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February 13, 2003

The Walt Disney Company

By Brady Willett & Todd Alway

Introduction

CEO Michael Eisner is calling for a 25-35% increase in operational earnings in 2003 and 2004…These growth targets would be more impressive if Disney's earnings had not declined by 32% over the last 5 years.

We do not believe that Disney is an attractive investment. Moreover, we believe that Disney management has been, and continues to be, overly optimistic about what the future may hold. Disney's near term challenges include a possible separation with profitable partner PIXAR Studios, unpredictable ratings from ABC, and overall sensitivity, particularly in the company's theme parks/resorts, to broader economic weakness.

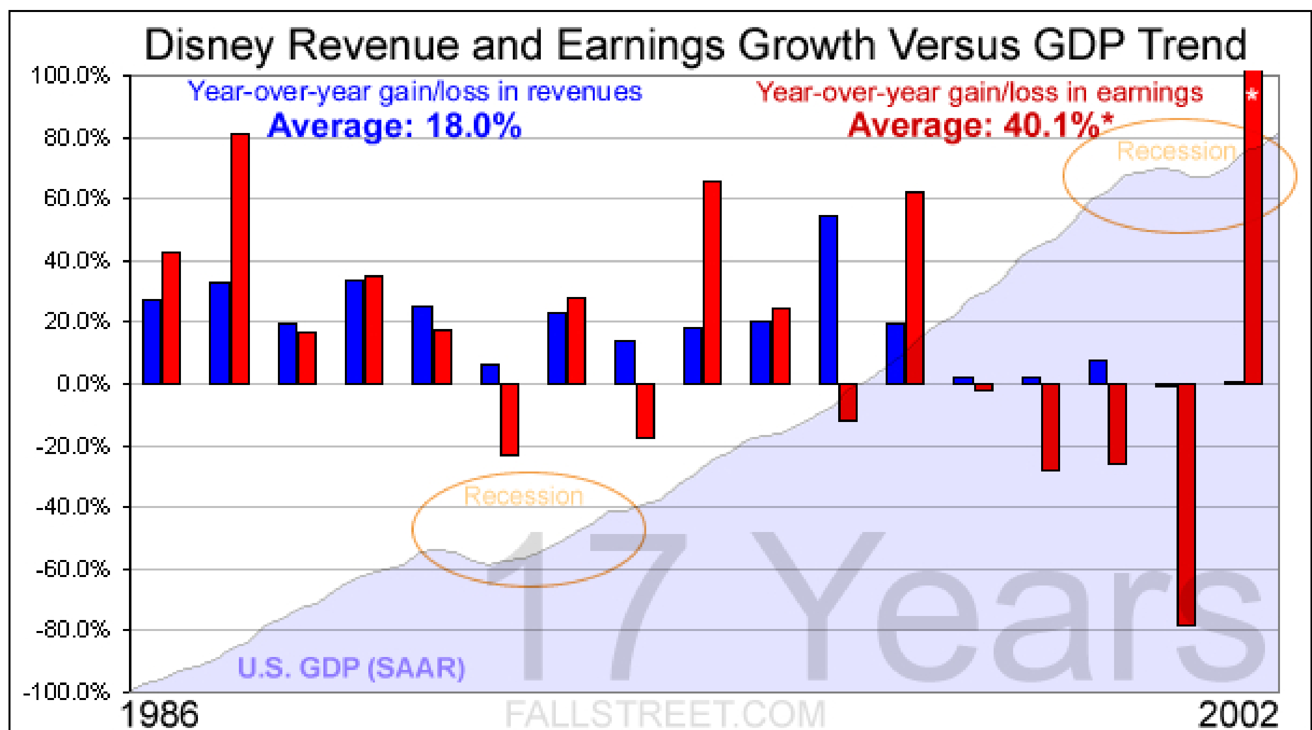
Beyond future uncertainties, Disney's current business structure is one that can be characterized by declining margins and misplaced capital investment. Disney has been in a transition phase since the mid-1990s, going from a niche-like media empire with high expectations for growth/margins, to a diversified media conglomerate with expectations of consistent cash-flow and dividends. And while there is nothing wrong with Disney focusing on producing consistent cash and dividend payouts, there may be something wrong with investors paying 31 times trailing earnings and nearly 20 times 2003 estimated earnings. Quite frankly, Disney lacks the growth potential it once had. As such, until the company's dividend yield reaches an attractive level -- either by a drop in stock price or through higher dividend payouts from increasing profits -- the company's stock price woes are likely to continue.

