



The **WALT DISNEY** Company

Report on The Walt Disney Company

<https://thewaltdisneycompany.com/investor-relations/>

Link to 10-K: <https://thewaltdisneycompany.com/app/uploads/2020/01/2019-Annual-Report.pdf>

Link to DEF 14A: <https://thewaltdisneycompany.com/app/uploads/2020/01/2020-Proxy-Statement.pdf>

For Fiscal Year Ending September 28, 2019

Report by Joseph Farizo

1. Summarize Item 1 (Business) and Item 1A (Risk Factors) of your firm’s 10K to describe your firm and its risks.

Item 1: Business¹

The Walt Disney Company is a “diversified entertainment company” divided into four segments: *Media Networks*; *Parks, Experiences, and Products*; *Studio Entertainment*; and *Direct-to-Consumer & International*. They employ 223,000 people worldwide. Recently, Disney has acquired the movie production studio Twenty-First Century Fox, and now owns 60% of the streaming platform Hulu.

Media Networks includes channels and brands such as Disney, ESPN, Freeform, FX, National Geographic, and ABC, among others. Revenues from this segment come from fees paid by distributors (i.e., cable companies) and through advertising sales on these networks. Expenses include production costs and advertising of its programming.

Parks, Experiences, and Products includes theme parks in Orlando, Anaheim, Paris, Hong Kong, and Shanghai, as well as licensed intellectual property to an independent park operator in Tokyo. Additionally, Disney operates a cruise line, a vacation club, and a resort in Hawaii. Consumer products include characters and property licensed to manufacturers, publishers, and developers for merchandise sales. Revenues include admission to parks and cruise lines, food and beverage sales, vacation rentals, and royalties from sales of merchandise. Expenses exclude operating costs, repairs, maintenance, fuel, taxes, insurance, and labor.

Studio Entertainment includes motion picture production under the Walt Disney, Twentieth Century Fox, Marvel, Lucasfilm, Pixar, Fox Searchlight, and Blue Sky Studios brands. Disney also offers post-production services (such as visual effects) through Industrial Light & Magic

¹ Item 1 is on pages 1 through 18 of the 10-K, while Item 1A is on pages 18-25.

and Skywalker Sound. Revenues include licensing of films to theaters, sale in electronic formats, and licensing fees for television. Expenses include costs of production and distribution.

Direct-to-Consumer & International include international operations of their brands, streaming platforms (including Disney+, ESPN+, Hotstar, and Hulu), as well as equity ownership of other brands like Endemol Shine Group, Seven TV, Tata Sky, and Vice. Revenues include advertisement sales and subscription fees.

Item 1A: Risk Factors

Disney lists several risk factors. In my own words, these risks include:

- Change in economic conditions may affect profitability
- Change in consumer tastes
- Shifting technology and how people consume entertainment
- Inability to maintain intellectual property rights
- Cybersecurity and protection of stored data
- Adverse weather, disasters, catastrophe, and terrorism
- Changes in business strategy
- Increased competition
- Long term contracts not renewed with favorable terms
- Change in regulations
- Changes in international laws
- Damage to reputation
- Risks in one area of their business may spill over into other businesses
- Turmoil in financial markets
- Labor disputes
- Seasonality of operations
- Costs of retirement benefits and employee health benefits
- Interest rates (particularly “LIBOR”)
- The acquisition of Twenty First Century Fox challenges, costs, and greater borrowing as a result of the acquisition

The risks I believe are most concerning for this company include... because... This article² talks about how Disney...

² Link to an article.

