Initiating Coverage at HOLD

Initiating Coverage with a Hold Rating and $105 PT

DIS has been a top performer in media, with the stock price up ~30% from a year ago. We think the stock is fairly valued to slightly ahead of itself, now as the story has become better understood over the past year, investors have sought safer havens within media, excitement over the potential of Star Wars has built up, and earnings estimates have been revised higher.

DIS has a favorably differentiated strategy and asset mix as compared to the rest of the media sector and as a result, has a longer tail on its growth rate, contributing to its valuation premium. ESPN is the leader in sports, where ad trends should be resilient; DIS focuses on fewer, but bigger films that create or leverage IP through the Parks, Consumer Products, Interactive Media, and Media Networks segments; and Disney is the global leader in theme parks.

We estimate Disney will grow revenue (3-year CAGR) at the high end of the sector range (~7%), and profit metrics in the middle of the sector range (~8% EBIT growth). Growth in affiliate, retransmission, and reverse compensation revenue, as well as the Theme Parks, are driving most of Disney’s growth, with Consumer Products also making a meaningful contribution.

Valuation Seems Pretty Full

Our PT is based on our Economic Returns Model, which is a market-based DCF model (WACC 9.0%, derived from our assumptions, including a 2.0% pre-tax cost of debt, 34.0% tax rate, 5.0% equity risk premium, 4% normalized risk-free-rate, and a beta of 1.1). The potential for further multiple expansion appears limited with the stock now toward the upper-end of its historical relative valuation range, trading at about a 22% premium to the S&P 500 2015 earnings multiple. We estimate a 5% average annual equity return over the forecast period based on our forecast and the company’s current market value. DIS runs a less levered balance sheet than most other media companies, which means DIS has to grow more in order to achieve the same equity return. Upside/downside risks include an increase/decline in theme park attendance, an acceleration/deceleration in the ad market, and greater/smaller than expected box office revenues from the upcoming tent pole films.
Investment Thesis

Outlook

Disney’s assets, strategy, growth prospects, and fundamentals make it appealing. However, we think the stock is fairly valued to slightly ahead of itself now as the story has become better understood over the past year, investors have sought safer havens within media, excitement over the potential of Star Wars has built up, and earnings estimates have been revised higher. We think the potential for further multiple expansion is limited with the stock now in the higher end of the historical relative valuation range, trading at about a 22% premium to the S&P 500 2015 earnings multiple.

Valuation

Our PT is based on our Economic Returns Model, which is a market-based DCF model. The model starts by taking the current market value of the company, and calculating the return to shareholders based on our forecasted fundamentals and capital structure. The return on Enterprise Value comes from two sources, the current unlevered FCF yield, and capitalizing the growth/decline in the unlevered FCF annuity stream at the company’s WACC. After forecasting the EV for each year, the capital structure is overlaid to incorporate the benefits of levered equity returns, share repurchases, and equity investments. We do this to remove the high subjectivity level inherent in determining terminal growth rates.

We estimate a 6% average annual equity return over the forecast period based on our forecast and the current market value. This driven by growth in FCF to the firm, a 5% unlevered FCF yield, and shrinking share count.

We calculate the Company’s WACC at 9.0%, derived from our assumptions, including a 2.0% pre-tax cost of debt, 34.0% tax rate, 5.0% equity risk premium, 4% normalized risk-free-rate, and a beta of 1.1.

Upside/downside Risks

- Material increases/declines in pay TV subscribers, which would positively/negatively impact profitability given a high fixed cost base in the Media & Networks business.
- Although we do not believe ad dollars will flee from TV en masse, we believe some marginal ad dollars are shifting to digital. Deceleration/acceleration in digital spending shift or an economic upturn/downturn could positively/negatively impact TV ad revenue.
- Precipitous increases/declines in ratings due to increased/lowered popularity of DIS’s content, measurement attributes/shortcomings, or changes in consumer behavior in response to the proliferation of video streaming services.
- Successful renewing/ failure to renew affiliate agreements with pay TV operators
- An increase/decline in theme park attendance, whether secular or cyclical
- Greater/smaller than expected box office revenue from the upcoming tent pole films.
- An increase/decline in the popularity of DIS’s franchises, characters and brands
Company Analysis

