Chilton Investment Services

Weekly Update

July 31st, 2017

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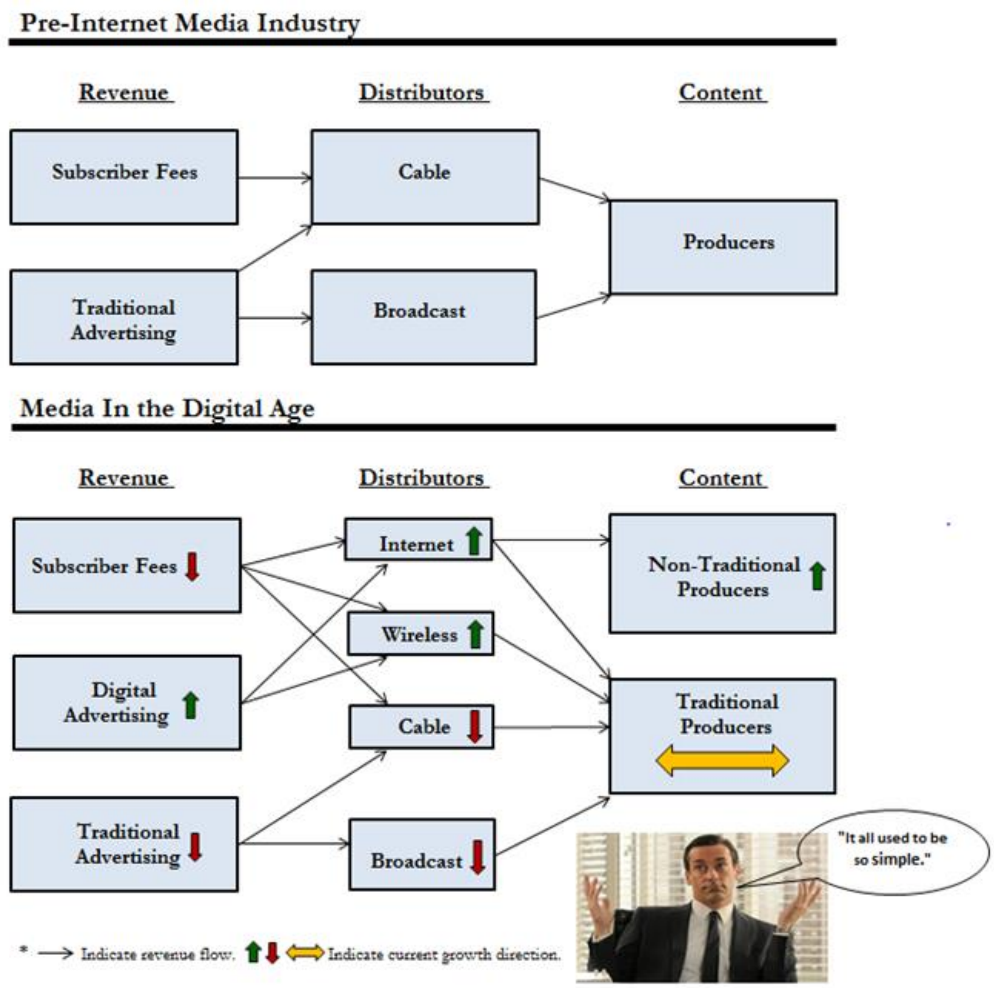
Media Industry Grapples With The Digital Age

We hold a neutral view on media credit fundamentals reflecting the high level of disruption occurring within the industry. As outlined in Chart 1 and referenced in our comment on the cable and telecommunication industries on May 31st, these disruptive trends include:

1) Proliferation of content distribution channels made possible by high-speed broadband
2) Breakdown of the traditional bundled pricing model of TV channels selected by the cable distributor
3) Cancellation of traditional cable subscriptions (a.k.a. "cord-cutting") in favor of various online-based options (a.k.a. virtual, streaming or "Over-the-top" programming).