During Disney's transition phase – a phase from which it has not yet emerged -- the company has remained extremely optimistic that the company was poised for terrific earnings growth. Unfortunately, this optimism has not been met by actual corporate performance. It would seem that simply wishing upon a star has not made Disney's corporate vision a reality.

Corporate Overview

Business Breakdown

First and foremost, Disney relies on 'leisure' and/or consumer discretionary spending from consumers. As such, given that U.S. consumers – and many global consumers for that matter – have spent much of the last decade increasing their debt load, this does not bode well for Disney going forward. As total consumer debt loads increase to record highs, discretionary spending is the first area likely to suffer. Quite frankly, and as the chart below demonstrates, Disney's revenue/earnings cannot be expected to increase during difficult economic times.

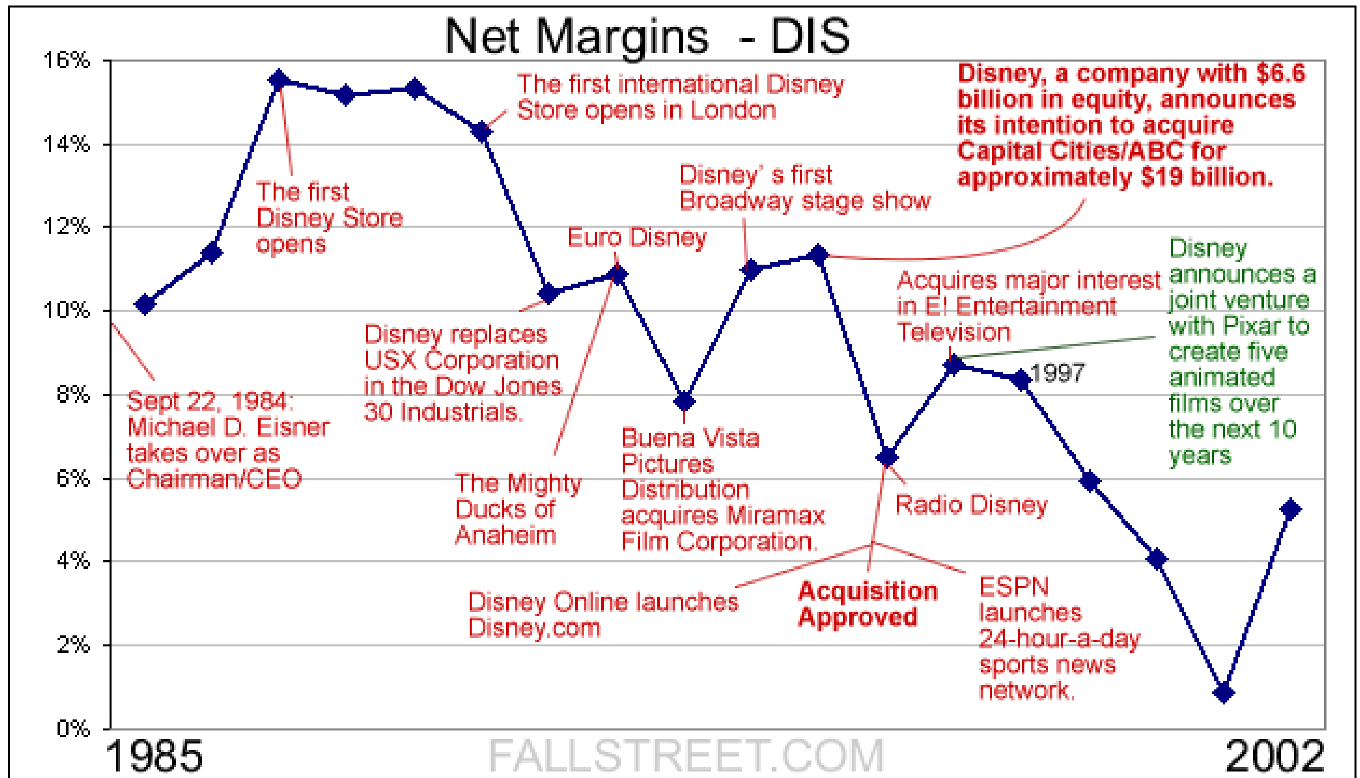


* Includes a 497% increase in earnings in 2002. Backing out 2002 and 2001 (9/11 irregularities) Disney's average annual growth rate (15 years) is 17.5%.

