PERSPECTIVES

The Urge to Merge: Possible Implications from the AT&T-Time Warner Ruling

June 22, 2018

Sara Araghi, CFA
Vice President, Research Analyst,
Franklin Equity Group

A recent US court ruling green-lighting the merger between AT&T and Time Warner marked an historic event that some say could open the door to more merger-and-acquisition (M&A) activity ahead. Sara Araghi, CFA, vice president, research analyst, Franklin Equity Group, and Marc Kremer, CFA, research analyst, Franklin Templeton Fixed Income Group, discuss some of the possible implications.

Tune in to hear more in our latest "Talking Markets" podcast.

TALKING MARKETS WITH FRANKLIN TEMPLETON INVESTMENTS

Here are some highlights of the views of speakers represented in the podcast:

- **Sara Araghi:** There's a lot of speculation there will be more media deals in the future. And while new in the United States, internationally, we've had convergence happening for a while. I think we should think about concentration within industries. What does that mean in terms of the health of an industry when you actually have more M&A?
- **Marc Kremer:** It does seem like the favorable AT&T-Time Warner ruling opens the door for more M&A activity and consolidation. I think that some companies certainly seem ready to use the benefits of recent US tax reform as well, such as repatriation of foreign cash, to bolster the business positions when they can.
- **Sara Araghi:** I believe that all of the convergence that is happening, whether its content and distribution or even wireless and wireline convergence, is a function of the rise of the internet companies.
- **Marc Kremer**: When somebody who has been in an industry a long time decides to sell or merge their company, that perhaps means that the industry really is undergoing some different pressures.

The full transcript of the podcast follows.

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton.

I'm your host, Richard Banks.

Ahead on this episode, we focus on the possible implications of the US court ruling in favor of AT&T's bid to merge with Time Warner. Here to discuss it all are Sara Araghi, vice president and research analyst with Franklin Equity Group, and Marc Kremer, vice president and research analyst with Franklin Templeton Fixed Income Group. Leading the conversation is Franklin Templeton's Lee Rosenthal. Lee, take it away.

Lee: Thank you, Richard. Let's start with this ruling and the significance of it. Sara, we'll start with you. Why were so many people interested in this case?

Sara: This case was very important because it was the first big merger that was being decided on under the Trump administration with a new DOJ [Department of Justice] chief. It was a vertical merger. It had gone to court. And so, the reason this was important was the fact that we had to see what the decision would be. It would then set potential precedent for vertical mergers down the line. So it was really the first high-profile case.

Lee: You mentioned the term vertical mergers. Explain more about that, what that means.

Sara: So vertical mergers are when two businesses that are various parts of the supply chain are merging rather than two businesses that are in the same area within a supply chain. So an example on the AT&T and Time Warner is AT&T is the distributor of content through their platform, Time Warner is the supplier of that content. And so, bringing those two together, they both provide two different areas of the supply chain coming together and essentially consolidating those two businesses together. Horizontal is the other version which is two businesses that are exactly in the same area.

Lee: We're going to talk more about the implications of this merger and potential other vertical mergers. But Marc, let's bring you in here, Sara referred to the way content is distributed versus owned. What's the significance here in this space in what AT&T is trying to do, and what other companies are trying to do?

Marc: AT&T already had access to Time Warner programming as a customer of Time Warner, but they believed that they could bolster their competitive position—improve things like subscriber retention and diversify their revenues by actually buying Time Warner. Consumer video consumption habits have really changed over the last several years as mobile, in particular, has become a more important part of a customer's delivery services. In addition, the real growth in advertising has been in digital ads since those can often be customized to individual users. So AT&T believes that knowing where their customers are and what they're viewing will enable them to target advertising to those customers—that it's more relevant to them and more useful for their advertisers.

Lee: Have we seen anything like this in this space or, or anything you can, compare it to?

Marc: No, I think this is really one of the first ones. I mean, we've seen other media companies trying to get together because they think size is better. But in terms of a more traditional media company merging with a telecom, this is probably the first case we've seen of that.

Lee: Marc, when you hear the Justice Department's arguments in this case, what do you make of them? Why were they so against it?

Marc: This is really the first vertical merger they litigated in, I think, over 40 years. And their argument was that permitting AT&T to acquire Time Warner would substantially lessen competition. They thought that AT&T would be able to raise prices on other customers who are subscribing Turner television networks, or they had the advantage then that, if for some reason the other customers of Turner didn't want to pay and they blacked out the network, that AT&T could get new customers because people would say, 'Well, we really want to have this content.' If there's sports on TBS and Turner, there's CNN, so that those customers could then go AT&T through DirecTV or DirecTV Now. So I think, you know, the view is that AT&T would benefit either way by taking a hard stance.