This has resulted in a massive shift in advertising dollars toward digital distribution channels and intensified competition for content and viewers. While we believe the increasing consumption of digital video is a favorable long term growth trend for media production companies, there will be winners and losers as legacy companies attempt to redefine their roles while upstarts seek a foothold. **In terms of investment recommendations, there is limited value in our media names given spread tightening over the first half of the year.**

Chart 1: Industry Transformation Showing How Producers are Ultimately Compensated



(The Right) Content Is King

For media production companies (i.e. Time Warner Inc., Viacom & Walt Disney), digital distribution has democratized the distribution of video content with internet-based providers such as Netflix and Hulu offering much greater choice in terms of what consumers view and when they view it. This has resulted in a pricing model shift toward the so-called “skinny bundle”, representing a smaller number of more highly curated channels than the traditional bundle. Additionally, the ease of distributing digital content has led to a surge in content non-traditional producers, ranging from Amazon to the latest trending YouTube “personality”. The clear winner is the consumer who has never had more flexibility. However, the effect for producers has been two-sided. As the supply of video content surges, differentiation is critical. Premium content – increasingly defined as live sports, news and cult programming – has never been more important. Conversely, those producers with second tier content increasingly find themselves shut out of skinny bundle offerings. With subscription losses mounting at cable companies, even top tier brands must be adroitly managed. Walt Disney stock came under pressure earlier this year as concerns intensified over cord-cutting-driven ratings declines at ESPN (cable networks represent 30% of Disney revenue). A key upcoming catalyst will be further details on an expected ESPN standalone online service in the second half of 2017, a move intended to offset cable losses. Regardless, we believe Disney's expertise at developing, acquiring and marketing branded content through a variety of consumer channels (film, video & theme park) remains a strong competitive advantage. With a very strong balance sheet, the company represents a high quality benchmark for our media coverage. Also boasting a strong content library is Time Warner Inc., owner of HBO, CNN, TNT & Warner Brothers. While Time Warner – like Disney – is exposed to cable subscriber losses, both companies maintain strong pricing power by virtue of their programming popularity, thereby commanding higher rates from distribution companies, both cable and internet-based. Conversely, Viacom is more challenged as its portfolio of brands (including MTV, Comedy Central and Nickelodeon) reports weaker rating trends. Charter Communications placed Viacom networks in its most expensive cable package and Viacom has been omitted entirely from Hulu and YouTube's offerings. With very high leverage, Viacom is our weakest media name.

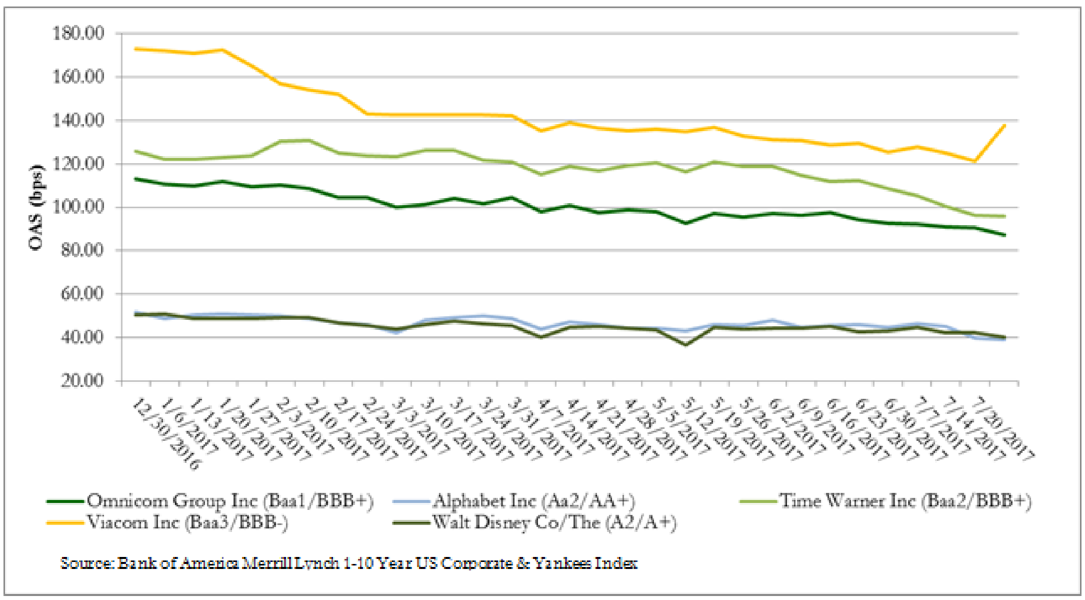
"Advertising is based on one thing: ~~happiness~~ data"

