THE STAHL REPORT

The Contrarian Series

March 24, 2017

Lionsgate Entertainment Corp.

(BUY)

Price: $23.39
52-Week Range: $18.28-$29.03
Shares Outstanding: 227.7m
Market Capitalization: $5,326m

Valuations within this text are based on a $24.02 Class B share price; the Class A shares trade at $25.35

Ticker: LGFA/B
Dividend: None
Yield: n/a

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Investment Thesis

Lionsgate Entertainment recently completed the largest acquisition in its history, purchasing the John Malone-controlled Starz media company last December. At the time of the original recommendation in this report (October 2014), such an acquisition was not imagined. Rather, the basic premise held that Lionsgate was developing a valuable library of content, both in motion picture releases and original television programming, that ultimately would produce a long revenue tail that was not being assigned a proper value by investors.

As the share price of Lionsgate is now modestly lower than the October 2014 level of $30, (though shares were issued in the Starz transaction, increasing the present market value by roughly $1 billion), it again appears that the market is dissatisfied with Lionsgate.

This seems rather odd, as the Starz transaction was nothing other than logical. Lionsgate is primarily a media content production company that, with each subsequent release, incrementally increases its overall intellectual property value. However, this is an unpredictable business that generates great earnings volatility.

On the other hand, Starz distributes third party content on various platforms such as cable television and satellite – it is the second largest premium pay cable network behind HBO. This is largely a subscription-based model that produces consistent revenues. In theory, the merged entity should lower the earnings fluctuations associated with Lionsgate and result in a new company with more predictable cash flow. Moreover, Lionsgate now has a controlled distribution outlet and subscriber base for its content that will likely reduce its overall costs.

Despite the considerable improvement to Lionsgate's overall operating model, it still trades at an unreasonably low multiple. In other words, an acquisition that removes a substantial amount of cash flow uncertainty would, more times than not, serve to raise a company's valuation profile. In this case, it actually seems to have caused a contraction. While seemingly illogical, this is not entirely surprising. Neither Starz nor Lionsgate, prior to this transaction, were noticeable beneficiaries of the flow of assets under management to passive management, as both were largely excluded from the more popular ETFs. Moreover, there is also a voting control issue (i.e., voting versus non-voting shares), as described later in this report, that might dissuade many investors anticipating a valuation catalyst via an acquisition by a larger media company.

Using the trailing three-year operating income records of both companies, it appears reasonable, if perhaps overly simplistic, that on a combined basis Lionsgate could earn approximately $1.55/share, which is calculated later in this report. In addition, there are likely to be redundant costs that could be eliminated over time. If the company were able to reduce overall expenses of $3.6 billion by merely 5%, this could add $0.52/share of incremental after-tax earnings. Thus, in the absence of aggressive or unrealistic expectations, the company could earn over $2/share annually. Relative to the non-voting Class B share price of $24.02, the implied p/e is roughly 11.6x. This is also the equivalent, as there are no meaningful capital expenditures, of an 8%-9% free cash flow yield.

While this base scenario is sufficient to consider purchasing the shares, there are other areas of optionality. For one, Lionsgate owns roughly one-third of a premium cable network company called EPIX. Now that Starz provides a wide content distribution platform, it has been reported that Lionsgate may sell its interest in EPIX. Based on a fairly reasonable valuation, this stake may be worth about $500 million, which is a little less than 10% of the Lionsgate market value.

Secondly, Lionsgate has over $500 million of U.S. net operating loss carryforwards that may be used to reduce future income taxes (ultimately accruing to the shareholder through increased earnings). It seems almost certain that John Malone will utilize these tax advantages to the fullest extent, as he is probably one of the most skilled tax avoiders in U.S. corporate history (this is not a derogatory characterization – Mr. Malone has saved his shareholders billions in potential tax liabilities throughout his career).

Given his ownership of Starz, he will now have a significant equity position in Lionsgate (about 7.8%), a little less than 10% of total voting power, and a position on the Board of Directors. Lionsgate is obviously not his only media investment. It stands to reason that he could use Lionsgate in some form to orchestrate other transactions throughout the media industry, and perhaps within his own investment portfolio. Given all of these merits, the shares are recommended for purchase.