Disney’s Strategy and Asset Mix Is Different from the Rest of the Media Sector

ESPN Is One of the Best Assets in Media
Its brand is synonymous with sports; it has long-term contracts for the broadest rights portfolio across the most important professional and college sports; its share of sports viewership and digital traffic exceeds all other competitors by a wide margin; and it is indispensable for pay TV distributors and the majority of households. ESPN offers advertisers many benefits: ~95% of viewership is live, ESPN’s commercial pods are shorter with less ad clutter, and ESPN is one of the few networks with digital scale and strength in the M18-34 demographic.

Leveraging Intellectual Property
Disney’s intellectual property (IP) portfolio lies at the center of its business strategy. The company creates, builds, and acquires IP on a greater scale than any other, which is leveraged across all of its businesses - theme parks, films, consumer products, interactive media, television, and video licensing. For every franchise, there is typically a film, theme park attractions, consumer products, video games and/or apps, some kind of online video element, and potentially a television component. No other company does this as well or as consistently as Disney, in our view.

Disney Goes Big in Movies
Disney’s Studio Entertainment businesses focus primarily on creating and continuing to leverage franchises ranging from very popular to iconic. Disney owns the vast majority of its films, and it makes only half as many as other major studios, but they tend to be bigger films with the goal of achieving bigger box offices and longer revenue tails through exploitation in Disney’s other businesses.
ABC Is Light on Sports, But Still a Leader in Entertainment and Female Audiences

ABC does not have as robust a sports portfolio as CBS, NBC, or Fox because Disney has put those rights into ESPN. However, it is still a leader in television viewership, and has growing retransmission and reverse comp revenue streams, and it over-indexes to female demographics as compared to other broadcast networks.

Disney Has Significant Leverage in Affiliate Negotiations

We believe ESPN is the most important network for pay TV operators to carry, practically ensuring future renewals on terms acceptable to Disney. Since Hearst owns 20% of ESPN, it is conceivable that a distributor could renew ESPN without renewing DIS’s other networks. However, we believe that ABC and The Disney Channel are strong enough on their own to ensure attractive renewal terms on these two networks, as well as ABC Family, Disney XD, and Disney Junior.

The Leading Theme Park Operator

Disney’s theme parks, resorts, and cruise lines continue to gain in popularity and grow on the back of investments into new attractions, international expansion, improving the guest experience, and price increases. We are projecting Shanghai to be a significant revenue driver by 4Q16, and a small contributor to EBITDA beginning in 2018 (after backing out the minority interest of the Shanghai partner).

Favorable Revenue/OI Mix

Disney’s total ad revenue as a percentage of consolidated revenue is only 16% and as a percentage of non-studio revenue it’s 19%. We estimate that about 45% of DIS’ ad revenue is ESPN, which we think will hold up well even as the TV ad model plays catch-up with consumer behavior and some TV ad spending shifts to digital. We think ESPN is very well-positioned in digital advertising because sports is a leading genre for mobile video usage, and ESPN is the overall leader in sports viewership by a wide margin.

Figure 3: Revenue growth by type (USDm)

Source: Company data, Deutsche Bank
Figure 4: Revenue growth rates by type

Source: Company data, Deutsche Bank

We estimate the ABC network and O&O stations are about half of the total advertising revenue, while ABC Family and the Disney Channels represent about 5%. ABC’s ratings performance has been good this season, with solid contributions from new shows Black-ish and How to Get Away with Murder. We are forecasting slightly declining advertising revenue for ABC over the forecast period.

Figure 5: Broadcast Networks Primetime L+7 Total Viewers

Source: Nielsen, Deutsche Bank
Forecast Discussion

Please refer to our Income Statement (Fig. 10)

Fiscal Year 2015
We expect revenue to grow 7% and OI to grow 12%, driven mostly by Cable Networks and Parks, with about 200 bps of incremental growth from the benefit of a 53rd week in the fiscal year, which occurs every 6 years in FQ4 due to Disney closing its books each quarter on the Saturday before the last day of the month. We estimate that this adds ~7.7% to Q4 growth in virtually all segments except for Studio Entertainment, content licensing revenue, and Interactive Media. Including this impact, for the full year, we estimate Cable Networks will grow revenue by 10%, Broadcasting by 4% (8% growth in content licensing and 38% growth in retrans & reverse comp), and 10% from Parks.

