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INSIGHTS

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A discussion by Franklin Djohan, Portfolio Manager of Private Portfolio Managers

Disney goes direct

Content and Distribution Wars or an astute progression?

On the surface, there seems to be a power struggle between the studios and content distributors. Apple is the most recent technology company to invest in original content. The budget set aside to produce original content for Streaming Video on Demand (SVOD) companies is not insignificant. Netflix, the pioneer in streaming services, spends around $6 billion a year to produce its own original content. Amazon is not far behind with a budget around $4.5 billion, and Apple around $1 billion.

So when Disney announced that it will pull out some of its content from Netflix and launch its own streaming service, one could be convinced that their relationship has been reduced to tit-for-tat, and it seems that there is an element of that. Obviously, as Netflix gets bigger, the balance of power tips over to its side. To make matters worse, streaming services also encroach deeper into content production. Traditional studios are definitely feeling the heat.

Restoring the status quo, however, is not the sole reason why Disney is planning to launch its own streaming service. The mind-set is different. Netflix, being a technology company, produce original movies and TV series as to differentiate themselves in order to attract subscribers to its platform and retain them. On the other

hand, for traditional studios like Disney, it is all about maximising the monetisation of its content. Disney is largely agnostic to where or how its content is distributed.

As the younger generation are now opting to access content through streaming and cutting-the-cord from cable - one of Disney's distribution channels - the company need to find a new way to monetise its contents. Launching its own streaming service is one way to do that.

One other advantage of having a streaming service is the effect of becoming closer to the consumers. Netflix has been collecting a lot of data on what its consumers watch. That data is then used to select content that is the most appealing to its subscribers. This kind of data will also be invaluable to Disney.

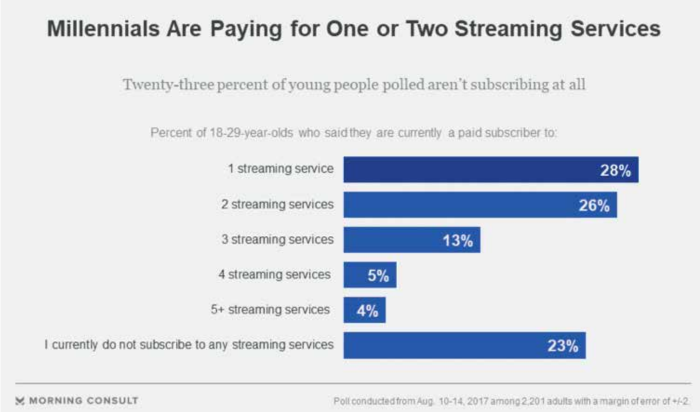
Even with all the benefits, venturing into a direct-to-consumer model is not an easy task even for a company like Disney. First, by pulling some of its content from Netflix, the company will forego some of their licensing revenue.

This is why Disney is hedging its bet, and only launching a streaming service on two of its brands, original Disney Characters and Pixar. While the decision for two other lucrative brands, Marvel and Lucasfilm, still remain pending upon the company's review.

Second, the company will enter into an already saturated SVOD market. Besides the aforementioned big names, there are other streaming services already in the market including Google's Youtube, Hulu, and HBO Now. Even the Millennials, avid users of streaming services, will have a hard time to subscribe to all of the available SVODs.

Content will play a bigger part, and continue to be the differentiator, amongst the various players.

This is where Disney - who own huge libraries of Intellectual Property from its previous acquisitions of Marvel ($4b), Pixar ($7b), and Lucasfilm ($4b) - will shine. Content is still king after all.



Peter Reed, PPM Portfolio Manager, discusses the evolving landscape of insurance and the positive investment story resulting from the concentration of market participants and premium growth.

An Insurer that ticks our boxes

Insurance is fundamental to any properly functioning, modern economy and we are always open to investment opportunities within the sector when the occasion arises.

By way of diversion, it is interesting to briefly review the history of this industry, a fascinating story in its own right. The modern insurance industry dates back to the late 14th century when merchant bankers began to separate marine insurance contracts from debt financing contracts. That is, separating credit risk from peril risk, thereby reducing the cost of both.

Thus, insurance originally evolved as a commercial instrument; it was not until after 1666, as a result of the Great Fire of London, that insurance for households – Fire Insurance – emerged. The aftermath of the Great Fire actually saw the creation of the first insurance company, The Insurance Office, in 1667. What happened to The

Insurance Office is unknown, but the oldest documented insurance company still in existence started life as a fire office: Sun Fire Office, now known as RSA, is one of the largest insurers in the UK.

Perhaps explaining the development and success of the industry over the centuries is the real benefits provided by the industry. At the macro level the industry helps efficiency and resilience of the economy by facilitating the transfer of risk. At the micro level it helps minimise the impact of unexpected events and helps people organise lives with greater certainty. For example, people would not be prepared to invest most of their wealth in a single house without insurance, thereby supporting the private housing market.