Starz Transaction Background[1]

In December 2016, Lionsgate completed the acquisition of Starz. This was a stock and cash transaction that ultimately led to the current dual share structure. Each Lionsgate shareholder was reissued 0.5 shares of Class A voting stock and 0.5 shares of Class B non-voting stock. Shareholders of Starz, which also had a voting/non-voting share structure, were issued a combination of Lionsgate Class A and B shares. As of February 6, 2017, there were 81.1 million Lionsgate Class A voting shares outstanding, and 123.7 million non-voting Class B shares outstanding.

In connection with the transaction, holders of 25 million Starz Class A shares have demanded an independent appraisal of their shares. As these Starz shares have not yet

[1] For a comprehensive review of the Lionsgate operations and financial history, readers may obtain the original report dated October 15, 2014, from PCS Research Services.

been converted to Lionsgate non-voting shares, Lionsgate has recorded a liability of $886 million to cover potential costs or equity issuances associated with the ultimate resolution of this dispute. On a fully diluted basis, assuming all Starz shares were cancelled and converted to Lionsgate shares per the transaction agreement, there are 227.7 million shares outstanding (according to the Lionsgate S-4 filed on November 4, 2016).

Prior to the acquisition, Lionsgate operated two primary businesses – motion picture production and television production. Over the last decade, the company has become a leading film production studio, releasing a number of critically acclaimed and Oscar-nominated titles. Most recently, Lionsgate produced *La La Land,* which received multiple Oscar nominations in 2017. It also developed the highly successful *Hunger Games* series of movies that became one of the higher grossing theatrical releases of all time.

The company's television production efforts have also achieved a fair amount of success over the last decade. It currently produces one of the more popular original-scripted series, *Orange Is The New Black,* and Lionsgate also owns the *Twighlight* series, which was a vampire-themed production viewed widely by younger audiences.

Starz is primarily a premium cable network channel that distributes content produced by other studios. It is a pay service commonly found on most cable and satellite television distribution platforms. This channel can also be purchased, for a monthly fee of $8.99, on various mobile phone applications. In this way, Starz is a competitor to the increasing number of content outlets, such as Amazon Prime, Netflix, Hulu, and others, all of which charge a monthly user fee in the neighborhood of $10.

Starz has increased its subscriber base from 18 million in 2010 to 24.5 million in 2016. The StarzEncore package of channels currently has 31 million subscribers. Of the three main premium pay cable networks, which are HBO, Showtime and Starz, Starz is the second largest by subscribers (HBO has 33.6 million subscribers and Showtime 23.9 million).

Starz has also begun to create its own original content, following a trend throughout the industry. It has released a series called *Power,* which is the second most watched series among the three premium pay channels.

Individually, Lionsgate was a content production company and Starz a distribution business. The marriage of these two assets effectively creates a broadly diversified media content and distribution company. Lionsgate will have a subscriber base of over 20 million viewers to which it can distribute its motion picture and television content. Starz can rely less on the increasing cost of third-party content and instead focus on the distribution of the Lionsgate library.

The New Lionsgate

One of the more obvious benefits of this transaction is that Lionsgate, in the earnings sense, should become a less volatile company. Despite a growing television production business, which in and of itself has some volatility, the pre-merger company relied heavily on its motion picture business. Some titles, such as *Hunger Games*, did extremely well at the box office, while many others did not. It is literally a hit-or-miss business. As shown in the following table, nearly two-thirds of the company's revenues were generated from motion pictures. However, the addition of Starz will reduce motion picture revenues to 23% of the total. The recurring and more consistent subscriber-associated revenues from Starz (now renamed the "Media Networks" segment) as well as other related revenues will contribute 63% of total sales.

Table 1: Transformation of the Lionsgate Revenue Profile

Pre-merger Lionsgate		**Post-merger w/Starz**	
Revenue Contribution:		Revenue Contribution:	
Motion Picture	61%	Media Networks	63%
Television Production	39%	Motion Picture	23%
		Television Production	14%

This will be very important because the motion picture business, at times, even caused Lionsgate to operate at a loss. The unpredictable nature of the company's earnings undoubtedly suppressed the valuation multiple investors were willing to accept.

