and WarnerMedia have been operating for some time. As we discussed above, if we look at the pre-pandemic numbers, a $12 billion base for EBITDA looks like a reasonable assumption. The following table shows revenue and EBTIDA prior to 2019 for both WarnerMedia and Discovery. Note that Warner was acquired by AT&T in June 2018 and we found proforma numbers from AT&T for that year in AT&T filings. Warner's 2017 and 2016 figures come from Time Warner's 10-K.

	2019*	2018**	2017	2016
Warner Revenue	$33,499	$32,227	$31,271	$29,318
Warner EBITDA	$9,701	$9,599	$8,877	$8,288
Margin	29%	30%	28%	28%
Discovery Revenue	$11,144	$10,553	$6,873	$6,497

Discovery EBITDA	$4,671	$4,139	$2,531	$2,413
Margin	42%	39%	37%	37%

In 2019, AT&T pulled Crunchyroll (a video game unit) out of Warner results as it was selling it. Also,* ***AT&T put its advertising unit Xandr into Warner – these numbers DO NOT include that.*

***Discovery acquired Scripps in March 2018. Those numbers are missing two months of Scripps results.*

****Xandr is an analytical advertising piece that AT&T put into Warner, it was not part of the merger with Discovery and was sold separately to Microsoft in early 2022. We used Xandr-free EBITDA figures in this report.*

Combined, the two companies were doing over $14 billion in EBITDA before Covid. Discovery's management touts is its ability to boost free cash flow at acquired companies and has been saying for some time that it can boost the margins at Warner. **We think this is a huge cushion for the guidance of $14 billion in EBITDA by the end of 2023 – this has already been accomplished in both 2018 and 2019.**

Looking at the 2021 and 2020 results, we can see that Covid hurt Warner with the loss of movie theater releases and even more so from losing sports. Discovery noted that advertising rates declined during Covid too. In 2020 and 2021, both companies began to roll out their streaming services HBO Max and Discovery+. That included considerable start-up costs to set up the systems and technology without revenue coming in and those start-up costs won't recur. We think that alone accounts for why the combined EBITDA looks light at $11 billion.

	2021	**2020**
Warner Revenue	$35,632*	$28,353
Warner EBITDA	$7,034*	$7,469
Margin	n/a	26%
Discovery Revenue	$12,191	$10,671
Discovery EBITDA	$3,817	$4,196
Margin	31%	39%

- The 2021 Xandr-free EBITDA for Warner was published in a Discovery 8-K filing from April 15, 2022, but not the revenue, so we cannot compute a margin. The $35.6 billion revenue figure does include Xandr and is likely about $2 billion overstated given the known Xandr results for 2020 and 2019.

- Discovery noted in 2021 that it had higher operating costs related to carrying the summer Olympics.

- Both highlighted higher spending to roll out streaming in 2021. What is interesting to note is the CFO at Discovery was looking at much of that as one-time in nature including the initial tech investments and some of the early marketing to introduce the streaming products. That penalized 2020 and 2021 earnings, but may not recur. Revenue and margins should leverage over that spending going forward.

  Gunnar Wiedenfels stated on the 3Q21 call:

  > *"What we said when we first announced this deal was **remember there's roughly $6 billion in technology and marketing spent between the two platforms.** We're assuming growth. We brought together two companies with significant expansion plans. **A lot of that spends is, by its nature, a fixed cost relatively independent of the subscriber number**. Obviously, there's a streaming-related cost that's there, but a lot of it is fixed."*

- On the surface, Discovery looks like it already bounced back in 1Q22. EBITDA came in at $1.027 billion vs $837 million in 1Q21 and $1.113 billion in 1Q22.

- Warner looked worse with EBITDA in 1Q22 of $1.446 billion vs. $2.123 billion in 1Q21. That does include an apples-to-oranges comp as 1Q21 included Otter Media but not 1Q22 as it was sold in 3Q21. 1Q20 was $2.161 billion or equal to 1Q21.

- Discovery was touting the starting point for EBITDA was on track with its internal thoughts after both 3Q21 and 4Q21 results.

- We can see the components of the lower starting point based on 1Q22 results with Discovery up about $200 million and Warner down about $500 million.

The reason we think much of this still looks promising is the shortfall in Warner's results is largely due to unusually high marketing which should normalize. We have the marketing figures for 2021 and 2020 provided by AT&T and based solely on partial figures given for parts of Warner from 2019-2020 can estimate at 2019 figure:

	2021	2020	2019
Warner EBITDA	$7,034	$7,469	$9,701
Warner Marketing	$4,137	$2,529	$1,900

Pre Mrkg EBITDA	$11,171	$9,998	$11,601

- We believe marketing was about $1.8-$2.0 billion in 2019 before the rollout of HBO Max started.
- Also, there were likely some start-up costs related to HBO Max in 2020 and 2021, that may not recur and the revenue should be seasoning as more customers pay for a full year.

Discovery sees the huge advertising spend as an area where it can revise its plans. It wants to delay some of the planned HBO Max advertising as it combines the companies and studies the situation further. We know that Warner was about $500 million below forecast for 1Q22 and the raw marketing cost that is quantified rose by $246 million y/y in 1Q22. It was up $1.6 billion for 2021.

We're comfortable saying Discovery is doing its $4 billion in EBITDA. Warner is supposed to be $8 billion but is at $7.0 billion. However, marketing was up by $1.6 billion in 2021 and if Discovery sees room to cut that total $4.1 billion in marketing down by $500 million to $1 billion – Warner is basically at $7.5-$8.0 billion in EBITDA. Remember that non-recurring start-up costs may have also weighed down Warner's 2021 EBITDA as well.