Although Disney's performance is hinged to consumer spending trends, the company's unique mix of businesses does allow it to be cushioned from cyclicality to a certain degree. For example, a decline in DVD sales can be combated with better ratings at ABC, while a new hit movie can help cushion the blow from weak resort revenues. In short, Disney is a big, cyclical Broadcasting/Media/Entertainment company (#2 media conglomerate in the world behind AOL), that has little overall pricing power (if U.S. consumers continue to save more Disney's margin will suffer). What 'pricing power' Disney does have is directly related to event successes (hit movies, popular rides, hot products), which can sometimes buck the overall economic trend.

Disney -- Business Breakdown & Margins							
Revenues (Mil $)	**1Q03 (12/31/02)**	**2002**	**2001**	**2000***	**1999**	**1998**	**1997**
Media Networks	3,240	9,733	9,569	9,836	7,512	7,142	6,522
Parks & Resorts	1,548	6,465	7,004	6,809	6,106	5,532	5,014
Studio Entertainment	1,891	6,691	6,009	5,918	6,548	6,849	6,981
Consumer Proucts	787	2,440	2,590	2,762	3,030	3,193	3,782
Earnings (Mil $)							
Media Networks	225	986	1,758	1,985	1,611	1,746	1,699
Parks & Resorts	225	1,169	1,586	1,615	1,446	1,288	1,136
Studio Entertainment	138	273	260	126	116	769	1,079
Consumer Proucts	190	394	401	386	607	801	893
Operational Margins							
Media Networks	6.9%	10.1%	18.4%	20.2%	21.4%	24.4%	26.1%
Parks & Resorts	14.5%	18.1%	22.6%	23.7%	23.7%	23.3%	22.7%
Studio Entertainment	7.3%	4.1%	4.3%	2.1%	1.8%	11.2%	15.5%
Consumer Proucts	24.1%	16.1%	15.5%	14.0%	20.0%	25.1%	23.6%
* 'Internet Group' no longer reported seperately.							
* ESPN, ABC, Disney and family-branded Internet Web sites reported in Media Networks segment.							
* DisneyVacations.com reported in the Parks & Resorts segment.							

As the above operational margin numbers highlight, Disney has seen its pricing power erode in each of its four business segments for much of the last 6 years. Judged by the results of the facelift Disney went through in 1995/96 – specifically the acquisition of ABC – the argument can be made that Disney is taking on more than it can handle: recent net margins (last 6 years) have been noticeably weaker than net margin trends since 1985. To note: margins began to drop well before the 2001 recession and before 9/11.



1997

Disney agrees to purchase Mammoth Records

Disney purchases a significant equity stake in Starwave Corporation, a leading producer of Internet media

1998

Disney becomes a 'major player' in the internet with purchase of Infoseek.

First ESPN Resteraunt opens in Baltimore.

Disney Cruise Line Launches.

1999

Acquisition/merger/expansion binge slows as operational results continue to slip.

2000

Alliance with Hasbro. SOAP Net is Launced.

2001

Acquires Fox Family Worldwide (renamed ABC Family Worldwide) and Baby Einstein

Success of Monsters Inc. and DVD sales (Snow White) hold Disney above water.

2002

6-year deal with the NBA

Internet group breaks even

A Less Than Magical Kingdom

The benefits of running numerous businesses under one umbrella are readily apparent: sports stars can be told to say that they are 'going to Disneyland' following an important victory, subliminal messages of Mickey can be placed inside of popular shows like '8 Simple Rules for Dating My Teenage Daughter', and odiferous movies can be rated highly by one of Disney's radio/television interests. Disney's power to mesh multiple mediums and sell what Eisner coins as 'family, fun and fantasy' is why the company has been such a great success in the past.