Table 2: Recent Lionsgate Operating History

Fiscal Year	Revenues	EBIT
2016	$2,347	($25)
2015	2,400	222
2014	2,630	260
2013	2,708	273
2012	1,588	33
2011	1,583	63

On a combined basis, or assuming the transaction had been completed during the nine months ending on December 31, 2016, Lionsgate produced $446 million of EBITDA (the company reports this as OIBDA, or operating income before depreciation and amortization). This compares to $432 million of EBITDA reported during the same period in 2015.

Table 3: Combined Lionsgate/Starz Operating Results

	Nine Months Ended December 31, 2016	2015
Total Segment Profit	$446	$432
Corporate General Expenses	(68)	(54)
Adjusted OIBDA	$378	$378
Depreciation & Amortization	(27)	(22)
Restructuring	(104)	(18)
Share-based Compensation Expense	(69)	(71)
Purchase Accounting Adjustments	(25)	(4)
Operating Income (EBIT)	$153	$263

The company's new debt structure is comprised mostly of 5-8 year term loans and maturing bonds. As debt was issued to finance the cash portion of the Starz payment, Lionsgate now has $3.75 billion of debt outstanding, and $595 million in cash. The weighted average interest rate is slightly under 4%, amounting to $140 million of estimated annual interest expense. While it will have over 3x interest coverage, a near-term priority will be deleveraging the balance sheet.

Table 4: Pro-Forma Lionsgate Balance Sheet

	Maturity	Amount	Terms	Effective Rate	Est. Annual Interest Expense
Revolver	5 Years	$50	Libor + 250	3.25%	$2
Term Loan A	5 Years	1,000	Libor + 250	3.25%	33
Term Loan B	7 Years	2,000	Libor + 300	3.75%	75
Bond	8 Years	520	5.875%	5.875%	31
Total		$3,570			$140

Valuation

While mention has been made of the variability in historical earnings, it is important to note that each title that is released increases the film or content library. This library is a source of future licensing or royalty income that is actually quite valuable. Much of the initial revenues of current releases is consumed by the production and marketing costs associated with development. The investor community, as would be expected, reacts to the outcome of each release, causing great share price uncertainty.

Yet, it is somewhat incorrect to assess the success or failure of a motion picture or television production based on the immediate revenue generated. Future sales, which can be earned over a period of years or decades, require virtually no associated expense. These sales come in the form of licensing contracts covering future replay or distribution, consumer products, and other related product sales. Thus, near-term volatility is nearly unavoidable, but this should not distract from the longer-term value that is created by an increasingly larger content library.

In any case, the addition of Starz should arrest some of the uncertainty that has followed Lionsgate over the years. Over the last three years, Starz generated on average $429 million of operating income (EBIT).

Table 5: Historical Starz Operating Income

Year	Revenues	EBIT
2015	$1,700	$410
2014	1,664	452
2013	1,778	425
2012	1,631	405
2011	1,614	425

In the 2013-2015 fiscal year period (ending March 31), on average Lionsgate produced $252 million of operating income (fiscal year 2016 was removed as it was a loss year), as demonstrated below.

Table 6: Historical Lionsgate Operating Income

Fiscal Year	Revenues	EBIT
2016	$2,347	($25)
2015	2,400	222
2014	2,630	260
2013	2,708	273
2012	1,588	33
2011	1,583	63

The simple combination of these two companies would result in $681 million of EBIT. After subtracting the interest expense, as calculated previously, of $140 million, and a 35% tax rate, this implies net income of $352 million. Using the 227.7 million shares outstanding produces $1.55 of earnings per share. This should be viewed relative to the current consensus estimate of $1.17/share for the next fiscal year. It might be noted that the range of estimates, which comprises 14 total analysts, is $0.54 to $2.32/share, suggesting that the analyst community has little idea of the actual profit Lionsgate will report.

Of course, there are bound to be redundancies within the two companies. Last year, Lionsgate incurred $2.372 billion of operating expense, while Starz reported $1.29 billion of costs, for a total of $3.662 billion. Let us assume that management is able to achieve an elimination of expenses on the order of 5%, or $183 million. This would add to after-tax earnings by $119 million, or $0.52/share.

This indicates that the company could earn $471 million of net profit, or $2.07/share. The Class B non-voting shares trade at a $24.02, a 7.2% discount to the voting shares. Using the Class B share price, the implied p/e ratio is 11.6x.

