

## **New Media Spin Off Opportunity – Autumn Stock Pitch Competition 2013 – Ben Murison MIFPT2014**

Newcastle Investment Corp (NCT US), Price \$5.86, Market Cap \$1.7bn

New Media offers investors the chance to potentially get exposure to a spin off business whose financial performance is likely to be far superior to what it has been historically due to the forgiveness of \$1.2bn of debt. The company has local competitive advantages shown by its recent pricing power, is very cash generative with return on tangible capital around 20% and is growing quickly in the key digital part of its business. The shares seem to be available at a near free price via the parent company's shares with little downside risk. There has been strong insider buying of the parent company in the run up to the spin off taking place.

### Back Ground

New Media is a company that operates in the "hyper local" newspaper market across the USA. Announced in September this year, the company will likely be spun off from Newcastle Investment Corporation (a US REIT) in Q4 2013.

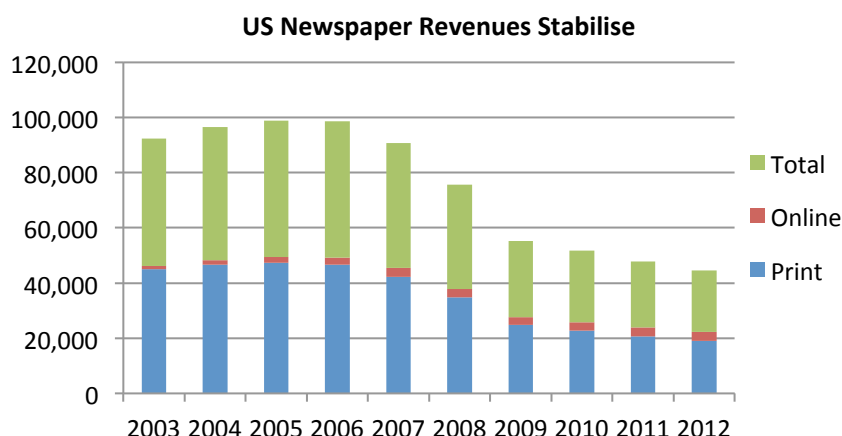
The company is essentially a debt restructuring of the local US newspaper company Gatehouse Media ("Gatehouse") who became overleveraged in the run up to the Great Recession of 2009. Newcastle Investment Corp ("Newcastle") has been a long term investor in Gatehouse bonds and currently owns 52% of the outstanding debt of Gatehouse. Newcastle were able to reach an agreement with the other creditors of Gatehouse in September this year whereby Gatehouse will retain its assets but have the vast majority of its debt removed and will be combined another business called Local Media Group, owned by Newcastle, to form a new spin off company called New Media Investment Group ("New Media").

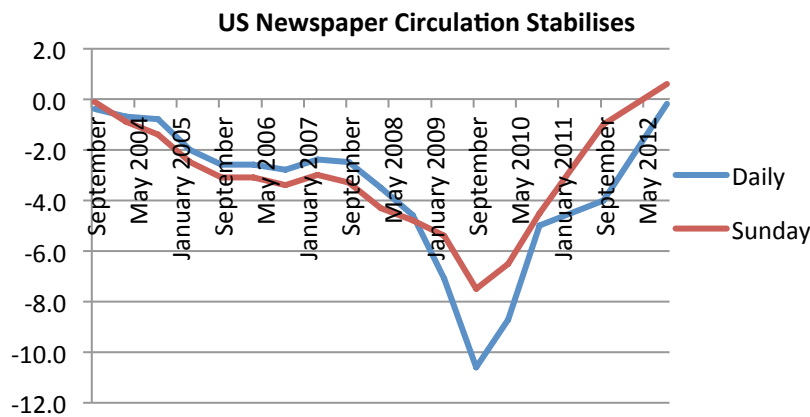
Gatehouse filed for Chapter 11 bankruptcy in September 2013 as part of the restructuring but the creation and spin off of New Media has yet to happen yet. Registration documents for New Media however were filed with the SEC on 27<sup>th</sup> September 2013 and Newcastle Management has indicated that New Media will be spun off in Q4 2013 or Q1 2014.

### The Newspaper Industry

The newspaper industry has admittedly not been a darling of investors in recent times given the rise in the adoption of the Internet and growing digital advertising competition. Many newspapers have failed to come up with an effective digital strategy to offset the shrinking traditional news print market. According to the Newspaper Association of America, US revenues for the industry are down from \$60bn in 2005 to \$36bn in 2012.