2. **Provide the names of the people on the board of directors, other jobs/roles for each member of the board, and identify who serves as the Chairperson of the Board or Lead Director.**

Board of Directors³

Director	Other Roles
Susan E. Arnold	Operating Executive, The Carlyle Group
Mary T. Barra	CEO, General Motors
Safra A. Catz	CEO, Oracle
Francis A. Desouza	CEO, Illumina
Michael B.G. Froman	President of Strategic Growth, Mastercard
Robert A. Iger	CEO, Walt Disney
Maria E. Lagomasino	CEO, WE Family Offices
Mark G. Parker	Executive Chairman, Nike
Derica W. Rice	EVP, CVS Health

Bob Iger is the Chairman of the Board at the time of this writing, but Disney chooses to have a Lead Director who is independent and not a manager at The Walt Disney Company. Susan Arnold serves as the Lead Director.⁴

3. **Provide your opinion on the diversity of the board of directors. How does the firm comment on board diversity in their own 10-K and on the DEF14A?**

Four of the nine directors on the board are women. Three of the nine directors are racially/ethnically diverse. The Independent Lead Director and all four of the Board committee chairs are women.⁵ I believe that this level of Board diversity is (adequate / inadequate / acceptable / unacceptable / etc.) because...

4. **List how many of the board members are “independent” (or do not work for the company). Is the CEO also the Chairperson of the Board? Explain how board independence relates to the agency problem, commenting specifically on the concerns about the agency problem at this firm.**

Only the Chairperson of the Board is not independent. Bob Iger is the only person with a management position at The Walt Disney Company. All other members of the Board of Directors are independent given they do not have senior management positions at Disney.⁶ Given this degree of board independence at Disney, I believe the agency problem...

³ This information comes from pages 57 through 62 of the DEF14A Definitive Proxy Statement and on page 138 of the 10-K.

⁴ The Walt Disney Company discusses this on page 8 of the DEF14A Definitive Proxy Statement.

⁵ This information is provided on page 3 of the DEF14A Definitive Proxy Statement.

⁶ This information comes from pages 57 through 62 of the DEF14A Definitive Proxy Statement.

5. List the items up for election, or the “Proposals” on the DEF14A. List if each is submitted by the firm or by the firm’s shareholders (Sponsor), as well as the directors’ recommendation (Recommendation) on how shareholders should cast their votes. In a few sentences, describe the items.

Items to be Voted On⁷

Proposal	Sponsor	Recommendation
1. Elect 9 Directors	Firm	FOR
2. Appoint PWC to be the firm’s public accountant	Firm	FOR
3. Executive Compensation	Firm	FOR
4. Stock Incentive Plan	Firm	FOR
5. Lobbying Disclosure	Shareholder	AGAINST

All 9 Directors are up for election. Their information is provided in a table above. The directors believe that PricewaterhouseCoopers should continue to serve as the independent auditor of their financial statements, citing their experience as Disney’s auditor since 1938. Shareholders are being asked to approve the executive compensation as discussed on pages 19 through 54 of the DEF 14A. Total compensation for CEO Bob Iger in 2019 was \$47 million, though only \$3 million of this was salary while the rest included bonuses and stock awards. Other named executives’ total compensation ranged from about \$7.5 million to \$14.9 million. The next item was to approve the Company’s plan to issue stock in order to compensate employees and directors (which may reduce the agency problem). The shareholder proposal submitted by “The Congregation of Sisters of St. Agnes” requested that the company provide an annual report disclosing money spent on lobbying. The directors were against this proposal, stating that this proposal has failed in the past 5 times, claiming that the firm already provides disclosures.

6. Provide your firm’s total assets, total liabilities, and total equity from your firm’s consolidated balance sheet over the last two fiscal years, verifying that $A = L + E$. Present common size numbers for each item as a percentage of that year’s assets. Interpret.

Summary Balance Sheet⁸

	<u>2019</u>	<u>2018</u>	<u>2019</u>	<u>2018</u>
Assets	<u>\$193,984</u>	<u>\$98,598</u>	<u>100%</u>	<u>100%</u>
Liabilities	<u>\$100,095</u>	<u>\$45,766</u>	<u>51.6%</u>	<u>46.4%</u>
Stockholders’ Equity	<u>\$93,889</u>	<u>\$52,832</u>	<u>48.4%</u>	<u>53.6%</u>
Liabilities and Equity	<u>\$193,984</u>	<u>\$98,598</u>	<u>100%</u>	<u>100%</u>

⁷ This information is listed on the “Notice of 2020 Annual Meeting” and “Proxy Summary” before and just after the Table of Contents and comes from pages 57 through 72 of the DEF14A Definitive Proxy Statement.

