The blockbuster merger of Warner Media and Discovery

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"With our collective assets and diversified business model, Warner Bros. Discovery offers the most differentiated and complete portfolio of content across film, television, and streaming. We are confident that we can bring more choice to consumers around the globe while fostering creativity and creating value for shareholders." – David Zaslav, CEO AT&T

Deal Overview

- Merging entity one: Warner Media LLC
- Merging entity two: Discovery Inc (NASDAQ: DISCA)
- Industry: Media and Entertainment
- Transaction amount: $65.32B
- Closing date: 8th of April 2022
- Advisors to Warner Media: LionTree Advisors & Goldman Sachs
- Advisors to Discovery: Allen & Company LLC & J.P. Morgan Securities

Deal Summary

Warner Media LLC (Warner), a subsidiary of AT&T (NYSE: T) - the third largest provider of mobile telephone services in the US - merged with Discovery Inc (Discovery) in the first quarter of 2022 creating a new powerful media giant. The new company was renamed "Warner Bros. Discovery Inc." and was valued at $65.32B. Shareholders of AT&T received stock representing 71% of the new company, whereas Discovery shareholders received 29%.

The deal combines two of the most valuable content libraries in the market. The new firm offers a broad choice of interesting products for all types of consumers, which includes sports content like the Olympic Games or NHL, franchises such as DC, and news platforms like CNN.

Both Warner and Discovery have rolled out a direct-to-consumer (D2C) video streaming platform, respectively HBO Max and discovery+, which will be combined in spring of 2023. This will lead to improved platform efficiency through economies of scale.

The merger also enables Discovery's advertising revenues to accelerate by expanding its reach whilst also increasing Warner's ad revenues by applying Discovery's successful advertisement models.

In addition to the revenue synergy potential, Warner Bros. Discovery will according to management also be benefitting from cost synergies worth more than $3B on an annual run-rate basis by the end of 2024. This decrease in costs, which mainly stems from overlaps in technology and marketing is expected to result in a greater free cash flow margin. The increased cash flow will be used to repay back debt and decrease the company's leverage ratio.

Company overview - Warner Media and AT&T

Warner Media, headquartered in New York, is a global media and entertainment services provider, which produces and distributes a wide range of content through its film studios, television networks, and digital platforms. Established in 1972 as Warner Communications, the company grew to become a major player in the industry with a large portfolio consisting of diverse entertainment assets. It includes film and television studios such as HBO and Warner Bros., as well as news and sports platforms such as CNN and Turner Sports.

Over the years, Warner Media has built a reputation for producing and distributing some of the most iconic and beloved films, television shows, and other content in the industry, including hits like "The Sopranos", "Game of Thrones", and "Harry Potter.".

In 2018, Warner Media was acquired by the telecommunication giant AT&T for $85.4B to expand its mobile video coverage and create long-term value for its shareholders. Nevertheless, the acquisition wasn't successful to an enormous debt burden and intense competition in the industry. In consequence, AT&T decided to spin-off Warner for a loss, merge it with the media company Discovery, and pivot back to its core business, related to broadband and wireless communication.

Company overview – Discovery

Discovery is a multinational mass media company that was founded in 1985. The company operates several factual and lifestyle TV brands, such as the Discovery Channel, Food Network, and HGTV. In addition to its domestic operations, Discovery has also expanded into international markets by acquiring stakes in local brands, such as Eurosport. The company has a strong presence in the sports and entertainment industry, both on television and through its online streaming service, Discovery+.

Discovery+ was launched in India in 2020, and it quickly expanded to the United States and Europe. The streaming service has proven to be a success, with over 24 million subscribers by the end of the first quarter of 2022. Discovery+ has become well-known for its immense collection of material as well as for its ad distribution strategy, which reaches a large audience through its multiple TV and internet channels.

Overall, Discovery is a well-respected and prosperous media organization with a sizable following both domestically and abroad. The corporation keeps being a leader in the entertainment sector thanks to its broad portfolio of TV brands and its popular streaming service. The company has a strong financial performance with consistent revenue growth and profitability. The organization has managed to succeed in a media environment that is continuously changing because to its varied business model, which encompasses both traditional and digital platforms.