There is evidence that the business is beginning to stabilise however. Total revenues and circulation are stabilising and digital pay walls are being adopted causing the proportion of online revenues to grow.





Source: Newspaper Association of America

### Gatehouse

New Media will consist of an amalgamation of the Local Media Group and Gatehouse Media with over 75% of revenue for 2014 expected to come from Gatehouse.

Focusing on Gatehouse specifically, sales and operating income have risen 245% and 80% respectively from 2004 – 2012. Whilst revenues have risen strongly, this is due to large scale acquisitions as opposed to organic growth. Once we focus on a period with fewer acquisitions we see that revenue fell nearly 30% from \$679m in 2008 to \$490m in 2012.

On the back of its acquisitions, Gatehouse became overleveraged, particularly in 2007, when it doubled its readership numbers. The price of this was a jump of \$648m in long term debt with virtually all of this going into Goodwill and Intangible Assets. This was then subsequently aggressively written off in 2008 and 2009 forcing the company to suffer huge losses in those years (-\$673m and -\$530m respectively). Overall Gatehouse has been a disaster for shareholders with the company making a loss in every one of the last 10 years prior to its eventual filing for Chapter 11 bankruptcy in September 2013.

Why then is Gatehouse worth anything at all?

Despite its terrible financial performance, Gatehouse is still the owner of one of the largest portfolios of local media assets in the US. The company owns over 400 local newspapers and 350 local news websites. In addition to newspapers it owns 91 “shoppers” (advertising only magazines) and 6 yellow page directories. Gatehouse’s publications touch nearly 10m people per week, or nearly 3% of the US population.

Its acquisition trail has left it with some high quality assets with firm barriers to entry. They focus on the “hyper local” news market in small town communities across the US covering local sports and community news and are often the only news channel able to operate in that area. With its mix of pay for newspapers and free advertising only shoppers Gatehouse can achieve nearly 100% penetration rates in the areas it operates in.

I believe there are a number of competitive advantages that Gatehouse has. Firstly many of its newspapers have been established for a very long time. More than 86% of their daily newspapers have been published for more than 100 years and all of them have been published for over 50 years. This longevity has allowed the company to build up strong local brands with advertisers.

Secondly, the company operates in small towns away from the competitive threats of large urban newspapers like the New York Times. Often the markets are not big enough for more than one newspaper which keeps the threat of entrants down and allows the company to exercise some pricing power since in small towns they are often the only media channel available to advertisers who want to target that area.

This pricing power has been exercised over the last few years as Gatehouse has raised its prices by 3 – 4% a year over the last few years:

	2010	2011	2012
Total Number of Publications	442	435	406
Proportion that are Daily	19.46%	18.16%	19.21%
Proportion that are Weekly	80.54%	81.84%	80.79%
Total Circulation	3,410,124	3,356,078	3,093,059
Number of Papers Sold	385,004,543	365,287,874	346,834,000
Circulation Revenue	136,377,000	134,201,000	133,358,000
<b>Implied Price Per Unit Sold</b>	<b>£0.354</b>	<b>£0.367</b>	<b>£0.385</b>
Price Increase		3.72%	4.66%

I believe that there is a genuine market for local news. People want to hear about what is going on in their immediate location and advertisers want to target people on a hyper local and relevant basis. Warren buffet, Jeff Bezos and Red Sox owner John Henry seem to agree as they have all been buying local newspapers recently.

What about its disastrous financial performance though?

The thing that really hurt Gatehouse shareholders was the over leveraging of the business. In 2004 interest expense alone was a shocking 31% of revenue. The debt fuelled acquisitions caused massive write downs of goodwill and intangibles as discussed above.

In addition to brutal impairments for goodwill and intangibles, cost control has also been an issue at Gatehouse. COGS rose from 49% of sales in 2004 to 57% in 2009 whilst Operating Expenses rose from 33% to 38% of sales over the same period.

The problems of high leverage, goodwill/intangibles and cost rises are now either moving in the right direction or have been solved by the company restructuring. Gatehouse will have \$1.2bn in debt written off as a result of the spin off and the substantial goodwill and intangible assets that hit Net Income in 2007 – 2009 have largely gone and so are unlikely to be a problem going forward. Costs have started to be aggressively reined in with SGA as a percentage of sales falling from 38% in 2012 to 34% in 1H2013 largely on the back of cuts in compensation which should provide positive earnings momentum going forward.

