DL Research

Institutional Equity Research
Initiation Report

October 27, 2013 | Media and Broadcasting

Stock Rating:

BUY

12-month Price Target	**$26.10**
TSX: CJR.B (10/25/2013)	$23.67

52-week Range	$21.67-$26.49
Shares Outstanding	84.4MM
Float	76.2MM
Avg. Daily Trading Vol.	123,466
Market cap	$2.00B
Dividend/Div Yield	$1.02/4.31
Fiscal Year Ends	August 31

FY2013 (Price as of October 25, 2013)	
P/B	1.73
P/LTM EPS	12.21
ROE	12.9
EBITDA Margin	33.6
Earnings per share	1.65

All prices in $C unless otherwise noted

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Corus Entertainment Inc.

Turnaround Ahead
— Massive Boost in Television Revenue in FY2014

- Corus Entertainment Inc. (TSX: CRJ.B) is the only large pure-play media company in the Canadian market. As the “last samurai”, Corus appears solidly positioned to take advantage of the pending asset acquisitions from BCE Inc. (TSX: BCE) and Shaw Communications Inc. (TSX: SJR.B). We project that the acquisitions will increase Corus’s revenue by about 14% in FY2014.
- Relative to other media and broadcasting companies in the Canadian and U.S. market, Corus appears undervalued with its stable EBITDA margin, consistent ability to generate strong free cash flows, and its shares currently changing hands well below the industry average P/E and at a slight discount to the company’s average since the 2008/09 recession.
- We believe the Canadian government’s potential plan to unbundle television channel packages has limited negative implications on Corus: 1) under a pick-and-pay scheme, the company will generate more premium advertising revenue; 2) the government will strike a balance between meeting shifts in consumer tastes and protecting Canadian media and jobs; 3) with a handful of large players, the highly-concentrated Canadian telecommunications and media industry has significant political influence; 4) a detailed plan on television unbundling won’t be announced until 2015.

<u>Recommendation:</u>

We are initiating coverage on the company with a BUY rating and a 12-month target price of $26.10. In valuing the company, we utilized three fundamental valuation methods: 1) EV/EBITDA; 2) P/Levered FCF; 3) Discounted cash flow. The EV/EBITDA multiple is currently at its highest level (9.1x) since the 2008/09 recession. The relatively high multiple was primarily a result of: 1) recovery in the economy; 2) “scarcity premium” resulted from the shrinking pool of players in the media and broadcasting industry in the country; 3) the allure of the consistent dividend increases in the prolonged low interest rate environment. For FY2014, we expect the economy to continue subdued recovery. As the “scarcity premium” and the “allure of dividend” have been factored into the current level of EV/EBITDA multiple, we are forecasting relatively constant EV/EBITDA multiple in this year (i.e., unless there is any key development that increases the likelihood of Shaw’s takeover of Corus). We also expect the P/Levered FCF multiple to remain stable. Our 12-month price target of **$26.10** is the weighted average of prices form the three valuation methods.

Exhibit 1

	FY2010	FY2011	FY2012	FY2013
EV/Adj. EBITDA (x)	8.7	7.6	8.8	9.1
Levered FCF Yield (%)	4.9	9.6	6.5	7.5

Company Overview:

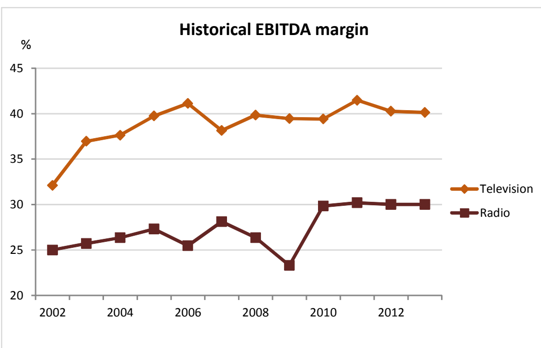
Corus Entertainment Inc. was founded as a separate division of Shaw Communications in 1998. Corus was spun off as a separate public traded company from the parent Shaw in 1999. It operates in three business lines, including radio broadcasting, television and merchandising. In FY2013, the radio business was the third largest in Canada with about 26% market share (i.e., after BCE Inc. (TSX: BCE) and Rogers Communications Inc. (TSX: RCI.B)) and accounted for 23% of Corus's revenue. Television and merchandising business generated the remaining 77% revenue, while 42% revenue in television came from Corus's top three pay and specialty channels (i.e., Movie Central, YTV and W Network).