- **Don Draper**

Disruption exists in the advertising industry as well with digital advertising revenue having exceeded traditional TV advertising revenue for the first time (digital is now 40% of global sales vs. 36% for TV). Growth is projected at double-digit rates in the medium term, the vast majority of which is expected to be driven by mobile advertising which now accounts for over 50% of total digital ad spend.[i] Tracking online activity and developing targeted advertising is the current challenge for the media industry. Not surprisingly, internet behemoths with leading online platforms - Google and Facebook - dominate the digital advertising industry, reporting a combined ~70% market share in this fast growing sector. It is imperative that legacy media companies find ways to level the playing field as traditional methods of customer engagement like the Nielsen TV survey are increasingly outmoded. An example of these efforts is the OpenAP consortium founded by Turner Networks, Viacom and Fox Broadcasting, an initiative designed to develop best practices for tracking digital activity and report this data in a standardized format to prospective advertising buyers. Meanwhile, advertising agencies such as Omnicom face similar challenges with the traditional, creative, TV-focused ad campaign ill-suited to the data-driven, algorithm-based world of digital advertising. Competition is intensifying with major consulting firms such as Accenture and Deloitte entering the market. For the ad agencies, establishing a foothold in the digital world is crucial with the value proposition shifting to designing and targeting their client's digital advertising efforts. To that end, Omnicom has established its own digital ad agency (Hearts and Science) which recently won Proctor & Gamble and AT&T as clients. The company is also partnering with internet companies like Facebook, Google, Instagram, and Twitter. An example of this was the recent YouTube (owned by Google) controversy in which certain advertisers objected to their ads appearing alongside objectionable YouTube content. Shortly thereafter, Omnicom offered clients a so-called "brand safety" tool which it claimed would help avoid such occurrences.

Relative Value

Chart 2: Spread Tightening In Most Media Names Limits Opportunities



Source: Bank of America Merrill Lynch 1-10 Year US Corporate & Yankees Index

In our covered names, opportunities are presently limited, arguing for a neutral weighting at best in client portfolios. As shown in Chart 2, most of our names have tightened over the year t levels which approximate fair value at best. While strong fundamentally, Disney credit spreads are very rich for a single-A rated name as bonds trade in line with double-A rated Alphabet (a.k.a. Google). Omnicom now trades rich to its index and rating category, a consideration which is potentially at odds with the intensifying competitive environment. Viacom spreads have jumped in recent days reflecting concern the company will engage in transformative M&A. However we still do not see enough value to consider adding the name. Finally, Time Warner's outlook is dependent on the success of the pending acquisition by AT&T, a transaction we believe to be positive for both companies. After widening following the deal announcement last year, Time Warner bonds have tightened year-to-date and currently trade rich to AT&T bonds, leaving little upside if the deal goes through. In fact, demand was so strong for last week's $22 billion debt offering from AT&T that the issuer was able to price this sizable new debt offering approximately 10 basis points <u>through</u> current trading levels, a very rare occurrence.

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[i] "Magna Advertising Forecasts Spring Update," Magna Global, June 14, 2017 https://www.magnaglobal.com/wp-content/uploads/2017/06/MAGNA-Global-Ad-Forecast-Spring-Update-June-2017-PR-Executive-Summary.pdf