Industry overview – Entertainment & Media

The Entertainment and Media (E&M) industry is composed of the following segments: Movies/Cinema, Television, Music, Publishing, Radio, Internet, Advertising, and Gaming. The whole industry currently generates revenues of around $2.3 trillion and this number is expected to reach $3 trillion in 2026, growing at a compound annual growth rate of 4.8%, a faster rate than the global economy.

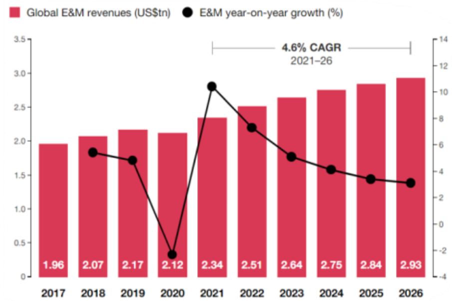

Figure 1: Source: PwC's Global Entertainment & Media Outlook 2022-2026, Omidia, 08/11/2022

The main competitors of Warner Bros. Discovery are companies such as Netflix, Paramount, and Disney. Most of these players have seen a significant share price drop this year, but WBD's stock has dropped substantially more than its peers' (around 65% as of the 17th of December 2022). Changes in the market environment such as the decline of online advertisement spending and a deteriorating macroeconomic condition have impacted all players.

Figure 2: Source: FactSet, WBD (orange) and its main competitors' stock price change, 17/12/2022

The direct-to-consumer (D2C) streaming demand is rising, which is why companies across the board are focusing on this segment of the market just like WBD. Warner Bros. Discovery now owns two large D2C content platforms, HBO max and discovery+, and aims to reach 130M paying subscribers in this highly intense and competitive market by 2025.

% Share of New US Streaming Subscribers
(Includes SVOD, FAST, AVOD, MVPD+, and Activated Bundle Deals)

	Q3 2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022
Prime Video	15%	11%	11%	12%	14%
Paramount+	7%	8%	11%	7%	13%
Peacock	11%	10%	9%	7%	10%
Hulu	8%	9%	8%	8%	8%
Disney+	10%	7%	6%	9%	6%
HBO Max	9%	5%	10%	7%	6%
Apple TV	5%	5%	4%	6%	5%
Netflix	4%	4%	5%	4%	5%
Discovery+	6%	4%	5%	4%	4%
Freevee	-	6%	2%	5%	4%

KANTAR — Source: Kantar, Worldpanel Division, ComTech, Entertainment on Demand Q3 2022 — ENTERTAINMENT ON DEMAND

Figure 3: Source: Kantar – Entertainment on Demand Q3 2022

Another big trend impacting WBD is the decline of cable TV consumption, which got replaced by the growth of demand for streaming TV, which in terms of hours watched has surpassed cable TV for the first time this year.

Deal structure

The deal was structured as an all-stock Reverse Morris Trust (RMT) transaction. The main benefit of this type of transaction is its tax efficiency. The RMT requires a parent company (AT&T) to spin off a subsidiary (Warner Media), which then gets merged with another entity (Discovery). This way heavy taxes are avoided when merging its subsidiary.

AT&T, Warner's ex-parent company, received a total of $43B in a combination of cash, debt securities, and Warner Media's retention of certain debt. Its shareholders received, on a tax-free basis, 0.24 shares of Warner Bros. Discovery for each share of

AT&T they owned. Additionally, seven members of the board will be elected by Warner Media and the other six by Discovery.

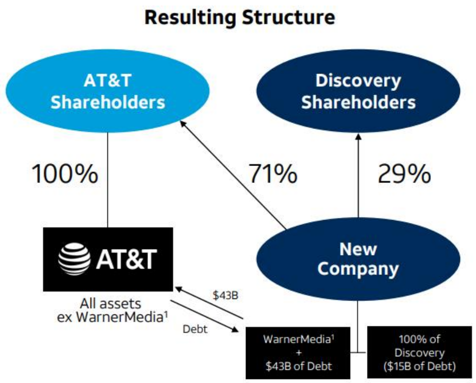

Figure 4: Source: AT&T Investor Presentation, 17/05/2021

In order to determine how the transaction evolved, we conducted a comparable company analysis including WBD's main competitors. Using the street forecasts for book value, sales, and EBITDA, we compared three multiples in the following table.