Investment Thesis:

The recent acquisition of Astral Media by BCE Inc. has provided Corus with an opportunity to acquire significant television and radio assets from Astral-BCE. On March 4, 2013, Corus reached an agreement with BCE Inc. to acquire the remaining 50% interest in TELETOON (i.e., including TELETOON, TELETOON Retro and TÉLÉTOON Rétro), Cartoon Network (Canada) and 50% interest in French-language specialty channels Historia and Series+. Upon the Canadian Radio-television and Telecommunications Commission ("CRTC") 's approval and the successful completion of the transactions, we expect Corus to strengthen its dominant position in women and children's television verticals and potentially achieve some synergies in the form of operational and programming efficiencies. Separately, Corus is acquiring the remaining 50% interest in Historia and Series+ from Shaw. The CRTC hearing on the proposed acquisitions will commence on November 5, 2013, and a decision is expected by end of 2013 calendar year. We anticipate approval by the CRTC and the closure of the transactions by early 2014 calendar year.

We project the acquisitions will bring about $98mm additional revenue and increase EBITDA in the television segment by about 18% in FY2014. By conservatively not incorporating any cost synergy, we are looking for 6% ($0.12 per share) increase in levered FCF. In the meantime, given Corus's long history of consistent dividend increases and stable EBITDA margin (Exhibit 2), we anticipate dividend to grow by 6% and reach $0.09 per month in FY 2014; this is equivalent to a 4.56% rate of return at the current price level. We believe Corus's high dividend growth profile will continue to attract "income-oriented" investors in the prolonged low interest rate environment.

Exhibit 2



After BCE's takeover of Astral Media, Corus is the only large pure-play media company remaining in the Canadian market. We believe that the acquisition of the last company in this space is merely a matter of timing. Given the large controlling stake held by the Shaw family, we consider Shaw Communications Inc. as the most likely acquirer. The potential acquisition would allow Shaw to double the size of its media business and realize considerable overhead cost savings on a combined media expense base of $1.2bn (i.e., Corus and CanWest Media combined). As well, it would better position Shaw to compete against BCE in terms of cost structure and access to media content. Based on recent transaction multiples (e.g., acquisitions of Astral Media by BCE Inc.), we expect the takeout price to be in the neighbourhood of $29, which would have positive implications for Corus's share price. At the very least, this potential should provide substantial downside protection for the share price of Corus.

Financial Forecasts:

Exhibit 3

Key Financial Measures	2010	2011	2012	2013	2014E	2015E	2016E	2017E	2018E
Revenue									
Advertising	435	407	386	381	491	506	521	536	553
Subscriber	283	300	298	299	299	299	299	299	299
Merchandising	118	137	158	123	125	125	125	125	125
Total	836	844	842	804	915	930	945	960	977
Direct Cost of Sales									
Amortization of Film Rights and Investments	204	216	218	216	247	251	255	259	264
Others	368	338	334	318	349	354	359	364	370
Total	572	555	552	534	596	605	614	623	633
Capex									
PP&E	82	46	19	13	18	19	19	19	20
Film rights and investments	219	179	238	231	238	242	246	250	254
Total	301	225	257	244	256	260	265	269	273
FCF to Shareholders									
EBITDA	264	289	290	270	319	325	331	337	343
Interest Expense	(47)	(59)	(52)	(46)	(62)	(62)	(62)	(62)	(62)
Income Tax Payable	(35)	(56)	(57)	(40)	(61)	(62)	(64)	(65)	(67)
Non-controlling Interest	(6)	(7)	(7)	(6)	(6)	(6)	(6)	(6)	(6)
Amortization of Film Rights and Investments	204	216	218	216	247	251	255	259	264
Capex	(301)	(225)	(257)	(244)	(256)	(260)	(265)	(269)	(273)
Total	79	159	135	150	181	185	190	194	199
Profitability									
EBITDA Margin	32%	34%	34%	34%	35%	35%	35%	35%	35%
FCF to Shareholders	9%	19%	16%	19%	20%	20%	20%	20%	20%