However, it is important to recognize that today's Disney may not look the same as tomorrow's Disney. Quite frankly, corporate longevity is not necessarily a 'buy' at any price. This is especially the case given a decreasingly profitable ABC, an increasingly frugal consumer and traveler (resort/hotel capacity), and a rampant "piracy" that could result in a precipitous decline in movie revenues in the future. Suffice it to say, the Disney Empire is not set in stone; weak bricks can and will be tossed aside, and this could potentially hurt shareholders. We believe the company will need to rid itself of further assets should margins continue to decline.

The Disney Empire

I hope that we don't lose site of one thing -- that it was all started by a mouse.
Walt Disney

Media Networks - 38.4% of Revenues

ABC Television Network (numerous divisions)
Buena Vista Television
ABC Radio Group (62 Radio Stations)
Radio Disney
ESPN
ABC Cable Networks Group (Disney Channel)
Lifetime Entertainment Network
A&E
The History Channel
E! Entertainment Networks

Studio Entertainment - 26.4% of Revenues

Feature Animation (Toy Story, Monsters Inc.)
Television Animation (Disney Channel)
Walt Disney Pictures (Movies - Non Animation)
Touchstone Pictures (Movies)
Miramax Films (Movies)
Giant Screen (IMAX)
Buena Vista Theatrical Group (Theatre)
Buena Vista International
Buena Vista Home Entertainment (VHS/DVD)
Buena Vista Music Group

Parks & Resorts - 25.5% of Revenues

Disneyland Resort (California)
Walt Disney World (Florida)
Tokyo Disney Resort
Disneyland Resort Paris
Hong Kong Disneyland -- Coming 2005/2006
Disney Cruise Line
DisneyVacations.com
Disney Regional Entertainment (EPSN Zone)
Anaheim Sports, Inc. (Anaheim Angels and Mighty Ducks)

Consumer Proucts - 9.6% of Revenues

Disney Licensing
Disney Retail
Disney Publishing
Disney Interactive

Percentage of revenues calculated from full year 2002 financial results.

As Disney focuses more on developing different segments of the conglomerate, the movie/cartoon/theme park aura of the company -- Mickey Mouse, Winnie the Pooh, Toy Story, Space Mountain, etc. -- is becoming less significant in determining the overall direction of corporate profitability. Given the new copyright extension for Mickey, to say nothing of the nearly $1 billion a year in revenues from Winnie the Pooh, one has to wonder why Disney has focused increasing attention on unpredictable fads (television/radio shows, sports in general) rather than on proven and lasting characters/themes that can be exploited on a global scale.

In Search of The Big Cheese?

Instead of focusing on and continuing to exploit its key brands (perhaps because slow growth margins/dividends were not what managers had in mind), Disney continues to expand into areas that are not necessarily 'mouse' related. Unfortunately for margins, ABC news is the same as any other news program. Can Disney charge more than the going rate for advertising on their 'brand' of nightly news? In the case of ESPN, Disney is quick to point out that it has capitalized on this asset by expanding its readership base (ESPN Magazine), developing its web presences (ESPN.com) and expanding abroad (ESPN Deportes). Nevertheless, as potential investors we have our doubts as to the long term value of the ESPN brand. Disney's mouse is THE

mouse – a highlight clip is a highlight clip…

In sum, Disney is a bloated consumer discretionary mutual fund peddling every type of entertainment product conceivable. We do not believe that Disney's new brands/businesses will last and/or be highly exploitable. In fact, ABC may well win the ratings race some day, ESPN could continue to be the sports leader, and the Mighty Ducks could win The Cup…but soon afterwards all of these businesses could start losing money or fail, especially the less than Mighty Ducks. Yes, the future is always unpredictable. However, there is one tiny but powerful presence that has withstood the test of time…the mouse.