⁸ Balance sheet data from page 76 of the 10-K. Data in millions of USD.

The book value of the firm grew substantially across these two years. Assets, liabilities, and equity all nearly doubled. Liabilities, however, now make up a greater proportion of assets than equity, rising from 46.4% in 2018 to 51.6% in 2019.

7. Calculate your firm's change in net working capital from the previous year to this year. Show your calculations. Comment on what this change in net working capital means in terms of cash flow.

Net Working Capital⁹

	<u>2019</u>	<u>2018</u>
Current Assets	\$28,124	\$16,825
Current Liabilities	<u>31,341</u>	<u>17,860</u>
Net Working Capital	<u>-\$3,217</u>	<u>-\$1,035</u>

The change in net working capital is:

$$\Delta NWC = (CA_{2019} - CL_{2019}) - (CA_{2018} - CL_{2018})$$

$$\Delta NWC = (28,124 - 31,341) - (16,825 - 17,860) = (-3,217) - (-1,035) = -2,182$$

$$\Delta NWC = -2,182$$

Disney had a negative change in net working capital of \$2,182. Both its current assets and current liabilities increased from 2018 to 2019, but in both years its current liabilities exceed its current assets. Given the change in net working capital was a negative, it represents a cash (inflow/outflow) because the firm has...

8. Calculate your firm's current ratio, debt-to-equity ratio and cash coverage ratio. Interpret each.

The current ratio¹⁰ is:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{28,124}{31,341} = 0.8974$$

The current ratio indicates that current assets are 89.74% of current liabilities. This is (good / bad / adequate / inadequate / etc.) because...

⁹ Working capital data is from the Consolidated Balance Sheet on page 76 of the 10-K. Data in millions of USD.

¹⁰ Data for the current ratio and debt-to-equity ratio is from the Consolidated Balance Sheet on page 76 of the 10-K.

The debt-to-equity ratio is:

$$\text{Debt - to - Equity Ratio} = \frac{\text{Debt}}{\text{Equity}} = \frac{100,095}{93,889} = 1.066$$

I define debt as the non-equity component of “right side” of the balance sheet. Given the debt to equity is greater than 1, this implies Disney...

Disney’s cash coverage ratio is:

$$\text{Cash Coverage} = \frac{\text{EBIT} + \text{Depreciation}}{\text{Interest Expense}} = \frac{15,593 + 4,160}{978} = 20.197$$

Disney did not report EBIT, or earnings before interest and taxes, in their financials. To find EBIT, I took the net income and added back taxes and interest expense.¹¹ A cash coverage ratio of 20.197 implies...

Looking at these three ratios together, I determine that Disney’s short-term liquidity and long term solvency are ..., because...

9. From your firm’s *consolidated statement of cash flow*, summarize your firm’s total cash flow, and cash flows from operating, investing, and financing activities from both this year and the previous year. Comment on the “health” of the cash flows by discussing each component.

Statement of Cash Flow Summary¹²

	<u>2019</u>	<u>2018</u>
Operating Activities	\$5,984	\$14,295
Investing Activities	(15,096)	(5,336)
Financing Activities	(464)	(8,843)
<i>Discontinued Operations and other</i>	<u>10,876</u>	<u>(25)</u>
	<u>\$1,300</u>	<u>\$91</u>

Disney had positive overall cash flows in 2019 and 2018. In 2019, it realized a positive cash flow of nearly \$11 billion when it divested certain assets internationally to earn regulatory approval for Twenty First Century Fox.¹³ Higher cash flows from operating activities are encouraging, while negative cash flows for investing activities are largely due to investing in parks and acquisitions. Negative cash flows from financing activities are largely due to paying debt, dividends, and share repurchases. However, cash flow from borrowing increased

¹¹ Net income and interest expense is on the income statement, page 74 of the 10-K. Depreciation comes from the statement of cash flows, page 77 of the 10-K.

¹² Cash flow data is from the Statement of Cash Flows on page 77 of the 10-K.