In contrast, I think AT&T—and the judge sided with them—their view is that it's really in their interest to try to get as much distribution as possible of their cable networks. They earn money by both subscriber fees as well as advertising revenue. So you want to have as broad a base of subscribers as you can and not just try to limit it to yourself.

Lee: So let's compare this to the technology companies and streaming services out there. Don't they already distribute the content and create it themselves?

Sara: Yes, they definitely do and they are vertically integrated. Netflix is vertically integrated, creating a lot more content themselves right now. So when you look at that comparison, it I believe it wouldn't have been anti-competitive from an AT&T or DirecTV perspective.

Lee: So I think this naturally transitions into what is the landscape in this, what seems to be, rapidly changing world of media content creation and ownership and distribution. How do you view it right now?

Sara: I believe that you're seeing all of this convergence happen, whether it's on the content and distribution or even wireless and wireline convergence that's happening right now, as a function of the internet companies as you just talked about, that have come in and taken profit pools from the traditional guys. So Netflix has taken viewership from traditional cable networks. Google and social media companies like Facebook have taken digital advertising dollars, shifting TV dollars to digital advertising, and so as a way to combat that, AT&T believes that they can take the eyeballs back by buying Time Warner and owning that content themselves, creating competitive products. I think you'll see that convergence continue.

You just saw as this deal got approved, Comcast put an official bid to buy Fox.

And that's just another example of this. There's a lot of speculation there will be a number of more media deals that happen. This is new in the US, but internationally, we've had convergence happening for a while. Whether or not that generates higher returns in the future is yet to be determined. But at this point, I don't think this is the end of this type of consolidation that's going to happen.

Lee: Marc, I'll ask you, what do you view the future or outlook for the pay-TV companies and the telcom space?

Marc: It's uncertain now. I think one of the things that we've seen, it's sort of funny, that just a few years ago people viewed the pay-TV universe was doing really well with cable companies adding broadband and video subscribers. And content companies took advantage of the growing revenue streams. Again, the dual revenue stream of both subscriber fees and advertising revenues.

But it's really significantly changed as the subscription video, on-demand providers like Netflix and Amazon have experienced huge growth, and that's created new viewing habits among customers. It's caused customers to say, 'Well, I don't need a full package of cable TV or paid TV.' So they started cutting cords, or cord trimming. And then you've had growth of alternative providers who come over the top. You don't need to have cable TV anymore. You could just have broadband and subscribe to services like Hulu. So it's really changed the world for the pay-TV guys.

It's really now for them a game of trying to maintain whatever subscribers they can, to provide the best service they can to those subscribers, and also try to find ways where they can add to their advertising revenues.

I think one of the advantages that some of the digital players have, like Facebook and Google, in disrupting the ad market, is that they have so much data about different customers that they can target advertisements to individuals. You know, it certainly raises some privacy concerns when some of the news comes up about how they get the data and how much do they have. But in reality, advertisers love the fact that they have so much data and they can customize advertising for individuals. Cable TV companies have some general data about us, and they've tried some experiments with targeted advertisements, but it's still really at early stages of that. So I think they really need to try to keep developing that if they want to maintain that input into the house.

Lee: So to me it seems like these companies are under intense pressure to further evolve and modernize and compete with the streaming services. At the same time, they're also now taking on an incredible amount of debt. Sara, how do you view that? How concerning is it?

Sara: I believe what this merger does for AT&T is it actually makes their income statement look better, their revenue growth profile look better and frankly, give them dividend coverage. But, from a debt profile, as you point out, it's going to be over four times levered. That introduces a lot of risk for AT&T, and that four times is a very big number. So, if we have any macro slow down, the Time Warner business has a cyclical element to it, which is the ad dollars. If those slow down, I believe that's going to be a very big problem for them in terms of leverage. So I think that introduces a lot of risk for a lot of these businesses.

Marc: I agree with Sara, and I think that it's interesting that some of the companies that we're talking about are struggling with consumer demand at a time of good economic growth and historically low unemployment. So I would be concerned that, you know, if some of these negative trends like cord cutting and cord shaving could accelerate if the US were to hit another economic downturn in the next couple of years.

Lee: And the streaming services are spending an incredible amount of money on content. How do you view their debt loads, Marc?