Historical Financial Overview

Selective Disclosure

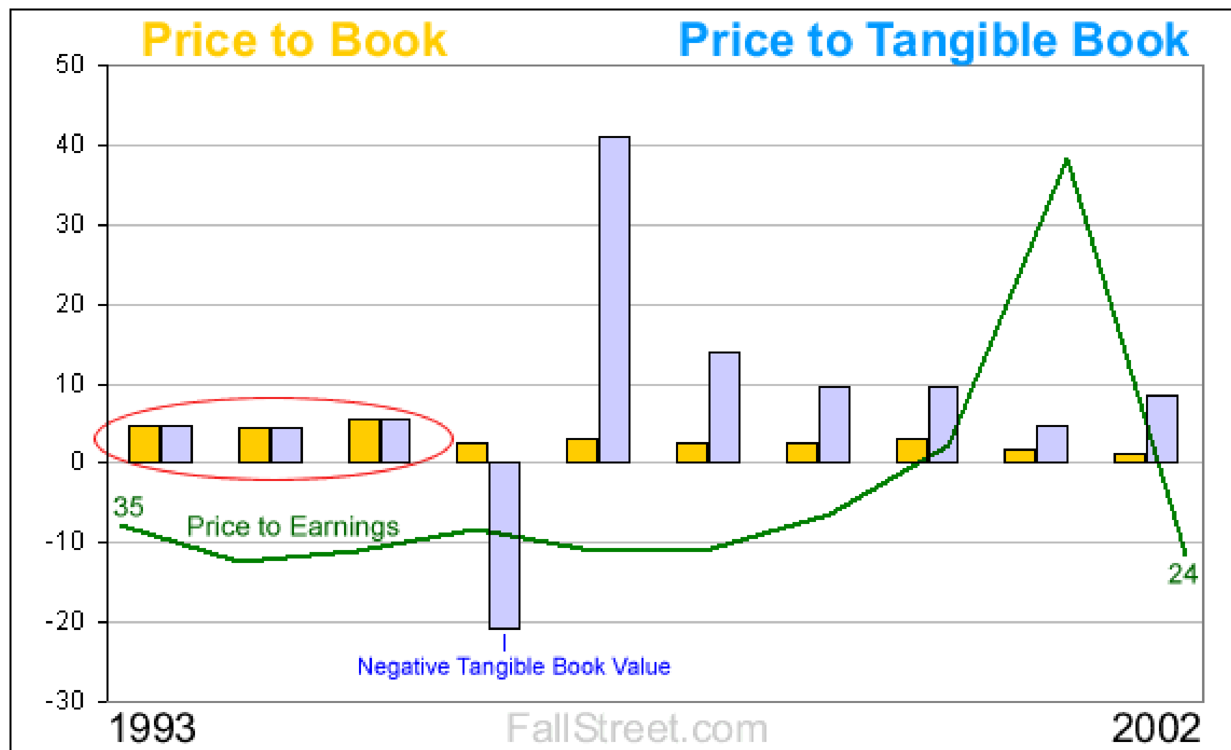
Disney's selective financial displays in its annual reports (or the company's abuse of now frowned upon 'pro forma' results) would not be so much of a problem if the audited financial statements were organized in the same manner each year - the investor could ignore what the company is saying and head straight to the data. Instead, Disney has changed its method of accounting for cash flows, business segment breakdowns, and expenditures numerous times throughout the last decade, and not all the historical data is openly revised and/or presented to investors. Case in point, we had to call the company to get cash from operations data for years prior to 2000. The company has restated this data and, dependent upon which investment site you visit, you will get different numbers.

Story of Intangible Optimism

Disney has always been extremely optimistic. Consider this quote from the 1996 Annual report, a quote that was reiterated in many annual reports while the company was performing well:

"Following the acquisition, the company's ongoing financial objective is to achieve 20% compound annual growth in earnings per share over any future five-year period. Additionally, steady improvement in return on equity (ROE) remains a secondary, but important, financial objective.'

As it turned out, Disney earned $1.9 billion in after tax profits in 1997 and has yet to match this total, let alone beat it by 20%. As for ROE – the company's 'secondary concern' – total equity has averaged an impressive 21% annually since 1985. However, total tangible equity is down from 1991 to year-end 2002 (Sept). We note this difference because up until 1994 the company recorded zero in intangibles. Today that figure is $19 billion (81% of assets).



Closing stock price for DIS's fiscal year-end used to determine ratios.

Incidentally, some people would argue that our assault on intangible assets is myopic – that Disney's real value is in its intangibles. As such, so the argument goes, you cannot write these cash generating intangibles off as valueless. We would agree with this theory to an extent. To be sure, as children many of us played (or at least imagined playing) in the 300 acres wood with Winnie and company. Accordingly, we are willing to pay a premium to provide our kids with the same joys. The name Winnie the Pooh has more intangible value than just any bear's name.