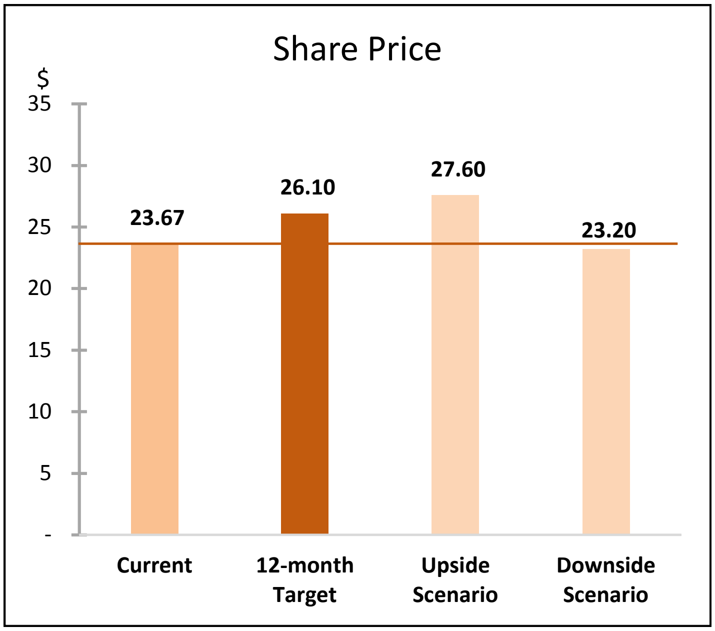
Corus reported $803.5mm revenue for FY2013: 47% from advertising; 37% from subscribers; 15% from merchandising. The weights of these three segments in total revenue have remained relatively stable in the past four years. For FY2014, we anticipate a soaring year for television on the basis of Corus's acquisitions of the popular specialty television channels from BCE and Shaw, in particular TELETOON (i.e., the remaining 50% interest) and the two French-language channels, H&S. H&S and TELETOON generated revenue of $50mm and $84mm, respectively, in FY2012. In the radio business, Astral Media was once the largest radio broadcaster in the country. Acquiring two Ottawa radio stations from BCE will expand Corus's radio platform into the Ottawa market and generate additional revenue. Though Corus's revenue in radio has declined by about 6% in the past two fiscal years (primarily in the Toronto and Edmonton markets), its acquisition of the two Ottawa radio stations, which were sold by Astral Media to BCE in 2013, coupled with the management's commitment in rock music (i.e., a niche market strategy in the current market trend) will bring a recovery year for the radio business. For FY2014, we anticipate advertising revenue to grow by 28.7%. In the merchandising business, Beyblade is on the downward side of its life cycle and will further decline in FY2014. With the newly acquired Emmy Award winning studio Toon Boom Animation Inc. , planned Mike the Knight merchandise and further development in its content business offsetting the decline in Beyblade, Corus is expected to have a flat year in merchandising. Though the OTT wave threats Corus's pay television business, and to a lesser extent, specialty television business, it can stimulate growth in revenue from merchandising and content business. Overall, revenue in merchandising is projected to grow by 1.6% this year.

Corus's EBITDA margins have remained relatively stable over the past four years (i.e., 23-30% in radio and 39-40% in television). We anticipate the margin to remain within the range this year. That being said, pro-forma EBITDA is estimated to grow by 18% in FY2013.

Valuation:

Exhibit 4

Calculation of Target Price	2013 *	2014E	2015E	2016E
EBITDA Per Share	3.21	3.76	3.78	3.82
FCF to Shareholders Per Share	1.78	2.13	2.16	2.19
EV Per Share				
Equity	23.67	25.08	27.79	31.70
Debt	5.38	8.88	6.44	2.81
Non-Controlling Interest	0.22	0.21	0.21	0.21
Total	29.27	34.17	34.44	34.72
Method 1: EV / EBITDA Multiple				
EV / EBITA Multiple	9.13	9.10	9.10	9.10
Price	23.67	25.08	27.79	31.70
Method 2: P / FCF Multiple				
P / FCF Multiple	13.32	13.30	13.30	13.30
Price	23.67	28.36	28.73	29.10
Method 3: DCF (Levered CF)				
Cost of equity	12.0%	12.0%	12.0%	12.0%
Price	23.67	24.79	25.13	25.47
Weighted Average	23.67	26.10	27.20	28.80



* Share price is as of Oct 25, 2013

Our 12-month target price is **$26.10**. This estimate reflects the closure of assets transfer from BCE in early 2014 calendar year and the associated debt financing. No other organic revenue growth is assumed other than a 3% annual increase in advertising. Margins are assumed to remain constant over time.

The price target is derived as the average of prices from three fundamental valuation methods: (i) EV/EBITDA multiple approach, where we applied a target multiple of 9.1 to F2014 EBITDA; (ii) P/Levered FCF multiple approach, where we applied a target multiple of 13.3 to FY2014 levered FCF; (iii) DCF approach, where we discounted leveraged free cash flows attributable to shareholders using a cost of equity at 12%.

We had also estimated the share price under an upside and a downside scenario. The upside scenario incorporates an expansion of revenue in the subscription and merchandising segments at a rate of 3% per year, like the advertising segment, and yields a share price of $27.60. The downside scenario reflects failure to acquire assets from Bell Media due to a CRTC ruling, and yields a share price of $23.20.