Studio Entertainment faces tough comps from Frozen and we model a 4% decline in revenue and 15% decline in OI. We continue to expect strong growth from Consumer Products from both traditional and new character-based merchandising/ licensing sales. We also model $5 billion in share buybacks for the FY keeping in mind its historical gross debt to EBITDA ratio (including $3.5 billion in unfunded pension obligation) of ~1.5x. Management has guided to a $150 million OI headwind from higher pension expense and a $75 million hit from forex for the year.

Fiscal 2015
We expect revenue growth of 4% and an OI decline of 5%. Studio Entertainment and ABC are a revenue drag due to tough film comps and weakness in ad revenue at ABC, while costs related to the new college football playoff series and NFL renewal weigh on margins. ESPN ad revenue should be up significantly (we estimate 18%), driven by college football.

Although ABC quarter-to-date is faring well in ratings YoY with the help of new hits Black-ish and How to Get Away with Murder, we do not believe the network is immune to the secular decline in TV ratings and tepid ad market. We model a 1% core ad revenue decline at ABC and -3% at the TV Stations.
We expect further margin expansion at Parks as previous margin drags from cost step-ups related to new initiatives such as Fantasyland expansion at Orlando (now complete) and My Magic Plus continue to ease. Studio Entertainment faces tough comps from Frozen, Iron Man 3, and Monsters University vs. this year's Cinderella, McFarland and Strange Magic (a DreamWorks film). We also model $390M in deferred tax write-down charge in Q2, which could appear as late as Q3 according to recent filings, although this should be adjusted out from the reported EPS.

Fiscal 3Q15
We expect revenue growth of 4% and OI growth of 5%. At Cable Networks, ESPN faces a World Cup comp, slowing revenue growth to just 2%, while OI increases by 9% on lower expenses. We continue to model declines in Broadcast advertising (down 2%), and Studio Entertainment should have a big quarter in revenue growth with Avengers: Age of Ultron, while its big budget and associated amortization expense, as well as P&A costs for Inside Out (Pixar) and Ant-Man (Marvel) next quarter should weigh on margins.

Fiscal 4Q15
We expect revenue growth of 11% and OI growth of 34%, partially driven by the inclusion of the 53rd week. The Cable Networks and Parks are driving the lion’s share of revenue and OI growth, due to favorable programming cost comps in cable and favorable expense comps in the Parks, combined with strong revenue growth in both segments. In Broadcasting, we model another 2% decline in advertising revenue, excluding the impact of the 53rd week, while costs drop 3% on an easy comp. Studio Entertainment should continue to benefit from Avengers: Age of Ultron, and the release of Inside Out (Pixar) and Ant-Man (Marvel). We expect revenue growth of 3% and OI growth of 22%.

Fiscal 2016
We estimate revenue growth of 6% and OI growth of 6%, against the onerous comps from the previous year’s inclusion of a 53rd week. Ex-53rd week, we still expect broadcast advertising to be slightly down, while we model Cable Networks advertising to grow at 2%. Combined with other sources of revenue and including the 53rd week comp, we estimate Cable Networks to grow 4% in total revenue and 4% in OI, while Broadcasting revenue grows 1% and OI 12%, which assumes ABC pulls back a bit on programming expenses.

OI Growth at Parks should slow to 5% given Shanghai Disneyland’s opening in spring 2016. On a consolidated basis, we expect Shanghai Disneyland to add $614m in revenue and drag EBITDA down by ~$300m, assuming 7 million in attendance and ~43% average hotel occupancy for the year.

We expect Studio Entertainment OI to be up 14% given a strong slate of theatrical releases including the highly anticipated Star Wars: The Force Awakens and 2 Pixar films (The Good Dinosaur, Finding Dory). We believe Consumer Products should have another year of strong OI growth at 8% (despite the 53rd week comp) driven by Star Wars and Shanghai Disneyland. We estimate $5.5 billion in share buybacks for the year.