The business despite the fall in revenue has been relatively stable from a Free Cash Flow, EBIT and Return on Tangible Capital perspective (both FCF and EBIT have been positive in all of the last 5 years). In addition, EBIT margins have been surprisingly stable around the 7% of sales level over a number of years. Now that a huge amount of debt has been removed from the balance sheet, the large scale goodwill/intangible write downs have taken place and cost cutting measures seem to be paying off, we have every reason to believe the business will be profitable going forward.

Gatehouse fairs reasonably compared to its peers although admittedly does lag a bit largely on the back of poor historic cost controls. Its 5 year average EBIT margins are lower at 6.7% vs. a peer average of 12.7% and an average fall in sales over the last 4 years of -0.69% vs. peers of -2%. The business is very cash generative with an average return on tangible capital of 22% over the last 5 years vs. a peer average of around 28%.

#### Local Media Group

New Media will consist of Gatehouse Media and Local Media Group, a US local newspaper company bought from News Corporation by Newcastle in September this year. Local Media Group (“LMG”) owns 33 publications across the US with 200,000 subscribers per week so is quite a bit smaller than Gatehouse (which has circa 10 million subscribers a week). The company is a very good fit for combining with Gatehouse as they both operate in the hyper local newspaper and media market in the US.

There is not a great deal of financial information about LMG since News Corp did not split out the results for the business in its accounts. What we do know is that its revenues were \$167m in 2012 and \$157m in 2013 and that it produced £30m and \$24m in EBITDA in 2012 and 2013 respectively (depreciation information was not available). We can see then that there is some evidence of EBITDA margin contraction (from 18% in 2012 to 15.2% in 2013).

LMG was bought by Newcastle for 2.5x 2013 EBITDA once you strip out \$33m worth of real estate that comes with the deal. We do not have specific Net Income data but on the face of it this looks like a good price provided the business does not shrink away to nothing which I do not believe it will given my belief that local news is a genuine market that will continue to be viable for many years to come provided cost control measure and a viable digital strategy are built upon.

## New Media Strategy

Combined, Gatehouse and LMG, trading as New Media will represent a sizeable force in the US local media market. New Media will operate in 338 markets across 24 states. Their portfolio of products, which includes 438 community publications, 365 related websites, and six yellow page directories, will serve more than 130,000 business advertising accounts and reach approximately 12 million people on a weekly basis according to the recent New Media SEC filings.

Newcastle management however believe that they have spotted an opportunity to build on this and acquire more decent local newspaper assets on the cheap. New Media believes it can invest up to \$1bn over the next 3 years buying up local newspapers in small towns across the USA. Once trading at 10x EBITDA, they believe they can acquire local newspapers at 2.5x EBITDA and directories at prices as low as 1x EBITDA. Clearly, as long as the newspapers are not on the verge of bankruptcy the likely net income yield this could represent is huge.

Given the problems in the newspaper industry, there could be many potential targets to acquire. One potential candidate could be Lee Enterprises for example. It operates a very similar business to what New Media will be (local niche news) and owns some 46 local papers with a circulation of 1.2m people per day. Like Gatehouse, Lee Enterprises has suffered from over leverage problems. Its debt/total assets ratio is currently 87% and its latest Q2 2013 EBIT barely covers its interest expense during that period. Gatehouse was lucky in the respect that Newcastle had been a long term investor having owned their bonds for many years. Newcastle in addition had a close relationship with the Gatehouse CEO and a majority holding in their bonds which made for a relatively quick and easy restructuring. Perhaps Lees Enterprises will be available on the cheap in a market with very few willing buyers thus creating an attractive opportunity for New Media.

Newspaper companies have in general been very successful at running websites. They are natural content producers and so have found it easy to drive traffic. This has been true at Gatehouse who in addition to local physical newspapers has an array of highly trafficked websites. Its Ohio cluster of websites alone for example has over 1.4m unique views per month. In Massachusetts their 160 websites generate 3.5m monthly unique visitors. Ebay.com achieves around 70m monthly unique as a benchmark. New Media should be able to use these website assets as a source for digital revenue growth going forward.

In addition to offering news Gatehouse has a very fast growing business called Propel that helps small mom and pop businesses build websites and market their businesses online. The business has grown from zero revenue in January 2012 to \$10m in June 2013. Gatehouse predicted revenue of \$30m from this business by 2014 in their 2012 annual statement. Although the business is showing explosive growth, it is too early to say how this will play out but Gatehouse management is exhibiting some prowess in its digital strategy which is comforting.

