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What is normal anyway?

As governments across the globe start to ease lockdown measures, a return to "normality" is starting to be discussed. Whether reversion back to a 2019 type of normal is possible, probable or desirable is a question for someone with many more pages to fill. It is likely that, at least for a while, we will see a "new normal" but what this might look like would take even longer to discuss. Indeed, how will we even know when we have returned to "normal", when perceived short term changes to our behaviour may have now become permanent features?

We recently read an article in the Financial Times in which the author posited visitation at Disney theme parks as the ultimate indicator for a return to normal life. When choosing to book a trip to Disneyland, the consumer needs to feel comfortable enough to visit a place with substantial numbers of other people, often crowded into tight spaces. Air travel also needs to have resumed, with significant numbers of visitors coming from out of state or internationally. In addition, the consumer needs to feel confident enough about their own personal economic outlook to shell out a substantial amount of money on a family holiday. Thus, the parks touch on many of the key aspects of life which have been so dramatically affected during the past few weeks.

We have written about Disney several times over the past couple of years as our original investment thesis has started to play out. However, in the wake of the coronavirus crisis and the impact it has had on such a consumer-centric business, we thought it appropriate to re-visit the investment case.

All three of Disney's main profit generating segments have been negatively affected by COVID-19. Internationally, Disney's theme parks have been shut since late January, and in America, since the middle of March. In the Media Networks segment, advertising revenue has been substantially negatively impacted, particularly with regards to ESPN, Disney's sports network. As retail sales fall, brands are looking to cut costs and advertising budgets offer an easy option. Lastly, in the Studio segment, the closure of cinemas and halt in production has resulted in a complete overhaul of the planned movie release schedule, with no new theatrical releases planned until July.

In order to reduce cash burn, the company has furloughed its theme park staff and is reducing administrative costs. Additionally, capital expenditure has been delayed and the dividend cut.

However, do we believe that the long-term value of the company has been materially impaired?

The short answer is no. With regards to both the Media Networks and the Studio segments, it is likely that existing trends such as cord cutting, the switch to online advertising and falling cinema visitation, will accelerate as a result of COVID-19 and the resultant changes to consumer behaviour. However, prior to the outbreak, we believed in Disney's strategy (i.e. launch of Disney+ and purchase of controlling interest in Hulu) to combat these trends. Just as the negative trends have accelerated, so have the positive, with the uptake of Disney+ surpassing all expectations. With people spending more time at home, we believe that overall demand for Disney produced content will only increase. Ultimately, through whichever medium, we believe that Disney will be in an exceptionally strong position to monetize their content.

Perhaps unsurprisingly, the area where we see the largest range of possible outcomes is the Parks, Experiences and Consumer Products division. As discussed, a return to "normality" for this division is about as difficult to forecast as a return to normality for society in general. It is an impossible task to predict when the parks may re-open and at what level of capacity. ▶▶

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We can, however, evaluate two extreme scenarios: one, a worst-case, where the parks are closed indefinitely and so an entire division is wiped out forever, and another, where a vaccine is developed in the next few months and life returns to a 2019 type of normal (albeit with some negative impact on the economy). Looking at these cases, we see attractive risk-reward at the current share price.

Ultimately, we believe that there will be a return to a version of “normal” life, whether that be through the development of a vaccine or through herd immunity with governments being forced to relax lockdown due to economic hardship and unrest. Although it may take some time to return to previous levels of visitation, we believe that there will be pent up demand, when the parks do re-open. In the meantime, Disney has indicated an ability to scale the cost base in order to manage the cash burn of the segment. With a long-lived fixed asset such as this, the loss of one year’s earnings does not impact the ability of the asset to generate earnings in the future.

Without doubt, this year will be a tough one for Disney, as the past few weeks have been for shareholders. However, as we look to the future, one does not have to be particularly optimistic about what “normal” might be to see the potential for recovery is substantial. We may be in for a bumpy ride in the short-term, but we continue to believe that the long-term future is bright. ■

Important notice