RED TIDE

Media giants have piled up mountains of debt to finance what they hope are transformative acquisitions. AT&T, Disney and Comcast now need to make sure they don't get crushed under those obligations

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Randall Stephenson, AT&T's chairman-CEO, summoned all of his folksy Oklahoma earnestness as he made an enthusiastic pitch to Wall Street analysts about the telephone company's bold efforts to transform itself into a multimedia powerhouse. It was late November, less than six months after AT&T had wrapped up its $85 billion acquisition of Time Warner. But before Stephenson could wax poetic about his plans to revitalize HBO, Warner Bros. or other newly acquired AT&T subsidiaries, he felt compelled to address the elephant in the room. ¶ "If you hear nothing else this afternoon, I want you to hear me on this," Stephenson said at the company's investor presentation in New York. "Our discretionary cash flow is going to go to one place. It's going to be

PAYING DOWN DEBT."

Stephenson had no choice but to try to appease those who are plenty anxious about the mountain of leverage AT&T has accrued in the past four years, not only from the Time Warner purchase but also from its $49 billion deal for DirecTV. The nut stands somewhere between $170 billion and $180 billion plus.

AT&T is not alone in seeing red-ink levels rise in an era of merger mania.

Comcast will have to shoulder $114.7 billion in debt, according to Moody's, now that it has shelled out $40 billion to buy Sky — this after losing the bidding war with Disney for 21st Century Fox. Like Comcast, Disney is carrying more leverage than it has in more than a decade.

The task facing AT&T, Disney and Comcast is a daunting one, requiring deft corporate maneuvering to avert disaster. All three companies have made big bets that the only way to survive and thrive amid the digital disruption is to get bigger, and they've used debt, lots of it, to finance their empire building.

"If there's an economic slowdown or interest rates continue to rise, I'm not sure these companies will look back and think that it was such a good idea to pile on the debt," says Hal Vogel, CEO of Vogel Capital Management.

These media giants are scrambling to catch up with the market-shaking rise of Netflix. The streaming giant has also fueled its ascent on the back of cheap debt. Unlike the leveraged financing used by Comcast, Disney and Fox, much of the money Netflix has borrowed is of the junk bond variety. That means that the cost of servicing the debt will fluctuate more wildly if interest rates rise.

"It can be a very painful experience for companies that are carrying a big debt load," says Schuyler Moore, a partner in the corporate entertainment department of Greenberg Glusker. "People lend money based on a company's theoretical equity value, but if the stock gets hammered, that equity cushion deflates as well."

The ballooning leverage only heightens the enormous stakes at play for the largest media companies. AT&T, Disney and Comcast are faced with reinventing large parts of their core businesses — to compete in the global streaming marketplace established by Netflix's fast rise — at the same time they navigate the tricky process of integrating high-priced acquisitions into existing operations, with all the potential for culture clashes, turf wars and dysfunction that entails. The demands of meeting ambitious synergy targets and servicing a higher level of debt require that everything go right for these corporations in the next two years in order for the math to work.

"Certainly there's a lot more leverage in the system than there was at the end of the last economic expansion cycle [in 2009]," says longtime media industry analyst Craig Moffett of MoffettNathanson. "That has to make you nervous if we're indeed headed into a recession at some point."

The stock buyback binge of the last 15 years has been fueled in part by borrowings because the cost of credit for well-established businesses was so low in a generally low-interest-rate banking environment. Companies under pressure to trim debt are, not surprisingly, vowing to put the brakes on future stock buybacks for the near term. Buybacks have started to draw more attention on Wall Street amid worries that corporate leaders who receive a large portion of their annual compensation in stock options are given a counterproductive incentive to spend corporate resources to keep the stock price high rather than invest in R&D, IP and other forward-looking initiatives that can be vital to a firm's long-term health.

Neil Begley, senior VP and senior analyst for ratings agency Moody's, points to Viacom as the poster company for problems that emerge when management is overly focused on propping up the stock price through buybacks rather than doing the hard work of strategic positioning for the future. In 2013, Begley sounded the alarm on Viacom because of his concern that the management under then-CEO Philippe Dauman was expending too much energy on borrowing money for stock buybacks rather than investing in the company at a time of turmoil for the entertainment industry. In 2016, Dauman was ousted and Viacom had to race to refinance some of that debt as hefty payments loomed.

"It's always easier to spend money to buy back stock rather than invest in the company," Begley says.

