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Research Update:

Disney Downgraded To 'A' On Risks Associated With Strategic Pivot And Integration Of Fox; Outlook Stable

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Rating Action Overview

- Burbank, Calif.-based TWDC Holdco 613 Corp. (to be renamed The Walt Disney Co. [Disney]) is poised to complete its acquisition of much of New York City-based Twenty-First Century Fox Inc. (21CF). At the same time, Disney will become the new parent company, and the former parent, The Walt Disney Co. (renamed TWDC Enterprises 18 Corp.) and 21CF will become wholly owned subsidiaries.
- On March 12, 2019, S&P Global Ratings lowered its ratings on Disney, including the issuer credit and issue-level ratings to 'A' from 'A+'. We removed our ratings on Disney from CreditWatch, where we placed them on Dec. 18, 2018. As a result of the downgrade, we lowered our short term rating on Disney to 'A-1' from 'A-1+'.
- We are also assigning our 'A' issuer credit rating to the proposed new parent company, TWDC Holdco 613 Corp. (renamed Disney).
- The stable outlook on Disney reflects our belief that, notwithstanding a low probability event or action, Disney will be able to navigate the strategic shift and potential economic downturn, without breaching our 2.5x downside threshold, and maintaining adequate headroom.

Rating Action Rationale

Disney is poised to close on its acquisition of certain portions of 21CF (including 20th Century Fox studio, selected U.S. domestic cable networks including FX and National Geographic, all international cable networks, and Fox's key DTC platforms including its 30% stake in Hulu and STAR India, its leading DTC service in India). The rest of 21CF (the Fox broadcast network, the 28 owned and operated stations, Fox News cable network, and the national sports networks including FS1) will be spun off into a new company, Fox Corp. Disney is required by the U.S. Department of Justice to sell 21CF's regional sports networks (RSNs) in order to get regulatory approval for the 21CF transaction. For our rating action on 21CF and its financing subsidiary 21CFA, see "Twenty-First Century Fox Inc. Ratings Raised To 'A' On Pending Disney Acquisition", which was published concurrently with this rating action.

The downgrade reflects the operational risks as a result of the transaction. While our base-case forecast shows that Disney could reduce leverage back to under 2x (the downside threshold for the prior 'A+' issuer credit rating) within two years, we believe Disney faces internal and external challenges that could delay that deleveraging process, resulting in adjusted leverage remaining above 2x.

A shift in content distribution strategy carries operational risks.

Disney is undertaking a fundamental strategic shift in how it controls and distributes its owned content. The company is moving away from a traditional distribution model in which it licenses or syndicates content to third-party distributors, such as television networks and streaming video-on-demand (SVOD) operators and toward a "walled-garden" approach in which Disney-owned content is only available exclusively through its owned direct-to-consumer (DTC) services such as Hulu, ESPN+, and the soon-to-be-launched Disney+. Disney plans to end syndicating and licensing any new content and to reclaim already syndicated/licensed content as its agreements with third parties expire. The most significant of those is its 2012 distribution agreement with Netflix which Disney let expire at the end of 2018. We anticipate Disney will do the same with 21CF's distribution agreements with Netflix and, potentially, HBO (expires in 2022). Eventually, the only place that consumers will be able to find and consume Disney and 21CF content, outside of first run movies that will continue to be released in theaters, will be Disney's owned DTC services.

Credit metrics will likely worsen in the near term as content costs ramp up and revenue is subject to increased volatility.

While we believe Disney, with its unique collection of iconic brands and intellectual property, has the ability, more than any other traditional media company, to succeed in this transformation, this strategy presents considerable risks. This pivot exposes Disney directly to the more volatile, lower margin consumer distribution model while forfeiting the more predictable higher margin syndication/licensing revenues. To expand its owned content library to attract and retain subscribers to these new DTC services, Disney will need to meaningfully increase spending on new original content. Over time, these DTC services should grow subscribers, generating revenues and cash flow which could eventually make up for the lost syndication revenues and higher programming spending. Until this happens, Disney's credit measures would likely worsen, the magnitude of which would depend on how long this transformation takes, how much Disney spends on new original programming, and how successful the DTC services are.

None of this is unique to Disney. Other traditional media companies have recognized the need to follow some version of this strategy, but the strategic risk (and the likelihood of failure) and the impact to earnings (and credit measures) has deterred every other traditional media company from following the same path.

The integration of 21CF carries risk because of scale and cultural differences.