	Market Data - as of 17.12.2022			Financial Data			Valuation		
Company Name	Price ($/share)	Market Cap ($mn)	EV ($mn)	BV (FY+1) ($/share)	Sales (FY+1) ($mn)	EBITDA (FY+1) ($mn)	P/BV (FY+1)	EV/Sales (FY+1)	EV/EBITDA (FY+1)
Paramount Global B	17.3	11'347.1	26'230.1	41.8	30'275.1	3'309.8	0.4x	0.9x	8.0x
Netflix	290.7	129'371.9	139'690.4	45.4	31'579.1	6'325.5	6.4x	4.4x	21.8x
Walt Disney	90.1	164'269.2	218'280.2	55.9	90'783.5	15'590.2	1.6x	2.4x	13.7x
Fox	30.7	16'187.6	19'195.6	22.4	14'985.7	3'374.5	1.4x	1.3x	5.7x
Median subest							1.5x	1.8x	10.9x
Average subset							2.5x	2.2x	12.3x
Charter Communications	305.0	47'473.8	147'777.8	61.4	54'075.6	21'640.8	5.0x	2.8x	7.0x
Shaw Communications	26.5	13'263.6	17'434.4	9.4	3'985.4	1'845.1	2.8x	4.2x	9.0x
Liberty Broadband	69.6	10'317.6	14'165.6	65.4	974.2	248.1	1.1x	2.6x	10.1x
Rogers Communications	44.5	22'548.0	39'824.0	14.6	11'223.8	4'667.5	3.0x	3.4x	8.1x
Median of entire set							2.0x	2.5x	9.6x
Average of entire set							2.6x	2.6x	10.7x
Warner Bros. Discovery	9.9	24'065.4	76'578.4	21.7	43'449.8	11'371.8	0.5x	1.6x	7.9x

Figure 5: Source: FactSet 17.12.22 – own illustration

Clearly, those multiples show that WBD currently is highly undervalued by analysts' forecasts. Our analysis shows that the company will be trading at a Price-to-book-value (FY+1) of 0.5x, which not only is below the competitor's median (2.2x) and average (2.7x) but also depicts a negative picture of WBD's worth. Additionally, analysts expect WBD to trade on EV/Sales and EV/EBITDA multiples which are much lower than its peers (39.5% and 24.7% respectively, compared to the peer average). There are numerous reasons which can possibly explain these below-the-market valuations. The low share price can be caused by a high skepticism of investors due to the very large portion of debt of WBD. Additionally, it could also be believed that the merger will not be a success and the market, therefore, values the company lower than its peers.

Potential Risks & Potential Upsides

In its first quarter as a combined company, WBD reported net losses amounting to $3.4B, of which $1B were due to restructuring expenses. This expense included $496M in content impairment, as well as content development write-downs amounting to $329M, and another $208M in expenses for employee terminations. The strategic shifts, such as cancelling the nearly finished movie "Batgirl", and cost-cutting measures have been met with a great deal of scepticism by the market, which was directly reflected in the share price of WBD.

Currently, the enormous debt burden WBD has represents its biggest risk, in fact, WBD has a gross debt of $50.4B with a net leverage ratio of 5.1x, making it one of the most indebted companies among peers. Additionally, its interest expenses are not covered by its EBIT. With increasing interest rates and an expected economic slowdown, firms with high debt levels are at higher risk of going bankrupt, which can explain why WBD's stock has been pushed down.

However, WBD has been capitalizing on its strong media library in the last few months by focusing on quality rather than quantity. It recently released shows such as "House of the Dragon" which had immense success. Furthermore, by combining discovery+ and HBO Max, the firm will be able to profit from synergies as well as cross-selling. Next, Warner Media never increased the price of their HBO Max subscription, therefore, the merger of the two DTC platforms could be followed by a price increase, which could boost the margin significantly. Finally, the company promised to use the available free cash flow to decrease its leverage ratio to 2.5x-3.0x as early as possible. In Q3 2022, WBD paid back $2.5B of debt and ended up with negative free cash flow ($-192M).