Fiscal 2017
We expect revenue to grow 8% and OI 7%. This is driven by 6% growth in revenue in the Cable Networks, with OI growing slightly less at 5% as the new NBA deal kicks in at ESPN. We expect 2% revenue growth in Broadcasting,
benefitting from the Presidential election and 14% growth in retrans & reverse comp. We expect Parks to grow 14% in revenue and margins to contract to 28% (down ~100 bps vs. the previous year) as a full year of Shanghai Disneyland drags EBITDA down. We model 20 million in attendance at Shanghai and a 60% occupancy rate. Walt Disney World should also benefit from the opening of Avatar Land. At Studio Entertainment, we expect revenue to be down slightly on tough comps including Star Wars, but OI to be up 4% on easing costs. We estimate $6.0 billion in share buybacks for the year.

Fiscal 2018
We expect 7% growth in revenue and OI based on largely similar growth at Cable Networks as FY2017, and Broadcasting OI flat on tough political comps. Growth in Parks OI should accelerate to 12%, which is despite our assumption of attendance growth slowing at the domestic parks, more than offset by consolidated EBITDA loss at Shanghai shrinking to -$188m and turning an EBITDA profit of $72m after backing out minority interest. We model $2.8 billion in revenue from Shanghai, assuming 30 million in attendance and a 70% occupancy rate met by our expectation of Disney doubling its hotel capacity in Shanghai. Studio Entertainment revenue should grow modestly at 4% and OI at 1%, with Avengers: Infinity War Part 1 and Star Wars Episode VIII. We estimate $6.5 billion in share buybacks for the year.

Potential Sources of Positive Optionality and Upside to Our Forecast

- Industry-wide improvements in audience measurement and ad delivery that drive higher measured viewership could accelerate growth in ratings and advertising, including beginning to insert current ads into VOD programming played beyond the C3/C7 window; further, the ability to insert targeted “digital” ads into VOD and content streamed to IP devices (i.e. connected TVs, computers, tablets, smart phones), which are sold at higher CPMs than linear ads. See our Sector report for a more in-depth discussion on this topic.
- A stronger TV ad market could benefit DIS by driving advertising pricing higher.
- Stronger than expected results from the Shanghai theme park, scheduled to open in spring 2016; or a turnaround in Disneyland Paris
- Greater than expected box office revenue from the upcoming film slate, including Star Wars, which will be released in December 2015
- Higher growth in consumer products, driven by the film slate in 2015 and beyond, including Star Wars
- Disney could participate in the upcoming broadcast incentive auction, currently scheduled for 2016. The details haven’t been hammered out yet, but Disney could potentially benefit from putting its spectrum up for sale in the auction. However, the impact would be relatively small given Disney’s overall size.
Valuation

DIS currently trades at a 2015 P/E of 22x, 13.1x EV/ 2015 EBITDA, and a 2015 unlevered FCF yield of 3.6%. Our PT of $105 implies a P/E of 19x our 2016 estimate, 11.5x EV/ 2016 EBITDA, and a 2016 unlevered FCF yield of 4.4%.

We estimate a 5.4% average annual equity return over the forecast period based on our forecast and the current market value. Our Economic Returns Model illustrates this below.

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<th>Figure 8: Economic returns model</th>
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<td>CV</td>
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<td>EQR</td>
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<td>Mean Geometric Return Over Period</td>
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Source: Company data, Deutsche Bank
### Figure 9: Comparable Company Valuations

