Q1 FY19 Earnings Conference Call

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Disney Speakers:

Bob Iger
Chairman and Chief Executive Officer

Christine McCarthy
Senior Executive Vice President and Chief Financial Officer

Moderated by,

Lowell Singer
Senior Vice President, Investor Relations

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to The Walt Disney Company's Fiscal First Quarter 2019 Financial Results Conference Call. (Operator Instructions)

As a reminder this conference call is being recorded. I would now like to introduce your host for today's conference, Mr. Lowell Singer, Senior Vice President of Investor Relations. Sir, you may begin.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

Thank you. Good afternoon, and welcome to The Walt Disney Company's First Quarter 2019 Earnings Call. Our press release was issued about 25 minutes ago and is available on our website at www.disney.com/investors. Today's call is also being webcast, and a transcript of the call will be available on our website.

Joining me for today's call are Bob Iger, Disney's Chairman and Chief Executive Officer and Christine McCarthy, Senior Executive Vice President and Chief Financial Officer. Bob will lead off, followed by Christine, and then, of course, we'll be happy to take some of your questions.

So with that, I'll turn the call over to Bob and let's get started.

Bob Iger – *Chairman and Chief Executive Officer, The Walt Disney Company*

Thanks, Lowell, and good afternoon. Before Christine talks about the quarter, I have just a few comments about what we're working on and what we're excited about.

First, I'd like to congratulate our Studio for its 17 Oscar nominations, 7 of which went to Marvel's *Black Panther*, including a historic nomination for Best Picture. Together, Disney and 21st Century Fox received 37 nominations, an indication of the creative potential of the combined companies.

As you know, DTC remains our #1 priority. Our corporate reorganization was designed to support our DTC efforts, while providing a greater degree of transparency into our investment and our progress in the space. We remain focused on the programming as well as the technology to drive the success of our DTC business, and we're thrilled with the continued growth of ESPN+.

The very first UFC fight night under our new 5-year rights deal led nearly 600,000 fans to sign up for the service. The fact that 49 million Americans, 15% of the entire population, watched ESPN content on linear TV that day, and millions more engaged on other platforms including ESPN+, speaks to the enduring power of live sports, the strength of the ESPN brand and the value of the UFC rights we acquired. We expect the expansion of combat sports content on the streaming service to drive continued growth in the months ahead.

ESPN+ now has 2 million paid subscriptions, double the number from just 5 months ago.

ESPN+ operates on BAMTech's platform, which has proved to be reliably stable during peak live streaming consumption and easily handled the volume of more than half a million people signing up in a single 24-hour period.

This same technology will power Disney+ when it launches later this year. We have a number of great creative engines across our company, all of which are dedicating their talent, focus and resources to develop and produce strong content for the Disney+ platform. Most of the teams creating shows and movies for this service are the same innovators and storytellers driving the prolific success of Disney, Pixar, Marvel and Lucasfilm, operating under the same expectations of excellence. We look forward to leveraging National Geographic to provide even more unique content for Disney+.

Presented with an over-abundance of choice, consumers look to brands they know to sort through the options and find what they actually want. The DTC space is no different in that regard, and we're confident that our iconic brands and franchises will allow us to effectively break through the competitive clutter and connect with consumers. We'll also use our brand to help subscribers quickly navigate the content on Disney+, creating an interface that enhances the experience and their affinity for the service. We'll demonstrate the Disney+ platform and showcase some of the original content we are creating for it at our Investor Day on April 11. We'll also take that opportunity to provide detailed insight into our overall DTC business.

The addition of content and management talent from 21st Century Fox will further enhance our DTC efforts and provide opportunities for growth across the company. Having already designed much of the integration process, we are prepared to start effectively combining our businesses as soon as we obtain regulatory approval from the last few remaining markets. We look forward to working with the tremendous teams at 21st Century Fox to create the world's premier global entertainment company.

I'm now going to turn the call over to Christine, and then I'll be back to take your questions.