The entertainment industry, like other business sectors, has enjoyed nearly a decade of easy access to cheap debt, encouraging companies to finance acquisitions, day-to-day operating needs and expansion efforts with bonds and loans. Most blue-chip companies like AT&T and Disney issue only investment-grade bonds, which mean lower yields for investors and lower costs for the issuing party.

But there's still a lot of range within the investment-grade spectrum. There's been a notable rise in the past few years in the amount of corporate debt across the U.S. economy that is rated on the low end of the investment-grade scale, which runs from the top AAA tier to the lowest BBB tier.

If a company's financial performance deteriorates, debt with BBB ratings is in danger of being downgraded to speculative or junk bond status by the three major credit rating agencies: Moody's, Standard & Poor's and Fitch. Such a downgrade would greatly increase debt financing costs for the issuer. The rise on BBB-rated corporate debt has been a focus for Wall Street in recent months.

"Debt is unforgiving — it always has to be repaid or refinanced," says financial journalist William D. Cohan, who has been sounding the alarm about rising corporate debt rates. "Debt has been very trendy for the last decade because the [Federal Reserve] has intentionally lowered interest rates. The trend has been to do big deals and finance them in debt markets. But when you pile on operational risk, integration risk and financial risk all together, that is a very dangerous stew."

Begley notes that AT&T — which has about $70 billion in BBB-rated debt that will come due over the next four to five years — is in a tight spot because of the company's need to maintain investment-grade status and its commitment to paying a sizable annual dividend to shareholders. Simply put, AT&T cannot afford a downgrade for its bonds. Such a move would have a ripple effect throughout the credit markets.

"The high-yield market could not easily absorb that level of debt from one issuer," Begley says. "That could cause market disruption in the speculative-grade world."

AT&T chief financial officer John Stephens emphasized at the Nov. 29 investor presentation that $150 billion of the company's debt load is locked in at low interest rates.

Hollywood studios and other content-focused firms have been able to manage significant debt, even with the volatility of the entertainment industry, because of the nature of the business.

"Historically most media companies have been able to carry more debt than average for their ratings," says Begley. "Some of those businesses have been very predictable and stable, like pay TV, and with high margins, but are not particularly capital intensive."

If push comes to shove, market watchers predict AT&T will have to temporarily slash the size of its dividend. That would undoubtedly have negative repercussions from investors because of the company's rock-solid history of dividend growth since 1985, the year after the federal government broke up the former Ma Bell's monopoly in the U.S. Viacom was also forced to cut its dividend amid its credit crunch in late 2016-early 2017.

In the face of tough scrutiny, Stephenson has made the Wall Street rounds to explain his vision of how AT&T will shave some $20 billion off its obligations by the end of 2019. It's a high-wire act, as the company is promising to still pay out about 50% of its earnings in a dividend and invest in HBO, Turner, and Warner Bros. and the upgrade of its wireless service to the super-fast 5G technology.

"We feel comfortable with our ability to manage the debt. And we're going to invest another $23 billion next year and still generate $26 billion of free cash flow," Stephenson said in a Dec. 4 Q&A at the UBS Global Media & Communications Conference. "The idea that the debt is constraining our investment is not true."

AT&T has also pledged to raise $6 billion to $8 billion this year in asset sales — a goal that has helped assuage some concerns. Among the sale candidates that AT&T has identified are its 10% stake in Hulu (inherited from Time Warner), which is valued at nearly $1 billion, and its 41% interest in the Sky Mexico satellite-TV platform.

"If you listen to [AT&T's] current message, they appear to be laser-focused on generating cash through assets sales to reduce their debt load," Begley says.

If grabbing cheap-debt financing was the trend of the past decade, taking a hard look at nonessential assets is becoming the go-to move of the next few years.

"Every single major media company is looking at selling assets to de-lever," says Carlos Jimenez, managing director and media specialist at Moelis & Co. investment bank. "What's even more interesting is we're seeing companies going back to fundamentals and being more focused. There was a time where people were just buying assets to grow an empire across as many verticals as possible. What we're starting to see is a focus on questions like 'Where do I deploy my capital to make sure I have biggest return on investment?' and 'Do I have enough

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STREAMING STRATEGY

1. Starting with 2019 releases, new Disney theatrical films such as "Avengers: Endgame" will be streamed only on Disney Plus.
2. "Star Trek: Discovery" has lured subscribers to the CBS All Access service.
3. "The Crown" is among the big-budget original-series expenditures that has fueled Netflix's growing debt load.

capital to compete in this [pay-TV] ecosystem?'"

The gyrations of the stock market of the past few months reflect this new corporate reckoning.