Comparatively, the multiples of other media network companies also trade at low valuations. For example, AMC Networks trades at 9.3x current year earnings, Scripps Networks at 14.5x, and Discovery Communications at 12.7x. It should be noted that Lionsgate paid $3.7 billion for Starz, which is a 15.5x multiple relative to the Starz 2015 net income of $236 million.

By simply using these comparable multiples, it is easy to conclude that Lionsgate is not egregiously undervalued. However, the inverse of the implied 11.6x p/e ratio, or the earnings yield, is 8.6%. Since these earnings are almost entirely free cash flow, this is also effectively the free cash flow yield. Assuming the company could do no better than earn this level of profit, one's going-in implied rate of return would be 8.6% annually.

At this level, Lionsgate trades at a 37% discount to the 2017 estimated S&P 500 p/e of 18.3x (Importantly, this p/e incorporates operating, not reported or GAAP earnings. If reported on actual earnings, the 2017 p/e would be 20x, and roughly a 25x multiple on 12-month trailing reported earnings – the S&P 500 companies are actually more expensive than is commonly reported). This should really bring into question the company's low valuation, as it is now a John Malone-influenced entity at a transformational stage. It has a large content library that is growing with each passing month, such that highly-valued licensing revenue will increasingly become a significant component of the company.

Its shares, however, are not part of the indexation product community, and therefore have been ignored by the vast majority of equity investors. If they were, the lucky owner of the shares might book a nearly 60% gain, care of a revaluation to a market multiple, simply through its inclusion into the programmed trades and asset flow reserved for passive equity funds. In fact, here is an interesting observation. Lionsgate, a $5 billion media company that is well covered by Wall St. analysts, is not even included in the lone traditional media ETF, the PowerShares Dynamic Media Portfolio (Ticker: PBS, $147 million of AUM). Lionsgate is a very modest position in a few small cap equity ETFs, but not in industry-specific funds? Is this not yet another example of the increasingly bizarre behavior (or complete lack of fundamental analysis/consideration) of ETF creators?

Beyond this fairly imaginative scenario, which is entirely out of the control of the fundamentals-based investor, there are other areas of optionality. For example, Lionsgate has over $500 million of net operating loss carryforwards that may be used to reduce future income taxes. Hence, the earnings scenario presented above could be understated, as the tax rate will not be 35%, it will likely be some lower figure over the next few years until the credits are depleted.

As well, Lionsgate owns 31.2% of EPIX, which is a premium pay cable network that is distributed on most cable and satellite television distribution systems. This company, a partnership between Lionsgate, Viacom, and MGM, has grown rapidly since its formation in 2008. In fact, it is the fourth largest premium pay cable network in the U.S., behind in subscribers to only HBO, Showtime, and Starz. The following table outlines the EPIX operating history since 2008.

Table 7: EPIX Operating Results

Year	Revenues	Operating Income
2016	$414	$168
2015	443	167
2014	353	91
2013	338	79
2012	326	72
2011	201	(32)
2010	n/m	(100)

When formed, EPIX served as a distribution platform for the Lionsgate content. This need no longer exists with the addition of Starz. Thus, it has been reported that Lionsgate intends to sell its stake in EPIX, perhaps to one of the other two owners.

As a standalone business, EPIX is quite valuable. Assuming that no additional debt would be placed on this company, it could generate $109 million of net income ($168 million of operating income taxed at 35%). At a p/e of 15x, the business would be worth $1.638 billion, or $511 million net to Lionsgate. If sold, these proceeds would amount to roughly 9%-10% of the company's market capitalization, which could be used to repurchase shares or repay debt. Relative to Lionsgate's initial investment of $80 million, this has been a rather lucrative experience.

On a final note, John Malone owned 3.3% of the Lionsgate shares prior to the transaction with Starz. He will now own over 7% of the total shares outstanding and approximately 10% of the voting power. Given his history, it is all but impossible that Lionsgate will not engage in future transactions. He has interests in a number of content assets as well as in distribution platforms. With valuations quite low throughout the media industry, it is an area ripe for creative consolidation. Lionsgate and its shareholders stand in a prime position to receive such rewards.