Christine McCarthy – *Senior Executive Vice President and Chief Financial Officer, The Walt Disney Company*

Thanks, Bob, and good afternoon, everyone. Excluding certain items affecting comparability, earnings per share for the first quarter were $1.84. These results represent a strong start to the fiscal year when you consider the headwinds we faced in this quarter, including comparisons to a very strong Q1 at the Studio last year, higher programming expense at ESPN in Q1 this year due to the timing of the College Football Playoffs, and continued investment in our direct-to-consumer businesses that we expect will drive meaningful future growth.

Last year, we announced the reorganization of our company into four segments: Media Networks, the combined Parks, Experiences and Consumer Products, Studio Entertainment and the newly formed Direct-to-Consumer and International. And several weeks ago, we filed three years of historical financial information, reflecting this new segment structure, which will help provide some context around our Q1 results.

At Studio Entertainment, higher TV/SVOD and home entertainment results were more than offset by lower worldwide theatrical results, reflecting the phenomenal performance of *Star Wars: The Last Jedi*, *Thor: Ragnarok* and *Coco* last year compared to *Ralph Breaks the Internet*, *Mary Poppins Returns* and *The Nutcracker and the Four Realms* this year. Our worldwide theatrical results were in line with the outlook we provided in our Q4 earnings call.

Given our studio's record performance in fiscal 2018, the difficult studio comp will continue in the second quarter. We have two releases during the second quarter: the highly anticipated *Captain Marvel*, which by the way is our first female-led superhero film, and a live action adaptation of the animated classic, *Dumbo*. *Dumbo* will be released at the end of the second quarter, so all of the film's pre-release marketing expense will be incurred in the quarter with only two days of box office. As a reminder, last year's second quarter theatrical results included the outstanding performance of *Black Panther* and the carryover performance of *Star Wars: The Last Jedi* and *Coco*.

Home entertainment results also faced a difficult comparison given Q2 titles last year included *Star Wars: The Last Jedi*, *Thor: Ragnarok* and *Coco*. As a result, we expect operating income from our theatrical and home entertainment businesses to be $450 million to $500 million lower than in Q2 last year, which was the best second quarter in the studio's history.

At Parks, Experiences and Consumer Products, operating income growth was driven by higher results at our domestic theme parks and resorts, partially offset by lower merchandise licensing and international park results. Growth in operating income at our domestic parks business was driven by higher guest spending at the park and higher occupied room nights at the hotels.

Attendance at our domestic parks was comparable to the first quarter last year. However, per capita spending was up 7% on higher admissions, food and beverage and merchandise spending. Per room spending at our domestic hotels was up 5%, and occupancy was up three percentage points to 94%. So far this quarter, domestic resort reservations are pacing up 4% compared to prior year, while booked rates are up 1%.

Results at our international operations were lower in the first quarter versus last year, as growth at Hong Kong Disneyland Resort was offset by lower results at Shanghai Disney Resort and Disneyland Paris.

Lower operating income from merchandise licensing primarily reflects strong sales of Star Wars and Cars merchandise in the first quarter last year. The theatrical success of *Star Wars: The Last Jedi* in Q1 last year was a key driver to licensing results, so the absence of a comparable franchise title in Q1 this year created a meaningful headwind to our licensing results. These results were partially offset by higher minimum guarantee revenue due to the adoption of the new revenue recognition standard.

Total segment operating income margin was up 160 basis points compared to Q1 last year, driven by about 340 basis points of margin growth at our domestic Parks and Experiences business.

Turning to Media Networks, operating income was higher in the first quarter as growth in Broadcasting more than offset the decline at Cable.

Total Media Networks affiliate revenue was up 7% in the quarter due to growth at both Cable and Broadcasting. The increase in affiliate revenue was driven by seven points of growth due to higher rates and one point of growth due to the adoption of the new revenue recognition standard, partially offset by approximately a one-point decline due to a decrease in subscribers. The sub trend improved modestly, marking the sixth consecutive quarter of improvement in the rate of net subscriber declines.