However, when Disney impairs $820 million (Go.com) in the blink of an eye (2001), investors should take notice. Quite frankly, investors should be aware that a large portion of Disney's $19 billion in intangibles are worthless, and none of Disney's intangibles can be used to pay off debt unless the corresponding 'asset' is sold. On a regular basis companies find this out the hard way (i.e. nearly $100 billion in goodwill wiped out from competitor AOL's balance sheet). In sum, the tale of intangibles can be ominous.

End of Story

Since the mid-1990s mantra of '20% growth' has not been achieved, the company has tweaked history to fit their unyielding optimism:

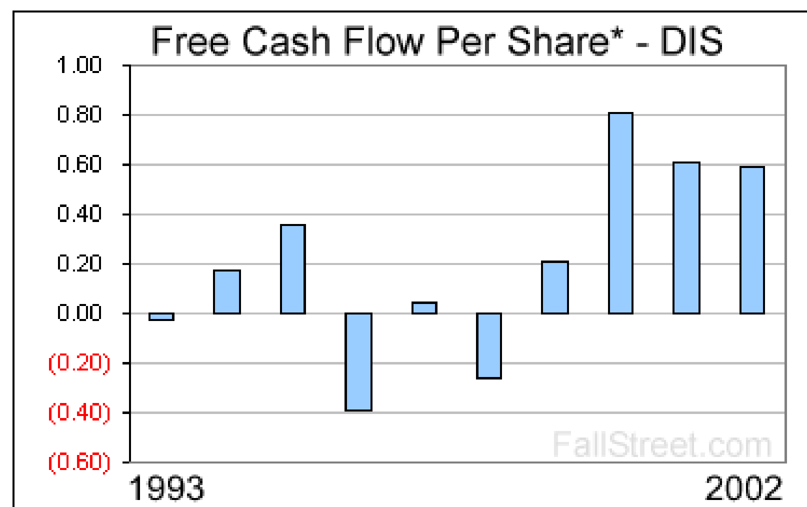
"Since 1996, the company has invested significant capital to either buy or build assets to fortify the leading market position of its key businesses…This capital investment has created a large-scale infrastructure to support both Disney and ESPN operations. Going forward, the company expects that the competitive advantage these investments yield – and the associated extension of the company's branded operations such as new theme parks, hotels, cable networks, radio networks and a cruise line – will enhance Disney's ability to deliver greater investment returns in the future."

Obviously the company's optimism has been taken down a notch because of less than average operational results. However, notice the company's spin on the 1996-present period as one of 'investment' and 'creating infrastructure'. In fact, the post-1996 operations have been more about failure given the company's stated objectives at the time. Being optimistic is one thing, but are Disney's observations realistic?

"I doubt that there has been a merger in American business history that has experienced a more seamless integration than the Cap Cities/ABC deal." 2002 Annual Report. Eisner.