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<td>21st Century Fox, Inc.</td>
<td>BUY</td>
<td>$35.64</td>
<td>$42</td>
<td>17.8%</td>
<td>11.1x</td>
<td>9.9x</td>
<td>8.4x</td>
<td>4.1%</td>
<td>4.9%</td>
<td>6.9%</td>
<td>20.9x</td>
<td>18.9x</td>
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<td>Viacom Inc.</td>
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<td>$83</td>
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<td>8.5x</td>
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<td>11.1x</td>
<td>9.7x</td>
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<td>Liberty Media Corp</td>
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<td>$40.28</td>
<td>$43</td>
<td>6.8%</td>
<td>NM</td>
<td>NM</td>
<td>NM</td>
<td>NM</td>
<td>NM</td>
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<td>NM</td>
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<tr>
<td>The Walt Disney Co.</td>
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<td>$105</td>
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<td>11.6x</td>
<td>10.5x</td>
<td>3.6%</td>
<td>4.4%</td>
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<td>CBS Corp.</td>
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<td>10.1x</td>
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<td>17.7x</td>
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<td>4.1%</td>
<td>4.7%</td>
<td>4.6%</td>
<td>37.8x</td>
<td>31.4x</td>
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Source: Deutsche Bank estimates
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<th>Total Segment Operating Income</th>
<th>Corporate and Unallocated Share Expenses</th>
<th>Restructuring and Impairment Charges</th>
<th>Other Income/(Expense), net</th>
<th>Total Interest Income/(Expense), net</th>
<th>Interest &amp; Investment Income</th>
<th>Income before Income Taxes</th>
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<th>Effective Tax Rate %</th>
<th>Net Income (before M.I.)</th>
<th>Growth % YoY</th>
<th>Net Income attributable to noncontrolling interests</th>
<th>% of Cable Networks &amp; Int’l Parks EBIT ex-Shanghai adjustment</th>
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<td>(214)</td>
<td>(349)</td>
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<td>9,620</td>
<td>(2,984)</td>
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<td>(500)</td>
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<td>(611)</td>
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<td>(294)</td>
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<td>12,246</td>
<td>(4,242)</td>
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<td>3,419</td>
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<td>2,559</td>
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<td>12,496</td>
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Growth % YoY

- Media Networks
- Broadcasting
- Parks and Resorts
- Media Networks Total
- Consumer Products
- Interactive Media
- Studio Entertainment
- Total Segment Operating Income
- Total Operating Income (In-Corp. Costs)

Source: Company data, Deutsche Bank
**Figure 11: DIS Balance Sheet**

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<td>19,740</td>
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<td>Land</td>
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<td>Intangible assets, net</td>
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<tr>
<td><strong>Total Assets</strong></td>
<td>81,241</td>
<td>84,186</td>
<td>88,622</td>
<td>90,438</td>
<td>92,771</td>
<td>95,049</td>
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<td>Accounts payable and other accrued liabilities</td>
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<td>Current portion of borrowings</td>
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<td>6,236</td>
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<td>Commitments and contingencies</td>
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<td><strong>Total liabilities</strong></td>
<td>33,091</td>
<td>36,008</td>
<td>39,485</td>
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<td>39,484</td>
<td>39,792</td>
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<td>-</td>
<td>-</td>
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<tr>
<td>Common stock</td>
<td>33,440</td>
<td>34,301</td>
<td>35,178</td>
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<td>35,978</td>
<td>36,378</td>
<td>36,778</td>
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<td>Retained earnings</td>
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<td>57,869</td>
<td>64,612</td>
<td>71,851</td>
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<td>87,479</td>
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<td>Accumulated other comprehensive loss</td>
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<td>(1,968)</td>
<td>(1,880)</td>
<td>(1,880)</td>
<td>(1,880)</td>
<td>(1,880)</td>
<td>(1,880)</td>
<td>(1,880)</td>
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<tr>
<td>Treasury stock</td>
<td>(34,562)</td>
<td>(41,109)</td>
<td>(46,162)</td>
<td>(51,662)</td>
<td>(57,662)</td>
<td>(64,162)</td>
<td>(71,412)</td>
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<td><strong>DIS Equity</strong></td>
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<td>46,648</td>
<td>48,287</td>
<td>49,814</td>
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<td>Noncontrolling interests</td>
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<td>5,443</td>
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<td><strong>Total equity</strong></td>
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<td>53,287</td>
<td>55,257</td>
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<td><strong>Total liabilities and equity</strong></td>
<td>81,241</td>
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<td>92,771</td>
<td>95,049</td>
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Source: Deutsche Bank
### Figure 12: DIS Cash Flow Statement