Programming and Production Costs are another big target for some cuts. Some of these costs are capitalized and amortized over time. We can see these on the cash flow statement and the level of new additions to inventory has exceeded the amount amortized. But, the gap has grown since AT&T took over. We do not have full numbers for 2018, so we have excluded that year from the table:

	2021	2020	2019	2017	2016
Chg Inv and Film/TV Costs	$16,472	$13,070	$12,852	$9,574	$8,774
Amrt. Film/TV Costs	$11,016	$8,603	$9,587	$9,162	$8,324

AT&T broke out cash spending for Warner's program and production costs in the 2021 annual report. It was $19.2 billion in 2021 and $14.9 billion in 2020. Discovery is looking at this as an even bigger area to reduce spending and boost results. Looking at the figures above, the higher spending under AT&T has pushed up the amortization expense for Film/TV costs by $1.4 billion and that should be a bigger figure for 2022 after the $19.2 billion total spending in 2021. Getting rid of CNN+ and several other projects already should be turning this around. The amortization of film/TV costs is not added back to EBITDA, lower spending overall will improve free cash flow at Warner and will lower that amortization figure going forward and boost EBITDA for Warner.

Our conclusion on the situation:

- We agree – the starting point on EBITDA looks about $300 million light.

- Nearly all of that shortfall looks like extra marketing at Warner.

- Discovery has over $23 billion of cash spending to review to find $3 billion in cost-cutting and that $23 billion looks very heavy compared to historic levels. That may be an easy $3 billion to find.

- That does not include some traditional areas of cost savings from a merger – having one set of H/R, Legal, fewer VPs, combining other staffs, eliminating duplicate real estate, and they are already seeing layoffs.

  As David Zaslav noted on Discovery's 4Q21 call:

  > *"We've got full teams and flight working on setting up the work streams et cetera. But that said we're still operating as two independent companies right now. There's very limited interaction regarding actual savings measures.*
  >
  > *So with that said,* ***what I would want you to expect is sort of an initial wave of savings after closing, which a lot of it is going to be straightforward early quick wins.*** *And then, we'll get to work on detailing out the longer term structure and setup and that's the reason why we had focused our communication on 2023* ***because 2022 was always going to be a little noisy. We're coming together a third into the year, et cetera. So 2023 is for me sort of the years for the full on synergy capture here."***

- Getting to $14 billion in EBITDA by the end of 2023 does not look like a stretch to us.

- Discovery has a history of boosting margins and improving cash flow. It tripled its forecasted savings on the Scripps deal from $350 million to $1 billion. Scripps was much smaller than Warner and Discovery achieved the savings early.

Two More Reasons to Like WBD

We have watched much of the weakness at NetFlix hit WBD since the merger was completed. In our view, this isn't Netflix at all:

- Netflix was 100% streaming after its DVD rental business – it does not have a diverse platform. WBD can make money with the theater release of movies, it can make money on cable TV, it can make money with streaming, and it can make money via advertising revenues on all three. It also has live sports which Netflix does not.

- JB Perrette, the president of Discovery Streaming noted this on the 4Q21 call:

> *"We have said, when we launched Discovery+ that we were confident to be able to get to a 20% margin at scale. That's where Netflix is at roughly today and the point that I want you to take away as well as I do think I've said many times, from today's perspective, **I think we're going to do better than that 20% number and that is because we are very uniquely positioned.** We're making through the combined company is going to be very uniquely positioned.*
>
> *We're making the content. We can decide flexibly where the greatest value is. **We've got multiple bites at the apple when it comes to monetizing the investment on our platform**. And, again, we've talked about that so much, you know, **we're virtually using every available revenue stream. In a way, we're sometimes double or triple dipping you know, monetizing content in our US linear environment, TV-everywhere**.*
>
> *Discovery+ on the international side, basic pay then in certain markets, we've been very successful launch create air on top, and almost every dollar that JB spends on content is used both on discovery+ International and linear platforms. **That's a huge advantage. Also the fact that we're getting subscription, distribution and advertising revenues**."*

- WBD has a huge content library it can monetize and grow with sequels. It pulled hit TV shows off other streaming services like Netflix to make them exclusive to WBD platforms. Even with a huge amount of programming-related spending – it's cash flow positive. Netflix can't say that:

Netflix	2021	2020	2019
CFO	$393	$2,427	-$2,887
CapEx	$525	$498	$253
Acquisitions	$788	$0	$0
Free Cash Flow	-$920	$1,929	-$3,140

Netflix cut content spending by $2.1 billion in 2020 during Covid to have a positive year. The gap between new spending and amortization is a $5.5 billion cash shortfall.

- On the other hand, Discovery is committed to generating free cash flow. The CFO, **Gunnar Wiedenfels noted on the 4Q22 call, "***So, I've always felt one of the great strengths of Discovery is that we were a free cash flow machine. And we were laser-focused on that*

> *metric as being a real metric that represents the quality of a company and when we look at 2023, and that $8 billion."*

Also, WBD has already worked hard to boost revenues via higher advertising prices. We have read that the other big players in media such as Fox and NBCUniversal were successful in boosting advertising rates by high single-digits in May and June.

Everything we have seen says WBD is aiming higher than that. *Variety* noted in June 2022 that WBD was asking for double the increase of other networks given that the combined company is no longer a niche player. It is also requiring high volume commitments for advertising in order to get access to many of its live events such as sports and get access to the full number of platforms.

We have no numbers to look at until WBD starts to release the results of the combined entity. It is worth noting that the company's forecast was mostly based on cutting costs by $3 billion. Revenue synergies were really not factored in. To the extent this policy works, it could be another area where WBD could beat forecasts.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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