## New Media Deal Structure

Although not finalised yet, Newcastle management has stated in the Q3 2013 Newcastle earnings call that each share of Newcastle will be eligible to receive one share in New Media. Bond holders of Gatehouse can either elect to sell their bonds to Newcastle at \$0.40 per \$1.00 face value or they can take shares in New Media. Equity holders in Gatehouse will be wiped out but will receive warrants allowing them to buy up to 5% of the New Media equity for 10 years. Newcastle has said the deal is likely to complete late in 2013 or Q1 2014.

## Valuation

New Media management (the CEO will be the current Gatehouse CEO) has released targets for what they call Funds From Operations (Net Income + Depreciation and Amortisation) of \$0.25/share in 2014 climbing to \$0.50/share in 2016. Given the business has relatively little depreciation and amortisation (circa 5% of total assets in 1H2013 for Gatehouse) this figure is approximately equal to Net Income.

Despite organic growth being difficult to come by in the traditional newspaper industry and digital revenues not likely to offset declines in traditional media for some time yet a P/E multiple of 10 seems to be warranted given a likely return on tangible capital of the old Gatehouse business of around 20% (average 5 year ROTC was 21.68%) and the barriers to entry for local physical newspapers discussed above (high start up costs, long time established newspapers, not enough room for other entrants in local markets).

In addition, from a comparables perspective Lee Enterprises which I discussed above as having a very similar business to Gatehouse currently trades on a 16x trailing 12m 2012 P/E. The overall peer universe trades at an average P/E (TTM) of 15.5. A P/E of 10 for the old Gatehouse business then seems conservative and allows for considerable declines in circulation from here

which do not seem likely given the stabilisation of circulation numbers at Gatehouse and the consistent price rises over the last few years.

Given the Gatehouse business has very small maintenance CAPEX requirements (about \$4m a year or \$0.01/share of New Media), a P/E multiple of 10 of projected 2014 earnings as predicted by New Media management puts us a \$2.50 per share value for New Media (i.e. once we also include the LMG business we get to \$0.25 in EPS x 10). Furthermore, if the market believes the growth prospects laid out by New Media management of \$0.50/share by 2016, this would represent \$5.00 (at 10x P/E) New Media shares. This ignores the likely P/E multiple expansion if this is achieved given it would represent a doubling of EPS in 2 years.

New Media shares seem to be worth at least \$2.50 on a 10x P/E basis if you trust Management's EPS targets with the potential to more than double from here if the company can deliver on growing the business by acquiring other assets at knock down prices.

For conservatism I have also modelled the likely EPS numbers using the pro forma numbers filed to the SEC for the New Media business. Using these numbers, my fair value and target price for the shares are more conservative with EPS 2014E at \$0.16 which would make fair value of the shares around \$1.60. Given these numbers are more conservative I would use these and would look to acquire shares in New Media around \$1.30 (8x P/E 2014E) with a view of an expansion in multiple to 12x P/E 2014E if management deliver on their growth in EPS forecasts.

#### Insider Buying

Newcastle as a corporation has been busy buying Gatehouse bonds clearly in anticipation of the New Media deal. They currently own \$626m of Gatehouse bonds which they say has cost them \$230m (average price of 36.74% of face). This could entitle them to anything between 59% to 100% of the equity of New Media, depending on how many Gatehouse debt holders elect to take New Media shares instead of cash.

Currently Newcastle have paid an implied price for Gatehouse of \$1.33 per share (\$230m cost to acquire Gatehouse debt which they say will give them a 59% stake of the 293m shares in New Media). This seems below the fair value of the business as discussed above.

On top of Newcastle as a company buying into New Media in a big way, it is comforting to see some serious insider buying from the Newcastle Chairman, Wesley Edens, who currently owns nearly 2.7m Newcastle shares. He bought 750,000 in the open market in June this year (at a cost of \$3.7m). This holding would give him a nearly 1% total stake in New Media should the deal complete. If the market believes the potential growth prospects of New Media of achieving \$0.50 in EPS in 2016, then the stock would very conservatively be worth \$5.00 in my opinion at 10x P/E) which would net Mr Edens more around \$13m in profit potentially over a very short time frame if he sold New Media shares at this price as his Newcastle shares were not materially affected by the distribution.

#### How to Play New Media Shares

In order to be eligible to receive New Media shares you need either to be a holder of Gatehouse bonds or Newcastle shares. Alternatively you can of course wait for the New Media share to begin trading in the open market before acquiring them.