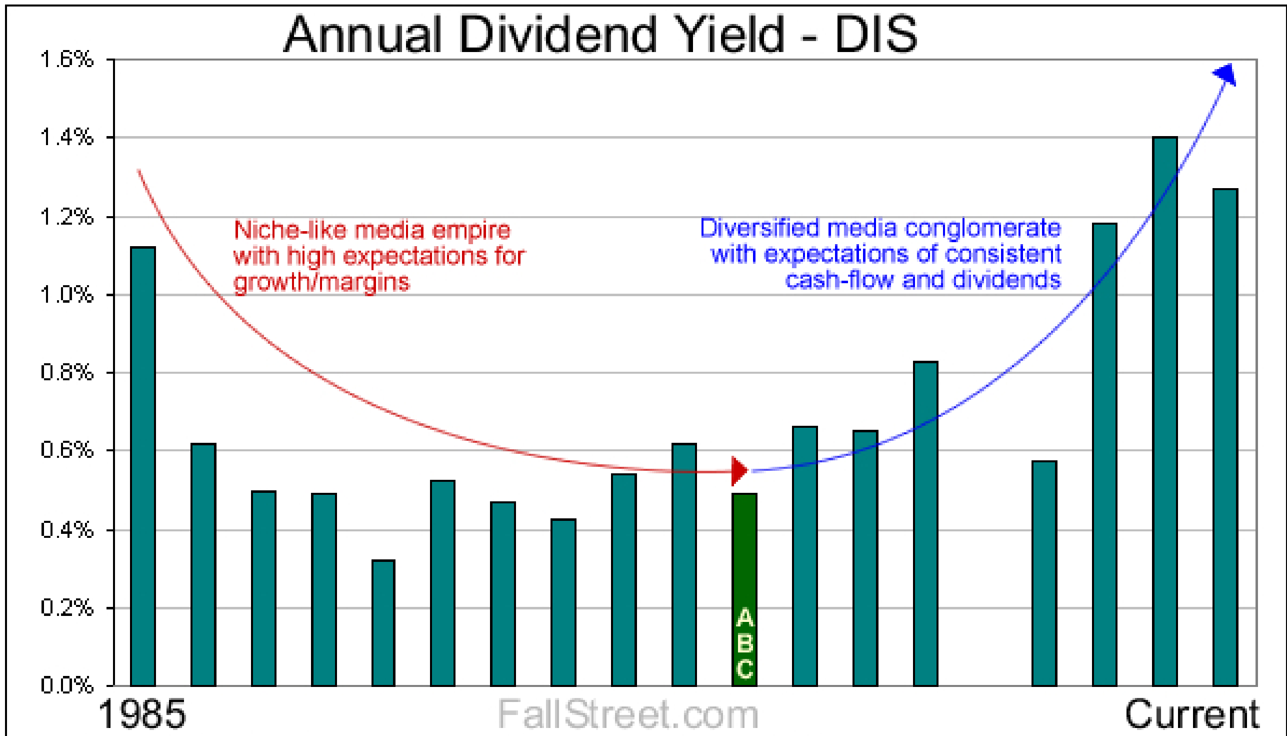
Cash Flow and Stock Options

Disney withstood the economic downturn well on a free cash flow basis and, to be fair, this does comment well on some of Disney's key brands (ESPN, Disney). In fact, it is almost as if the economic slowdown has sharpened Disney's focus, as the basic FCF numbers on Disney have become moderately attractive (we note 'moderately' because Disney trades at a steep 25 times FCF, and the company does not have an attractive dividend yield.)



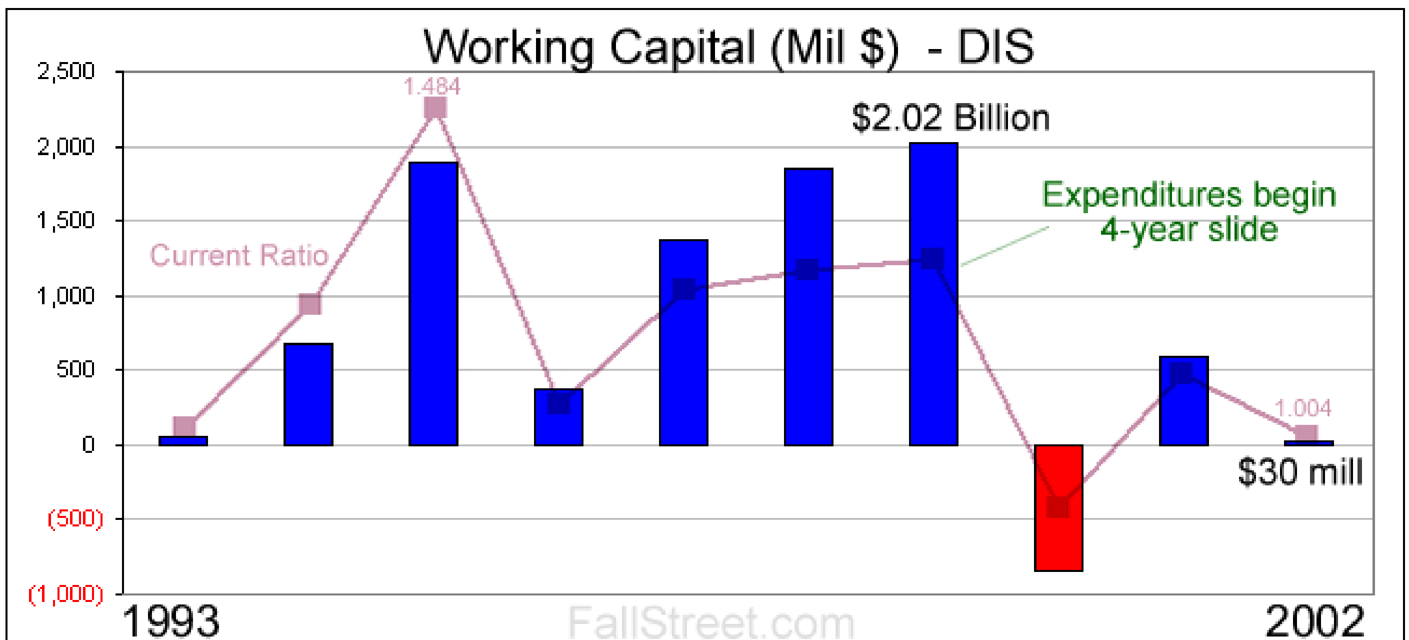
*Cash From Operations minus Expenditures divided by outstanding shares. Data adjusted for accounting changes that have occured since 1999 (Film costs no longer included in expenditures and related changes in calculating cash from operations).

