Trophies and trophy assets

In our search for value, we often find ourselves drawn to companies which have announced the separation of their different business units. We have written previously about the stock market anomaly of conglomerate discounts and spin-offs. For various reasons, companies which are comprised of unrelated business units tend to trade at a discount to the theoretical value calculated when simply adding together the individual parts. The spin-off provides a catalyst for the realisation of this theoretical value and can, under the right circumstances, result in very satisfactory returns for shareholders.

Our recent purchase of Madison Square Gardens (MSG) aims to take advantage of this phenomenon. In its current form the company is comprised of two distinct businesses. Firstly, "MSG Sports" which includes the New York Knicks basketball team and the New York Rangers ice hockey team. The second division, "MSG Entertainment" has one main asset, the Madison Square Garden arena in Manhattan along with several smaller venues in Boston, Chicago and California. This division is also engaged in the construction of the MSG Sphere in Las Vegas – a new concept, which promises to be the most technologically advanced entertainment-focused venue in the world. A second MSG Sphere in London is currently in the planning stages.

After announcing the proposed spin-off in October 2018, MSG has delayed the date for completion twice, which has been taken negatively by shareholders. Management has explained that the multiple stakeholders (including various sports leagues and local authorities, all of whom operate on different timetables) make this separation very complex which is the reason for the delay.

Adding to shareholders' misery, MSG disclosed a much higher than expected estimate for the cost of construction of the Las Vegas Sphere. We understand that the structure of the cost-plus contract negotiation is such that contractors are incentivised to initially "highball" their estimate, since profit is capped above that benchmark. This initial estimate will almost certainly be subject to negotiation and could therefore be revised down subsequently.

This set-up presented an attractive opportunity in our view, given MSG seemed to be significantly undervalued compared to the sum of its parts, not to mention an upcoming separation which should further unlock that value.

Sports teams are trophy assets which have generally been more valuable to billionaires as privately held investments than to shareholders of public corporations. Part of this can be attributed to the prestige of owning a team, but there are also significant income tax advantages. In general, the highest valuations are ascribed to teams based in major cities with the biggest fan bases and the most celebrated history. Forbes provides estimated valuations for teams every year and the New York Knicks and Rangers are considered to be the most valuable franchises in the basketball and hockey leagues respectively. Forbes' valuations have further proved conservative when compared to recent transactions involving the Brooklyn Nets and Houston Rockets.

In addition, the MSG Entertainment division looks to be meaningfully under-appreciated. The Madison Square Garden Arena benefits from a unique location in the heart of Manhattan, directly above the busiest commuter rail station and fifth busiest subway station in the United States. It would be impossible for any competitor to build a new stadium there due to the prohibitive cost of land as well as planning approval. The stadium is considered one of the premier venues in the United States and regularly hosts top music performers, political events, as well as a multitude of sporting events. Moreover, the most recent draft of the sports betting bill in New York allows for sports betting licences at large stadiums and therefore, should the bill pass, it could bring in material additional revenue streams at little incremental cost. ▶

Whilst the spin-off delays and high Las Vegas Sphere price tag have spooked some shareholders, we are more sanguine. The drop in share price effectively means that the company is getting little to no credit for any return on the investment being made and we thus believe that MSG should be able to generate a very satisfactory return.

In Las Vegas, the MSG Sphere will be located adjacent to the Las Vegas Sands Venetian resort, hence benefiting from exposition traffic. The Sphere will also be a short walk from the Wynn and Bellagio. The innovative spherical architecture combined with cutting-edge technologies will create truly unique venues in the under-served markets of Las Vegas and London.

Since our purchase, the company has given its final approval for the spin-off which is now anticipated to take place in the first quarter of 2020.

Finding stocks with such high-quality underlying assets is rare. It is even rarer to find them trading at such a discount to their intrinsic value and with a catalyst to realise their potential.

Important notice