Broadcasting delivered a strong quarter driven by growth in affiliate and advertising revenue and higher program sales compared to Q1 last year. Higher affiliate revenue was driven by contractual rate increases and benefited from the adoption of new revenue recognition standards.

Broadcasting advertising revenue was up 6% in the first quarter driven by higher Network rates and increased political advertising at our TV stations, partially offset by lower Network impressions. Quarter-to-date, primetime scatter pricing at the ABC Network is running 40% above upfront levels.

Higher program sales were primarily due to increased revenue from licensed programs to Hulu and the sale of Marvel's *The Punisher* in the quarter and no comparable sale in Q1 last year.

Domestic Cable results were lower in the quarter as higher operating income at the Disney Channel was more than offset by a decline at domestic ESPN and Freeform.

At ESPN, operating income was lower in the first quarter as higher affiliate and advertising revenue was more than offset by higher programming and production costs. As I mentioned at the outset, ESPN's programming costs were higher in the quarter driven primarily by the timing shift of the College Football semi-final games. ESPN aired three of the New Year's Six bowl games during the first quarter, similar to last year. However, this year, two of those were semi-final games, whereas the semi-final games aired during the second quarter last year. In addition, contractual rate increases for NFL, college sports and NBA programming also contributed to programming expense growth in the quarter.

ESPN's domestic linear advertising revenue was up 3% in the first quarter and reflects the benefit of the College Football semi-final games. This ad revenue stream is reported within Media Networks and does not include any ad revenue generated by the international channels or domestic addressable advertising revenue as those are now reported in the Direct-to-Consumer and International segment. If you add the domestic addressable revenue generated by ESPN, then ESPN's total domestic advertising revenue was up 5%.

So far this quarter, ESPN's domestic cash ad sales are pacing down 2% compared to last year, reflecting the absence of the College Football Playoff semi-final games that shifted into Q1 this year.

Turning to Direct-to-Consumer and International, growth at our International Channels and lower equity losses from our investment in Hulu were more than offset by ongoing investments in our Direct-to-Consumer businesses, which reflect content, distribution and marketing expense at ESPN+ and costs associated with the upcoming launch of Disney+. While our share of equity losses from our investment in Hulu is reported within DTCI, I'll remind you that the overall impact of Hulu on the company's results includes revenue from program sales as well as affiliate and advertising revenue. Over the past three years, our aggregate equity losses have largely been offset by these revenue streams.

Results in the quarter also reflect lower operating income from BAMTech's third-party technology services business.

Last quarter, we mentioned the continued ramp-up of ESPN+ would have an adverse impact on operating income of about $100 million for the first quarter. The actual number came in a bit better than that, though we expect ongoing investments in our direct-to-consumer businesses to continue to impact DTCI's financial results. In the second quarter, we expect the continued ramp up of ESPN+ and ongoing development of our Disney+ service to have an adverse impact on the year-over-year change in operating income of about $200 million, with about two-thirds of that attributable to ESPN+.

Overall, we feel good about the start of the fiscal year and are excited for the opportunities ahead of us. While our full year results will be influenced by the timing of the 21st Century Fox acquisition in addition to the Studio and DTCI items I mentioned, I'll highlight a couple of additional items that will affect the comparability of our second quarter results.

First, at Parks, Experiences and Consumer Products, while the adoption of new revenue recognition standards benefited Licensing's Q1 results, in Q2 the new revenue standard will result in an $80 million operating income headwind. Also, the Easter holiday period will fall entirely in Q3, whereas last year, one week of the holiday period fell in Q2. We estimate this will result in about $45 million in operating income shifting from Q2 to Q3.

And at Broadcasting, we face a difficult program sales comparison that we expect to have a negative impact of about $85 million on operating income. Lower program sales are due in part to a shift in the timing of the sale of Marvel's *Jessica Jones*, as last year we recognized the sale of season two during the second quarter, whereas this year, we expect to recognize the sale of season three during the third quarter.