"What the market is grappling with right now is recession risk," Moffett says. "The market is trying to figure out when it's coming and who is in the crosshairs if we head into a meaningful recession. This time around the companies that appear most at risk are those carrying excessive levels of debt."

AT&T is under the gun to prove the worthiness of the Time Warner acquisition because it has seen disappointing results from DirecTV, which it acquired for $48.5 billion in 2015. Time Warner cost $85.4 billion plus millions of dollars more in legal fees waged in the nearly two-year antitrust fight with the Justice Department, which remains on appeal.

"It was clear from the beginning that DirecTV was a bad transaction," Moffett says. "They were buying an asset at an absurdly high price at what almost everybody understood to be its absolute peak. There was nowhere for DirecTV to go but down. Now they're paying the price for an ill-advised DirecTV transaction."

AT&T isn't the only media giant facing more

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William D. Cohan, financial journalist

skepticism. Analysts, once bullish on Netflix's continued dominance of the streaming space, have grown noticeably more cautious as the streamer has relied more heavily on high-yield debt that will impact its cash flow. Some of that worry has been reflected in the stock price, which is down more than 30% since it topped the $400 mark in June and July.

The strategy is littered with risks, but it could also yield substantial riches if these companies pull it off. Most of them have looked to a future in which consumers have cut the cable cord, ditched the Blu-ray player and opted to largely steer clear of the multiplexes.

Companies are following consumption habits, says Elsa Ramo, managing partner of Ramo Law. "They're shifting how their movies are monetized. Once it was theatrical box office or sales on VHS. Now it's monthly subscription plans."

To reach the changing audience, Disney and WarnerMedia (the newly rechristened Time Warner) are launching direct-to-consumer offerings to rival Netflix. It's a bold bet that will put them in a new business. In the past, movie and television studios have relied on cable operators or theaters to ply their wares. They haven't spent much time developing a relationship with

AVENGERS: INFINITY WAR: MARVEL/DISNEY; STAR TREK: DISCOVERY: JAN THIJS/CBS; THE CROWN: ROBERT VIGLASKY/NETFLIX customers without the aid of a go-between.

However, the timing is tricky. Disney, for instance, has to simultaneously integrate Fox's sprawling workforce into its operations, create enough compelling content to make its offering irresistible at the time it launches and keep paying down the debt it accrued to buy Fox. AT&T must contend with its own debt burden while navigating its way around an entertainment industry that operates in a manner that's dramatically different from its core hardware business. There aren't a lot of red carpets in telecom.

"It's hard to have the ability to perform while you transform," says Michael Kassan, CEO of MediaLink. "It's almost like driving a stick shift. You have to put a certain amount of pressure on the gas and a certain amount of pressure on the clutch, but you can't hit the brakes. It requires an elegance."

A GREAT DEAL OF CASH is needed to break into the streaming space. Netflix spent $13 billion on content in 2018, and that figure only stands to keep growing. The digital giant is projected to shell out $22.5 billion annually on content by 2022, according to a recent Goldman Sachs estimate. As HBO or Showtime can attest, attracting subscribers demands watercooler shows. That, in turn, requires a lot of money. Netflix's debt stands at $8.3 billion as of its most recent quarterly earnings report and will rise to $10 billion after another $2 billion debt issue is completed. Netflix's debt is below investment grade, but that hasn't stopped investors from embracing the company, despite the projection it will have negative free cash flow of $3 billion for 2018. Netflix maintains that the equity value of the company as its pay-TV market share grows is more than enough to reassure lenders.

"We are striving to make the right choices and investments to grow the value of the firm, and that is what also ultimately secures our debt," Netflix CEO Reed Hastings wrote in a letter to investors last February. "High yield [debt] has rarely seen an equity cushion so thick."