Price Target Impediments:

Macroeconomic environment The overall state of economy has a large impact on the level of advertising expenditures. Canadian economy is currently undergoing a weak cyclical recovery from the recession. The growth in the Canadian GDP slowed to 1.7% in 2012 from the 2.5% increase in 2011 and has continued at a weak rate in 2013. Given the contemporaneous uncertainties in the U.S. economy, we anticipate the growth in the Canadian economy to remain on the weak recovery track in 2014. However, any unexpected material downswings in the economy could negatively affect Corus's advertising revenue and pose downward pressure on the stock price.

Regulatory framework

1) Corus's acquisition of Bell and Shaw assets, including TELETOON, TELETOON Retro, TÉLÉTOON Rétro, Cartoon Network (Canada), two French-language networks (i.e., Historia and Séries+) and two Ottawa radio stations (i.e., CKQB-FM and CJOT-FM) is pending approval by the CRTC. Hearing will commence on November 5, 2013, and a decision is expected by the end of December. While it is highly expected that the CRTC will approve the transaction, any delay or unexpected impediment will have negative implications for Corus.

2) A plan to unbundle television channel packages was highlighted in the Throne Speech on October 16, 2013. The CRTC also commenced a public consultation on October 24, 2013 and will launch a formal review in the spring of 2014 to redesign Canada's regulatory framework for broadcasters in response to an evolution in the way Canadians consume media content. The CRTC's review of the regulatory framework and the pick-and-pay scheme represent uncertainties and challenges for Corus. However, we believe that: a) a detailed plan to unbundle television channel packages and a new regulatory framework won't be announced before 2015; 2) the CRTC will try to strike some form of balance between meeting shifts in consumer tastes through providing pick-and-pay television and protecting Canadian media industry and jobs. That being said, with over 50% revenue exposure to specialty and pay television, Corus will face challenges in the short term if the CRTC revolutionize the regulatory framework. In the long term, television unbundling could actually prevent further cord-shaving and cord-cutting and have positive implications for the traditional media and telecommunications industry.

Lower-than-expected revenue in merchandising Beyblade is anticipated to further decline with no replacement in FY2014. Mike the Knight, a top five performer on Corus's Tree House channel is scheduled to hit the retail with special price and is expected to somewhat offset the decline from Beyblade. Corus has some other products in the pipeline but no other immediate plan to carry out to boost merchandising revenue in FY2014. Therefore, we expect the revenue growth in merchandising and content business to be flat in 2014. That being said, any larger-than-expected decline in Beyblade or lower-than-expected revenue in Mike the Knight and other merchandising lines will have negative implications for Corus.

Stronger-than-expected OTT infection We anticipate the current OTT wave will have limited disruptive impact on Corus's revenue in television in the next 3-5 years, while bringing some positive implications on the merchandising and content business. However, any stronger-than-expected OTT infection will represent impediment to the price target.

(Note: Table of Comparable Valuation Multiples on the next page)

Exhibit 5

Comparable Valuation Multiples				EV / EBITDA Multiple		P / E Multiple	
	Currency	Symbol	Fiscal Y/E	F2013	F2014	F2013	F2014
Broadcasting							
Corus Entertainment [1]	CAD	CJR.B	Aug 31	9.1	8.7	14.0	12.3
Newfoundland Capital	CAD	NCC.A	Dec 31	8.2	5.9	12.9	11.4
TVA Group	CAD	TVA.B	Dec 31	5.0	4.8	16.3	13.5
Astral Media [2]	CAD	ACM.A	Aug 31	9.3	n/a	15.7	n/a
LIN Media	USD	LIN	Dec 31	13.6	8.0	46.5	15.2
Entercom Communications	USD	ETM	Dec 31	8.7	8.1	14.2	11.8
Average				**9.0**	**7.1**	**19.9**	**12.8**
Canadian Diversified Telecommunication							
Shaw Communications	CAD	SJR.B	Aug 31	7.1	7.0	14.7	14.2
BCE	CAD	BCE	Dec 31	6.8	6.6	15.0	14.2
Rogers Communications	CAD	RCI.B	Dec 31	7.1	6.9	13.4	12.7
Average				**7.0**	**6.8**	**14.4**	**13.7**
U.S. Media Conglomerates							
CBS Corporation	USD	CBS	Dec 31	11.5	11.0	19.4	17.0
Time Warner	USD	TWX	Dec 31	10.8	10.1	18.8	16.4
Viacom	USD	VIAB	Sep 30	11.6	10.7	18.4	15.5
Walt Disney	USD	DIS	Sep 30	11.4	10.3	20.5	17.6
Average				**11.3**	**10.5**	**19.3**	**16.6**

(1) EV includes anticipated debt financing for the pending acquisition of assets from Bell
(2) Share price as of July 8, 2013