¹³ Discontinued operations are discussed on page 98 of the 10-K.

significantly in 2019 (by \$38,240) but was offset by paying off debt (a reduction of borrowing of \$38,881). Therefore, I assess the cash flow health of Disney to be... because...

10. Conduct a Dupont analysis of your firm. Discussing each of the components.

Dupont Analysis¹⁴

$$ROE = \frac{Net\ Income}{Equity} = \frac{Net\ Income}{Sales} \times \frac{Sales}{Assets} \times \frac{Assets}{Equity} = ROE$$

$$ROE = \frac{11,584}{93,889} = \frac{11,584}{69,570} \times \frac{69,570}{193,984} \times \frac{193,984}{93,889} = 12.34\%$$

$$ROE = 0.1234 = 0.1665 \times 0.3586 \times 2.065 = 12.34\%$$

The return on equity of 12.34% implies that the firm generated \$0.1235 of accounting profit for every \$1 of equity on the balance sheet. This is (good/bad/other) because... The profit margin is 16.65%, or the firm earns \$0.1665 in accounting profit for every \$1 in sales. A (higher/lower) profit margin is (good/bad/other) because... The total asset turnover is 35.86%, or the firm generates \$0.3586 for every \$1 of assets on its balance sheet. A (higher/lower) total asset turnover is (good/bad/other) because... The equity multiplier is 2.065x, or the firm's assets are 2.065 times that of its balance sheet equity. A high equity multiplier entails (greater/lower/other) leverage because... This is (good/bad/other) because...

11. Define and calculate your firm's internal growth rate. What is this growth rate used for?

$$Internal\ Growth\ Rate = \frac{ROA \times b}{1 - (ROA \times b)}$$

ROA is the return on assets, or net income ÷ assets. For Disney, this is \$11,584 ÷ 193,984 = 0.05972. *b* is the firm's plowback ratio, or [1 - (Dividends/Net Income)]. This is [1 - (2,895/11,584)] = 0.7501.¹⁵

$$Internal\ Growth\ Rate = \frac{0.05972 \times 0.7501}{1 - (0.05972 \times 0.7501)} = \frac{0.044796}{0.955204} = 4.69\%$$

¹⁴ Net income and sales are from the income statement on page 74 of the 10-K, while assets and equity are from the balance sheet on page 76.

¹⁵ Net income is from the income statement. Assets are from the balance sheet. Dividends are disclosed on the statement of cash flows. These are on pages 74, 76, and 77 of the 10-K.

Disney's internal growth rate is 4.69%, which means that... This growth rate is used to tell us that...

12. Define and calculate your firm's sustainable growth rate. What is this growth rate used for?

$$\text{Sustainable Growth Rate} = \frac{ROE \times b}{1 - (ROE \times b)}$$

The ROE and b are computed above. The firm's sustainable growth rate is therefore:

$$\text{Sustainable Growth Rate} = \frac{0.1234 \times 0.7501}{1 - (0.1234 \times 0.7501)} = \frac{0.0926}{0.9074} = 10.20\%$$

Disney's sustainable growth rate is 10.20%, which is the growth rate at which Disney...

13. Reference the MD&A, Notes to the Statement of Cash Flows, and 10-K overall. Discuss the firm's investments, investment activities, projects, acquisitions, and divestitures. Discuss specifically NPV and IRR and how they might be used in the context of investing in projects.

On page 54 of the 10-K, in the *Management Discussion and Analysis* section, Disney discusses that capital expenditures are generally for expansion and capital improvements to theme park resorts, attractions, and cruise ships. The large increase in 2019 was in part due to the creation of the *Star Wars: Galaxy's Edge* land in Disney World and Disneyland. Within the Media Networks part of the business, Disney's investments include expenditures on facilities, equipment, upgrades to broadcast centers, and production studios. For the Direct-to-Consumer segment, Disney discloses that investments were a result of spending on technology. Acquisitions include nearly \$10 billion on Twenty First Century Fox. Expenditures are expected to be higher in 2020 due to increased investments on technology and corporate offices.