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<td>Net income</td>
<td>6,871</td>
<td>8,004</td>
<td>8,622</td>
<td>9,440</td>
<td>10,086</td>
<td>10,821</td>
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<td>Depreciation and amortization</td>
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<td>Deferred income taxes</td>
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<td>517</td>
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<td>Equity in the income of investees</td>
<td>(688)</td>
<td>(854)</td>
<td>(894)</td>
<td>(924)</td>
<td>(971)</td>
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<td>(1,070)</td>
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<td>Cash distributions received from equity investees</td>
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<td>718</td>
<td>744</td>
<td>766</td>
<td>789</td>
<td>813</td>
<td>837</td>
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<td>Net change in film and television costs and advances</td>
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<td>(964)</td>
<td>329</td>
<td>(345)</td>
<td>(263)</td>
<td>(335)</td>
<td>(300)</td>
<td>(300)</td>
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<td>Equity-based compensation</td>
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<td>408</td>
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<td>400</td>
<td>400</td>
<td>400</td>
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<td>Impairment charges</td>
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<td>–</td>
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<td>Other</td>
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<td>234</td>
<td>171</td>
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<td>Changes in operating assets and liabilities:</td>
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<td>(272)</td>
<td>(394)</td>
<td>(108)</td>
<td>(300)</td>
<td>(133)</td>
<td>(124)</td>
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<td><strong>Cash provided by operations</strong></td>
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<td>Investments in parks, resorts and other property</td>
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<td>(3,311)</td>
<td>(4,075)</td>
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<tr>
<td>Other</td>
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<td>397</td>
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<td><strong>Cash used in investing activities</strong></td>
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<td>(3,678)</td>
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<td>(3,500)</td>
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<td>(3,900)</td>
<td>(4,100)</td>
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<td>Commercial paper borrowings/ (repayments), net</td>
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<td>(731)</td>
<td>(500)</td>
<td>–</td>
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<td>(1,500)</td>
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<td>Reduction of borrowings</td>
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<td>Dividends</td>
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<td>(1,975)</td>
<td>(2,218)</td>
<td>(2,458)</td>
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<td>(5,500)</td>
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<td>Proceeds from exercise of stock options</td>
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<td>404</td>
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<td>Other</td>
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<td><strong>Cash used in financing activities</strong></td>
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<td>(6,710)</td>
<td>(5,628)</td>
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<td>(8,458)</td>
<td>(9,251)</td>
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<td>(11,436)</td>
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<td>Impact of exchange rates on cash and cash equiv.</td>
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<td>(235)</td>
<td>(105)</td>
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<tr>
<td>(Decrease)/increase in cash and equivalents</td>
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<td>(510)</td>
<td>2,681</td>
<td>328</td>
<td>647</td>
<td>622</td>
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<td>Cash and cash equivalents, beginning of period</td>
<td>8,159</td>
<td>8,938</td>
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<td>7,700</td>
<td>6,494</td>
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<td>Cash and cash equivalents, end of period</td>
<td>8,938</td>
<td>8,428</td>
<td>6,103</td>
<td>6,431</td>
<td>7,078</td>
<td>7,700</td>
<td>6,494</td>
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Source: Deutsche Bank
Appendix 1

Important Disclosures
Additional information available upon request

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<td>105.57 (USD) 4 Mar 15</td>
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*Prices are current as of the end of the previous trading session unless otherwise indicated and are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

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Disclosures marked with an asterisk may also be required by at least one jurisdiction in addition to the United States. See Important Disclosures Required by Non-US Regulators and Explanatory Notes.

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Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s) about the subject issuer and the securities of the issuer. In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Bryan Kraft
**Equity rating key**

Buy: Based on a current 12-month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield), we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock.

Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

Notes:

1. Newly issued research recommendations and target prices always supersede previously published research.

2. Ratings definitions prior to 27 January, 2007 were:
   - Buy: Expected total return (including dividends) of 10% or more over a 12-month period
   - Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period
   - Sell: Expected total return (including dividends) of -10% or worse over a 12-month period
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