Historically 60% of Disney's free cash flow (which has been positive in 16 of the last 18 years), is paid out in dividends. Given that dividends as a percentage of FCF are unlikely to trend higher (unlike the dividend leaders (Tobacco) Disney requires capital to maintain its infrastructure and constantly reinvent mediums of popular entertainment), the current dividend yield of 1.29% is not attractive. Quite frankly, Disney is, and historically has, paid out a healthy dividend when compared to the cash that the company generates. However, the yield has remained unattractive because the company's stock price has been too high (investors were buying on the company's stated goals of super growth). As the chart below demonstrates, Disney's yield has begun to escalate as its growth/margins story begins to transition into a consistent cash flow story.



* Closing stock price for DIS's year-end used to determine dividend yield.

Because of the company's strong FCF and tightening but not negative margins, there is no immediate danger in financing its debt obligations. However, as the chart below demonstrates, poor operational results from Disney have had a negative impact on the company's working capital. Recall that the U.S. consumer has not yet retrenched despite the 2001 recession. It is therefore worth noting that a consumer led recession would likely exacerbate Disney's declining working capital trend and could force the company to sell some more assets (since 1996 Disney has regularly sold some of ABC's interests) and/or cut its dividend.



Lastly, there is the area of stock options. The FASB could adopt stock option regulations late this year. If they do, Disney's earnings will suffer. Although there would be no material cash change in the company's value, the perception of slumping earnings could hurt the company's stock price. Like many company's, Disney uses buy backs to obscure the dilution caused by stock options.

Disney - Stock Options	2002	2001	2000	1999	1998	1997
Net Income ($Mil)	1236	-41	1196	1300	1850	1966
Net Income If Options Expensed	930	-325	958	1169	1749	1870
% Impact on Net Income	-24.76%	-	-19.90%	-10.08%	-5.46%	-4.88%
Dilued Outstanding Shares	2044	2100	2103	2083	2079	2060
Outstanding Options (Mil)	216	188	162	159	163	183
Exercisable	88	66	51	57	51	63

Conclusions

Disney highlights everything that was wrong with corporate thinking during the 1990s, and everything that remains wrong today. During the 1990s Disney began embracing goodwill and intangibles as an asset class, it began issuing copious amounts of stock options, it overestimated pension rates of returns, it did not expense stock options, it did embrace pro forma, and it moved away from its key brands.

In sum, and given that we do not anticipate a strong recovery in the U.S. or global economy, the near term outlook for Disney is not good. We are interested to see what will happen if Disney does not continue its partnership with PIXAR Studios. In our opinion PIXAR, which has the technology and expertise that helped produced Toy Story, Monsters Inc., and other highly lucrative brands, is the type of company Disney should of bought out instead of ABC. An investment in PIXAR could help solidify Disney's animation dominance whereas an investment in ABC has merely weakened margins.

Disney is not the hero of this particular investment story.

Sincerely,

Brady Willett & Todd Alway

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