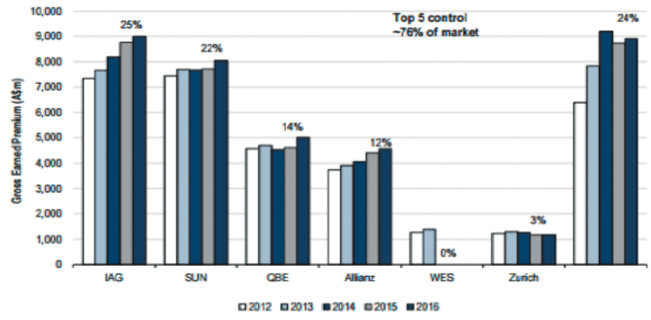
Not unlike the Australian banking industry, we have long considered the general insurance industry to be attractive from a structural point of view.

The top 5 insurance providers control around 76% of the market with the top two, IAG and Suncorp combined, comprising just under half.

This structure has helped produce acceptable growth in premiums over the long term. Although the industry has a cycle, focused particularly around large event losses, premium growth over a 20 year period has been around the 4% per annum level.

These are the underpinnings of what could potentially be an attractive opportunity for long term investors.

Figure 8: A heavily concentrated general insurance market
Australian general insurance – GWP (A$mn) / market share (%) – Dec 16



Source: Company data, APRA, Credit Suisse estimates

Homing in on IAG, the largest Australian general insurer, the company has been well managed over a long period of time, in our view, and most recently under Mike Wilkins took the CEO role in 2008.

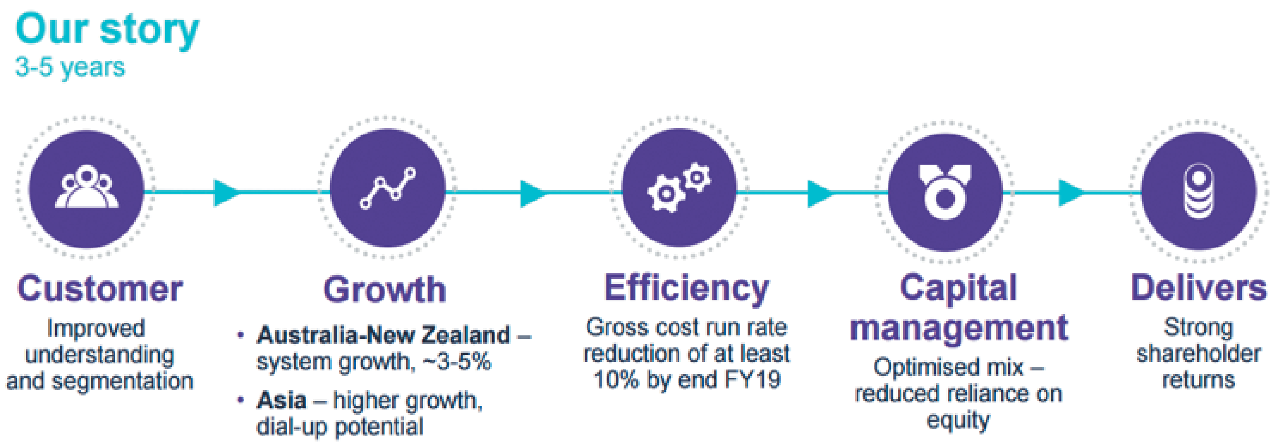
Further, management have detailed a clear strategy over the next 3-5 years which should deliver attractive, above-market growth over this time.

This strategy has a number of components, each providing a level of confidence in the investment proposition. First is the top-line growth outlook of 3-5% - in line with the long term experience. Our view is that this is quite achievable given the elevated level of claims experienced by the industry as a result of weather events and the need to rebuild profitability and capital.

Cost out, or efficiency opportunities, provide an additional level of confidence to the investment story. IAG management have highlighted this as a key goal, thereby indicating a high level of belief in their ability to achieve at least a 10% reduction in the cost base. Further, we would suggest that competitors Suncorp and QBE have, of late, led IAG in this endeavour, highlighting the opportunity for IAG.

The final leg to the IAG investment thesis lies with its strong capital position. Currently, the company holds 1.8x its required regulatory capital amount – above its target of 1.4-1.6x. Capital generation from earnings growth in addition to the benefit the company received from a so-call quota deal with US insurer Berkshire Hathaway which will result in a reduced capital requirement of approximately $700 million over the first five years of the transaction.

We envisage the company having increased capacity for higher returns being made available to shareholders over the coming years.



Source: IAG 8 December 2016.

Each of these points is important in their own right and together, in our view, present a compelling investment case for IAG.

By way of note, IAG and Berkshire Hathaway have had a successful reinsurance relationship since 2000. The 2015 deal between the two companies, labelled as a strategic partnership, partly involves Berkshire taking a 3.7% stake in IAG in addition to a quota share arrangement. The quota share is a 10 year deal where Berkshire receives 20% of IAG's consolidated gross written premium and pays 20% of claims. Crucially, Berkshire will also reimburse IAG for its share of operating costs and pay a percentage-based fee which recognises the value of accessing IAG's franchise.

The benefit to IAG is that it will diversify the company's funding whilst also delivering a more stable income stream with fee income replacing volatile premium income. Further, the quota share arrangement will result in a reduced capital requirement for IAG of approximately $700 million over the next five years. In so doing the company expects the deal to enhance its ability to deliver a through-the-cycle 15% return on equity.

For further information about PPM's services, please contact either Sally Humphris or Adam Griffiths on 1800 463 359 or email ppm@ppmfunds.com.

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