Marc: I think Netflix is spending $8 billion this year, Amazon $5 billion, Netflix is not free-cash-flow positive yet, but we do feel that once they get to free-cash-flow positive, and I think they have the ability to do that over the next couple of years, they can reduce debt pretty quickly. The traditional media guys do still have very strong free cash flow. So it's just a matter of how far do they want to take leverage in an era when, you know, there's still a lot of secular change and uncertainty as well as the potential for some cyclical downturn in the relatively near future.

Sara: And just one thing I'd like to add is the new digital players, for example, YouTube owned by Google, has one of the new TV products out there, YouTube TV. Google can fund that because Google is flush with cash. So for a Google or Amazon, who has a lot of excess capital to continue to spend on content, the traditional guys will have to continue to compete with that.

Lee: Moving onto the bigger picture, this merger has far and wide implications. Sara, take us through them.

Sara: I would say that a lot of M&A may have been on hold because of anti-trust concerns because people were just waiting to see what happens here. Companies believe that, traditionally, it's easier to get deals done with a more pro-business, Republican administration. So you might see a wave of deals come through. Now, I would give a counter to that, in that, first of all, the DOJ chief didn't approve this deal. He took it to court.

If you actually read the documents from the judge, he said every vertical merger should be viewed on its own basis. Vertical mergers are harder to analyze versus horizontal mergers. And there's a number of horizontal mergers on the table. Sprint, T-Mobile is one of them. Horizontal mergers are a calculation of market share concentration. Verticals are tougher to analyze. So I'm not necessarily sure if the DOJ chief is going to be easier on deals going forward. Frankly, he could look at this and say, 'I lost this one. I'm going to be tougher on the next one,' or it could go the other way and say, 'we're not going to waste time and approve deals.' So I'm not sure if this gives us indication that the next few deals will be approved as well. I think it gives better chances to, for example, a Comcast trying to buy Fox because of this precedent set.

Marc: I agree. I think it's, you know, it's hard to extrapolate too much across sectors and individual situations, but it does seem like the favorable ruling opens the door for more M&A and consolidation. I think that some companies certainly seem ready to use the benefits of recent tax reform as well, such as repatriation of foreign cash, to bolster the business positions when they can. So to the degree that this opens the door and gives them a little bit more certainty that a deal could get approved, I think many of them will try for that. One of the issues has been, for companies, is that you get tied up strategically in an M&A deal, trying to get approval and not sure of what the outcome is going to be. It really is a lot of cost in terms of time, in terms of moving your business forward. So to the degree that they do believe that there's a greater certainty of getting a deal done, it probably does bode well for increased M&A.

Lee: Sara, what does an environment with more M&A and consolidation mean for the investor? What should they be thinking about or factoring in?

Sara: I would think we should think about concentration within industries. What does that mean in terms of the health of an industry when you actually have more M&A? So if we actually do see consolidation in the wireless industry, for example, what does that mean in terms of pricing which has actually been going down in that industry? Does it actually improve the business? And then for the investor, obviously the investors that are invested in the companies that are taken out should benefit from those multiples. So I think you probably will see multiples go higher in that scenario.

Marc: For investors, sometimes M&A can give an indication of the direction that business is going. I think a lot of people pointed to the fact that Rupert Murdoch deciding to sell Fox is an indication that he felt he wasn't big enough to compete and the industry was really going through some difficult and changing times. So you can gain some information by the fact that when somebody has been in an industry a long time decides to sell or merge his company, that perhaps means that the industry really is undergoing some different pressures.

Lee: Ok, thank you both.

Host/Richard Banks: That's it for this edition of Talking Markets with Franklin Templeton. Thanks to all our contributors. If you've enjoyed their insights and would like to hear more, check out our archive of previous episodes and subscribe on iTunes, GooglePlay, or just about any other podcast provider. So until next time when we uncover more insights from our on the ground investment professionals, goodbye.

This material reflects the analysis and opinions of the speakers and may differ from the opinions of Franklin Templeton Investments' portfolio managers, investment teams or platforms. It is intended to be of general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice.

The views expressed are those of the speakers, and the comments, opinions and analyses may change without notice. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, security or strategy. Statements of fact are from sources considered reliable, but no representation or warranty is made as to their completeness or accuracy.

This information is intended for US residents only.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

To get insights from Franklin Templeton Investments delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @FTI_US and on LinkedIn.

What are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Investing in a single-sector involves special risks, including greater sensitivity to economic, political or regulatory developments impacting the sector.