On top of a shift in distribution strategy, Disney will be integrating its largest acquisition ever and reorganizing its businesses. This integration, which will include new business segment leadership, with several coming over from 21CF, will be significantly more challenging and more complex than previous acquisitions This is not only because of the size and global scale of 21CF but also because of the seismic differences in Disney's and 21CF's corporate cultures. By itself, this integration will challenge the organizational, leadership, and operational skills of Disney's senior leadership. Adding in the strategic shift will surely amplify these challenges and increase the risk of potential missteps.

Economic uncertainty increases risk at a time of elevated leverage and integration challenges.
While not explicitly factored into our base-case analysis, Disney's strategic pivot is being initiated, in our opinion, late in the credit cycle. Disney remains vulnerable to swings in the economy, not just through its reliance on advertising which is correlated to GDP, but also at its theme parks business which depends on consumer spending. Thus, a global economic slowdown would put added negative pressure on Disney's credit measures.

Deleveraging prospects will partly depend on asset sale proceeds and future acquisitions.
Overhanging our ratings on Disney is the uncertainty surrounding 21CF's regional sports networks (RSNs) whose divestment the U.S. Department of Justice has mandated, as well as Disney's future ownership plans for the 40% of Hulu that it doesn't own (Comcast Corp. and AT&T Inc. own 30% and 10%, respectively). The required sale of 21CF's 22 RSNs has yet to be finalized, and the results of that process will have a material impact on Disney's pace of deleveraging. Our base-case forecast assumes Disney receives post-tax proceeds of $12 billion-$13 billion (8x multiple), which we expect would be used to reduce the amount of new debt needed to purchase Fox.

In addition, uncertainty remains regarding Disney's desire to acquire the 40% of Hulu that it doesn't own, pro forma for the Fox acquisition. AT&T has publicly stated that it would be interested in selling its 10% non-voting stake. We factor $1 billion in unspecified acquisitions annually into our Disney forecast. This would more than likely capture a transaction between AT&T and Disney yet would not be sufficient if Disney were to also acquire Comcast's stake.

The acquisition of 21CF adds to the depth and breadth of the company's content and distribution footprint.
Our ratings on Disney reflect the company's unparalleled collection of iconic brands, which includes Disney, Star Wars, Marvel (21CF is adding the X-Men and Fantastic Four), Pixar, and Avatar; the breadth and depth of its studios which is greatly enhanced with the addition of the 20th Century Fox studio and library; the global distribution footprint which was greatly enhanced by Fox's cable networks and SVOD services; and the company's broad diversity in its media and entertainment businesses. In our view, Disney remains the preeminent company for monetizing intellectual property across the full breadth of its businesses. Somewhat tempering these strengths is Disney's exposure to shifts

in media consumption and advertising spending, particularly within the U.S. television industry. The rating benefits from Disney's conservative financial policy, which balances conservative credit metrics with shareholder returns and acquisitions and Disney's strong cash flow generation, though this could be somewhat tested over the next few years due to the strategic shift.

We forecast Disney's adjusted leverage, pro forma for the Fox transaction, will rise to roughly 2.4x. Over the next two years, we expect the company will focus on reducing adjusted leverage back to below 2x. To aid in that process, Disney has already suspended its share repurchase program and will likely slow the annual growth in its dividend. Our base-case forecast shows adjusted leverage of 2.4x at the end of fiscal 2019 (which will roughly include six months of 21CF – 2.3x on a pro forma basis), declining to around 2x as of fiscal 2020 (18 months post-closing).

Our base-case forecast includes the following assumptions:

- U.S. GDP growth of 2.3% in 2019 and 2.3% in 2020, and eurozone GDP growth of 1.5% in 2019 and 1.5% in 2020.
- Consolidated revenue growth of about 16% in fiscal 2019 (2% on a pro forma basis) and 24% in fiscal 2018 (6% on a pro forma basis).
- Operating expense growth rising modestly faster than revenue growth (primarily because of growth in programming expenses and integration costs), resulting in a 10% decline in EBITDA in fiscal 2019 and high-teens percentage growth in fiscal 2020 (mid-teens on a pro forma basis).
- Adjusted EBITDA margins declining to the 24-26% range in fiscal 2019 and 2020 (it was 32.9% in fiscal 2018).
- Free operating cash flow of about $6.5 billion in fiscal 2019, which is significantly lower than fiscal 2018 levels, and above $7.5 billion in fiscal 2020.
- Discretionary cash flow of about $3.5 billion in fiscal 2019 and more than $4 billion in fiscal 2020.
- $1 billion in acquisitions annually. We believe this would capture the price of AT&T's 10% stake in Hulu.