When considering investments, Disney might use the NPV or IRR approach. If it were to expand theme parks, it might consider incremental cash flows as additional ticket sales or food, beverage, and merchandise sales. If the present value of these cash flows are greater than the cost, it would be a positive NPV project worth pursuing. Sunk costs, including the cost of land that Disney already owns, should not be considered in the NPV computation.

Side effects might include a decrease in ticket sales at other parks, and this *should* be considered in the NPV computation. For example...

IRR might also be used to evaluate projects. However, if projects are mutually exclusive (i.e., Disney can either build a hotel or a new park on a certain plot of land), they should *not* compare the IRRs. Rather, they should choose the project with the higher NPV. Additionally, if the cash flows are expected to be uneven...

- 14. Assume your company issued 30-year bonds with a face value of \$1,000 and 3.5% coupons (paid semiannually) 5 years ago at par. Given current interest rates, what is the value of these bonds in markets today? Explain why the value has changed given the coupons remain the same.**

Given the current interest rates are 2.96% (as of September 2019)¹⁶, the inputs to determine the bond price are:

$$N = 25 \times 2 = 50$$

$$FV = 1000$$

$$I/Y = 2.96\% \div 2 = 1.48\%$$

$$PMT = \frac{3.5\% \times \$1000}{2} = \$17.50$$

$$PV = \$1,094.92$$

This bond's price is now \$1,094.92. Given interest rates have fallen (from 3.5% to 2.96%), the bond price has risen from \$1,000 to \$1,094.92.

This bond price has risen as interest rates have fallen because...

- 15. Value your company's stock using the dividend discount model. Use a three-period model.**

To determine the value of this stock, I will use the dividend discount model shown in the formula below:

$$V_0 = \frac{D_1}{1+k} + \frac{D_2}{(1+k)^2} + \frac{D_3 + P_3}{(1+k)^3}$$

To find k , I will use the Capital Asset Pricing Model (CAPM). I obtain the risk-free rate using 90-day T-bills from the FED's FRED website (1.89% as of September 2019)¹⁷, Disney's beta

¹⁶ Average US Corporate bond interest rates are available at <https://fred.stlouisfed.org/series/BAMLC0A0CMEY>

¹⁷ The return on 90-day T-bills comes from <https://fred.stlouisfed.org/series/TB3MS>.

is 1.2¹⁸, and the expected return of the market of 10% based on the historical average of the market over the last century.

$$k = R_f + \beta(E(R)_M - R_f)$$
$$k = 0.0189 + 1.2(0.10 - 0.0189) = 11.622\%$$

If the beta is 1.2 and I expect the market to increase 10% each year for three years, I estimate Disney's stock will rise $10\% \times 1.2 = 12\%$ per year. Therefore, my estimate of the price in three years will be the current price grown by 12% year-over-year for three years, and the current price is \$130.32.

$$P_3 = 130.32 \times (1.12^3) = \$183.09$$

This is only a quick forecast of dividends stock price and may change dramatically if market conditions or the stock's beta change. Disney paid a total of \$1.76 dividends per share over the last year.¹⁹ If I expect this dividend to grow at 5% per year:

$$D_0 = \$1.76$$
$$D_1 = \$1.76 \times 1.05 = \$1.848$$
$$D_2 = \$1.76 \times 1.05 \times 1.05 = \$1.9404$$
$$D_3 = \$1.76 \times 1.05 \times 1.05 \times 1.05 = \$2.0374$$

Therefore, I estimate the value of the stock to be:

$$V_0 = \frac{1.848}{1 + 0.11622} + \frac{1.9404}{(1 + 0.11622)^2} + \frac{2.0374 + 183.09}{(1 + 0.11622)^3} = \$136.33$$

I believe this stock is worth \$136.33 today, but it trades in markets at \$130.32. Therefore, I believe it can be purchased for less than it is truly worth, and I recommend...

¹⁸ Disney's beta is from FINVIZ.com: <https://finviz.com/quote.ashx?t=DIS&p=d>.

¹⁹ Disney lists its dividends on page 114 of its 10-K. Given it pays dividends twice a year, I added the two last dividends together.