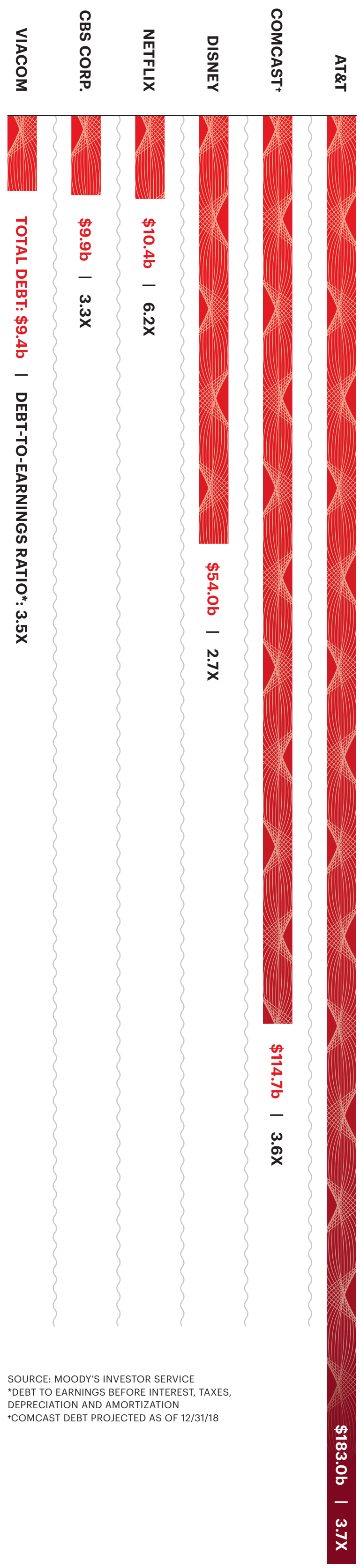
The streamer's rising-star status has put inordinate pressure on its traditional competitors.

"The money Netflix is spending forces all the others who fight with Netflix to keep spending, spending, spending, and frequently that requires debt, debt, debt," says Peter Csathy, founder of Creatv Media.

Signing mega-deals with Shonda Rhimes and Ryan Murphy isn't the only way Netflix is brandishing its checkbook. The company has also invested heavily in its infrastructure, devoting billions in recent years to marketing and R&D. It has been money well spent. Netflix's interface — with its searchable database, recommendation engine and ability to be accessed via everything from game consoles to smart TV apps — is sleek and easy to navigate. Would-be rivals like Disney and WarnerMedia will be lucky to debut a service that is as user-friendly and bug-free.

THE DEBT BET

The largest media companies have loaded up on short- and long-term borrowings thanks to low interest rates and easy access to credit. Following are debt projections as of Q3 2017 from Moody's Investor Service:



SOURCE: MOODY'S INVESTOR SERVICE
*DEBT TO EARNINGS BEFORE INTEREST, TAXES, DEPRECIATION AND AMORTIZATION
+COMCAST DEBT PROJECTED AS OF 12/31/18

Of course, Netflix was able to become Netflix, preeminent destination for all things bingeable, only because studios ignored the potentially existential threat it posed and licensed their content to the company in exchange for big paydays. Disney, for instance, is wrapping up a three-year movie-output pact with Netflix that generated an estimated $300 million in annual license fees. Other studios, such as Paramount and Warner Bros., signed similar deals with streamers.

As Disney and WarnerMedia unwind their licensing deals to stockpile content for their nascent streaming services, they are forgoing billions of dollars in pure profit. That squeezes their bottom lines and points to another hurdle they must overcome. Investors are already skittish about the amount of debt companies have packed on in all the merger madness, an anxiety that may only grow more pronounced as these firms struggle to turn hype for their services into profits.

Netflix's market value has soared in recent years even though the company has concentrated more on building market share than it has on making money. Subscriber growth has been the yardstick by which Netflix is measured. Not so Disney and WarnerMedia, which are assessed on a cash flow basis. If these companies want to prevent their stock from being hammered, they must convince investors to become as interested in how many customers are signing up for Disney Plus and the yet-to-be-named WarnerMedia streaming product as they currently are in ABC's ad sales or the box office performance of "Aquaman."

"The victory if they are successful is substantial," says Erik Hodge, managing director at The Raine Group. "In the best case, these companies may change the way that Wall Street values them. More importantly, they will have built a real relationship with their audience for the first time and can realize all the benefits that could come along with that."

In the streaming wars to come, there will be victors and losers. Netflix and Amazon Prime may be cheaper than a monthly cable bill, but consumers are unlikely to subscribe to every digital video service available. There's only so much discretionary spending to go around.

"When you look across the proliferation of direct-to-consumer video services, there will be a few big winners, and there will be many more that find they can't go it alone," says Csathy. "But you don't have a choice. You have to be fearless and experiment. If you place your head in the sand, you're as good as dead."

If this reinvention works, then the corporate chieftains who relied on debt to finance their expansion plans will be hailed as visionaries who wrested control of an uncertain future. If it fails, it will be another story entirely.

"Debt is a two-edged sword," says James Angel, associate professor at Georgetown University's McDonough School of Business. "When things go well, debt will amplify your profits. When things go badly, debt will amplify your losses."