For more details on our forecast, see our full analysis on Disney to be published shortly.

Outlook

The stable outlook on Disney reflects our belief that, notwithstanding a low probability event or action, Disney will be able to navigate the strategic shift and potential economic downturn, without breaching the 2.5x downside threshold, and maintain sufficient headroom against this threshold.

Upside scenario

We could raise our ratings on Disney if the company is successful with its DTC services and 21CF integration andcash flow stability continues at its theme parks, while adjusted leverage decreases to below 2x on a sustained basis. This is likely if growth in Disney's DTC revenues makes up for the losses in traditional revenues and there is a clear path toward cash flow breakeven for its DTC services.

Downside scenario

We could tighten our leverage threshold for our issuer credit rating on Disney or lower the rating if secular trends worsen or significant missteps occur with its DTC strategy, causing permanent operating metric erosion. In addition, we could lower the rating if Disney's leverage rises above our 2.5x threshold, with no prospect of declining over the next two years. This could occur if the company changes its financial policy such that the result would be a permanent increase in leverage or if a global economic downturn triggers a sharp decline in revenue and EBITDA without a corresponding debt reduction.

Liquidity

We are revising our assessment of Disney's liquidity to strong from exceptional in spite of the still-healthy cash generation and still-strong cash balances as the company will have elevated cash uses for the next 12-24 months due to the 21CF acquisition and the associated integration costs, Disney's venture into DTC products that will lose cash for the next few years and consolidation of Hulu which remains a net user of cash. Our assessment is based on the company's high standing in credit markets, exceptional access to capital, and well-established and solid relationships with banks. Management exercises very prudent risk management, which was evident in the company's credit profile stability during the 2008-2009 recession. We expect Disney's liquidity sources to cover uses by more than 1.5x over the next 24 months. The company's compliance with the interest coverage covenant could survive a more than 30% drop in EBITDA. We believe the company has the ability to absorb high-impact, low-probability events (such as market turbulence and sovereign risk) without refinancing, and that its discretionary cash flow will be sufficient to cover maturing debt, notwithstanding a period of peak capital expenditures for a major theme park.

Principle sources of liquidity include:

- Cash balances totaling $4.5 billion as of Dec. 29, 2018;
- A recently increased $12.25 billion commercial paper program;
- Availability of $11.5 billion under its revolving credit facility as of Dec. 29, 2018, including $6 billion 364 days facility maturing in March 2020; and
- Annual cash flow from operations of $12 billion in fiscal 2019 and over

$13 billion in fiscal 2020.

Principal uses of liquidity include:

- Increasing capital expenditures of under $6 billion in fiscal 2019 and more than $6 billion in fiscal 2020, which include increased spending at theme parks;
- Shareholder dividends of $3 billion in fiscal 2019 and $3.3 billion in fiscal 2020;
- Debt maturities of about $2.8 billion in fiscal 2019 and $3.0 billion in fiscal 2020; and
- No share repurchases in fiscal 2019 and fiscal 2020.

Ratings Score Snapshot

Issuer Credit Rating: A/Stable/A-1

Business risk: Strong

- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: a+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Exceptional (no impact)
- Management and governance: Strong (no impact)
- Comparable rating analysis: Negative (-1 notch)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity

Descriptors For Global Corporate Issuers, Dec. 16, 2014

- Criteria | Corporates | Industrials: Key Credit Factors For The Media And Entertainment Industry, Dec. 24, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded; CreditWatch/Outlook Action		
	To	From
Capital Cities/ABC Inc.		
Disney Enterprises Inc.		
Issuer Credit Rating	A/Stable/--	A+/Watch Neg/--
The Walt Disney Co.		
Issuer Credit Rating	A/Stable/A-1	A+/Watch Neg/A-1+
TWDC Holdco 613 Corp.		
Senior Unsecured	A	A+/Watch Neg
Commercial Paper	A-1	A-1+/Watch Neg
Capital Cities/ABC Inc.		
Senior Unsecured	A	A+/Watch Neg
Disney Enterprises Inc.		
Senior Unsecured	A	A+/Watch Neg
The Walt Disney Co.		
Senior Unsecured	A	A+/Watch Neg
Commercial Paper	A-1	A-1+/Watch Neg

New Rating;		
TWDC Holdco 613 Corp.		
Issuer Credit Rating	A/Stable/--	

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.