Conclusion

Lionsgate recently completed the acquisition of Starz, thereby creating a rather powerful media content and distribution company that should have considerably more earnings predictability than was historically produced by Lionsgate. The market is decidedly pessimistic in its assessment of media companies, such that the potential merits of this transaction have all but been ignored. The company now trades at a p/e ratio of under 12x possible earnings, creating a free cash flow yield of almost 9%. The involvement of John Malone, now a significant shareholder and Director, leaves to the imagination a number of value-enhancing maneuvers that may come to pass. Before that happens, one is able to acquire these shares at a massive discount to the S&P 500, and invest alongside the most astute media investor of the last century. Accordingly, the shares are recommended for purchase.

LIONS GATE ENTERTAINMENT CORP.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

	December 31, 2016	March 31, 2016
	(Amounts in millions, except share amounts)	
ASSETS		
Cash and cash equivalents	$ 595	$ 58
Restricted cash	3	3
Accounts receivable, net	777	570
Program rights	236	—
Other current assets	259	237
Total current assets	1,870	868
Investment in films and television programs and program rights, net	1,816	1,458
Property and equipment, net	168	43
Investments	357	464
Intangible assets	2,024	11
Goodwill	2,734	535
Other assets	405	321
Deferred tax assets	6	134
Total assets	$ 9,380	$ 3,834
LIABILITIES		
Accounts payable and accrued liabilities	$ 531	$ 355
Participations and residuals	499	437
Film obligations and production loans	257	663
Debt - short term portion	118	40
Deferred revenue	180	246
Total current liabilities	1,585	1,741
Debt	3,457	825
Participations and residuals	304	170
Film obligations and production loans	162	52
Other liabilities	33	23
Dissenting shareholders' liability	886	—
Deferred revenue	76	82
Deferred tax liabilities	461	—
Redeemable noncontrolling interest	94	91
Commitments and contingencies (Note 16)		
SHAREHOLDERS' EQUITY		
Class A voting common shares, no par value, 500,000,000 shares authorized, 78,811,162 shares issued (March 31, 2016 - no shares issued)	582	—
Class B non-voting common shares, no par value, 500,000,000 shares authorized, 120,964,447 shares issued (March 31, 2016 - no shares issued)	1,813	—

Common shares, no par value, no shares issued (March 31, 2016 - 146,785,940 shares issued)		—		886
Retained earnings (accumulated deficit)		(52)		8
Accumulated other comprehensive loss		(21)		(44)
Total shareholders' equity		2,322		850
Total liabilities and shareholders' equity	$	9,380	$	3,834

LIONS GATE ENTERTAINMENT CORP.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2016	2015	2016	2015
	(Amounts in millions, except per share amounts)			
Revenues	$ 752	$ 671	$ 1,945	$ 1,556
Expenses:				
Direct operating	430	404	1,183	927
Distribution and marketing	175	203	522	428
General and administration	89	57	235	180
Depreciation and amortization	13	3	23	7
Restructuring and other	52	13	70	18
Total expenses	759	680	2,033	1,560
Operating loss	(7)	(9)	(88)	(4)
Other expenses (income):				
Interest expense				
Cash interest	24	12	50	33
Discount and financing costs amortization	3	2	8	7
Total interest expense	27	14	58	40
Interest and other income	(1)	—	(4)	(2)
Gain on Starz investment	(20)	—	(20)	—
Loss on extinguishment of debt	28	—	28	—
Total other expenses, net	34	14	62	38
Loss before equity interests and income taxes	(41)	(23)	(150)	(42)
Equity interests income (loss)	(2)	11	11	29
Loss before income taxes	(43)	(12)	(139)	(13)
Income tax benefit	(12)	(45)	(92)	(44)
Net income (loss)	(31)	33	(47)	31
Less: Net loss attributable to noncontrolling interest	—	8	—	8
Net income (loss) attributable to Lions Gate Entertainment Corp. shareholders	$ (31)	$ 41	$ (47)	$ 39
Per share information attributable to Lions Gate Entertainment Corp. shareholders:				
Basic net income (loss) per common share	$ (0.19)	$ 0.27	$ (0.31)	$ 0.26
Diluted net income (loss) per common share	$ (0.19)	$ 0.26	$ (0.31)	$ 0.26
Weighted average number of common shares				

outstanding:								
Basic		161.4		149.5		152.2		148.5
Diluted		161.4		159.4		152.2		154.4
Dividends declared per common share	$	—	$	0.09	$	0.09	$	0.25