Currently I believe Gatehouse bonds trade around 40% of par. Buying the remaining Gatehouse bonds at 40% of face value for \$230m ( $0.4 * \$577m$ ) would entitle the holder to up to 121m shares of New Media (the full 293m less the 172m already held by Newcastle). This represents an equivalent price of \$1.92 for New Media shares. This represents a P/E of 7.68 using the 2014 management estimate of \$0.25 EPS) which I do not think represents the kind of margin of safety I want for a business that has been going through such changes.

A better way to access New Media I believe is via Newcastle shares which are up only 3% since the spin off was announced on 27<sup>th</sup> September 2013. Based on my conservative valuation above, I value the equity of the New Media business at \$1.65/share \* 293m = \$483m. Newcastle also have 293m shares outstanding (coincidentally), and so I would have expected Newcastle shares to have gone up by at least 40% (allowing for some risk that the deal does not complete) of the dollar value of the New Media shares when it announced the spin off *given that before the New Media announcement took place Newcastle shareholders only owned bonds in the struggling Gatehouse, not equity in the restructured and much improved business*. The addition of a substantial portion of the equity in New Media to Newcastle represents a significant added value to the business. *Why did Newcastle shares not rise in price to reflect this?* I believe Newcastle shares should have risen in price by around  $0.4 * \$1.64 =$

\$0.66 or 12% given Newcastle traded around \$5.70 when the announcement happened. This did not happen and so, provided that Newcastle shares were not over valued before the New Media spin off announcement took place, looks like a way to get access to New Media shares for next to nothing. I believe the market has not fully realised that when the spin off was announced Newcastle effectively switched its bonds in the overleveraged Gatehouse to stock in a largely delevered business. This represents a great trade for Newcastle shareholders since the bonds were likely to be recovered at a fraction of their face value paying low interest rates, whereas, I would argue the equity is worth far more as per the discussion above..

To check Newcastle shares are not an accident waiting to happen a closer inspection of Newcastle itself reveals that the business is undergoing a major shift from dealing in real estate bonds and CDO's to the senior housing market, with good success to date. They have been able to secure sizeable investments in the senior housing market at attractive "high teen" leveraged (net of interest expense) yields which seems very attractive. The business has an average occupancy in line with peers (86%) which is rising which is good to see. Revenue per bed is rising and Management predict that if they can continue to invest the cash of \$210m they have at these yields by their target of one year, then their EPS will triple. In short, the Newcastle business is growing and moving away from the CDO business which perhaps has caused it to trade at low P/E ratios (around 12 2013E EPS) and has an adjusted Funds From Operations yield (Net Income + Depreciation + Gains on the sale of property sales) of around 43% vs. a peer average of 9% suggesting very little downside risk in the short term. This should mean we can get access to New Media shares for virtually free with little downside risk on our Newcastle share holdings whilst waiting for the spin off shares to be allocated.

If my thesis is correct and Newcastle shares do not fall significantly in price after the distribution of New Media shares then today I could buy Newcastle shares for \$5.90 and be given New Media shares worth at least \$1.65. I could then sell both shares immediately for a very near term profit of 30% within the few months.

#### Natural Selling

The New Media business seems to have all the classic qualities that make for natural sellers of its shares (and also its warrants). Owners of Newcastle stock are large institutions which primarily care about exposure to real estate, not newspapers. The top 10 institutions hold over 26% of Newcastle shares and consist of large players like Fidelity and Blackrock via real estate focused funds. They are likely to be forced/natural sellers given New Media is not a real estate company.

In addition, Gatehouse bond holders are likely to be sellers of New Media shares given they are probably annoyed at taking large losses on the company's bonds and also by virtue of the fact they are natural bond and not equity holders.

This leads me to believe that there is likely to be a lot of selling in New Media shares when they list and could represent an opportunity to buy them at prices significantly below my valuation of \$1.65 a share.

Given we cannot be sure of the size of any potential fall in the share price of Newcastle post New Media distribution, I would recommend buying half of any desired position in New Media via Newcastle shares now and waiting until New Media begins trading in the open market for a few hours after open to buy more should they fall significantly below my fair value price (perhaps to 8x P/E 2014E of circa \$1.30). Although Newcastle shares themselves seem to trade at attractive yields, I would recommend selling them as soon as the spin off shares have been allocated since the majority of this business is running CDO's which I do not have much colour on (unless Newcastle shares do drop significantly after the distribution in which case I would recommend holding onto them and collecting the considerable yield and waiting for the Newcastle valuation to pull back more in line with its peers).