And with that, I'll now turn the call over to Lowell, and we'd be more than happy to take your questions.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

All right, Christine, thank you. And operator, we are ready for the first question.

Operator

(Operator Instructions) Our first question comes from Michael Nathanson with MoffettNathanson. You line is now open.

Michael Nathanson – *Analyst, MoffettNathanson*

Thanks, I have two for Bob or Christine. So Bob, thanks for the update on ESPN+. That was helpful. I wonder now that you're launched for about nine months, what surprised you about that launch? And what can you take in terms of lessons learned that can apply to Disney+? And the second question is there seems to be a lot of controversy on the street about the size of the revenue displacement from basically foregoing licensing revenue at Disney as you move to Disney+. Can you talk a bit about the size of that displacement of foregone licensing, and maybe the timing of that impact, to help us think about how this phases out over time?

Bob Iger – *Chairman and Chief Executive Officer, The Walt Disney Company*

So the first part of your question, Michael, I'd say that what we've learned, which is extremely valuable as it relates to future launches particularly at Disney+, is that the BAMTech platform that we invested in when we bought BAMTech is an extremely robust platform, capable of handling not only scale in terms of live streaming simultaneously, but a substantial number of transactions in a very short period of time. I mean, there were times before the UFC fight that

BAMTech was taking in or making just under 15,000 transactions a minute, and the stability of the platform is critical in times like that.

We also learned, which is not really unexpected, but we saw it in real time, that ESPN's primary platforms are fantastic marketing tools for the direct-to-consumer service. And you can obviously expect that we will use Disney's strong marketing platforms for the Disney+ service.

We also feel that consumers had a good experience not just in terms of the ability to watch live events under high-quality circumstances on mobile devices, but in general, the price-to-value relationship seems very strong. And I'd say lastly, the brand is very strong as well.

So if we consider all of that, the fact that we have a technology platform that's working, a user interface that's working, the ability to sign consumers up en masse, the use of the primary platforms to promote the new platform in what we believe will be a strong price-to-value relationship with Disney and the strength of all the brands, I think it all adds up to a very, very positive picture ahead of the launch of the Disney service, which is going to come toward the end of this calendar year.

Christine McCarthy – *Senior Executive Vice President and Chief Financial Officer, The Walt Disney Company*

Michael, I'll take the question on foregone licensing. When you look at foregone licensing, it's going to cross over two segments, our Media Networks and the Studio. When you look at fiscal '19, that licensing revenue in combination, net of APR, we estimate would be a decrease of about $150 million to OI year-over-year. That will be more heavily weighted to the second half.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

$150.

Christine McCarthy – *Senior Executive Vice President and Chief Financial Officer, The Walt Disney Company*

$150. That would be weighted to the second half. And to put that, some context on that, *Captain Marvel*, which is coming out in the second quarter, is the first film that we will withhold from our output deals. So that's where you can see the foregone licensing revenue begin.

Michael Nathanson – *Analyst, MoffettNathanson*

Okay. And can you talk about the whole year? What do you have in the third and fourth quarter, too?

Christine McCarthy – *Senior Executive Vice President and Chief Financial Officer, The Walt Disney Company*

No. The $150 million is for the full fiscal year.

Michael Nathanson – *Analyst, MoffettNathanson*

For the whole year? Okay.

Christine McCarthy – *Senior Executive Vice President and Chief Financial Officer, The Walt Disney Company*

Yes.

Michael Nathanson – *Analyst, MoffettNathanson*

That’s great, thank you.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

Okay Michael. Operator next question please.

Operator

Thank you. Our next question comes from Alexia Quadrani with JP Morgan. Your line is now open.

Alexia Quadrani – *Analyst, JP Morgan*

Thank you so much. It's just two questions. I guess, the first one is somewhat similar to Michael but maybe a much more broader perspective. I'm curious if you can talk broadly, I know you'll give specifics in April, how you -- Bob, I guess how you balance your existing business and the Direct-to-Consumer initiatives, I guess, in many facets? How you balance potentially more aggressive investment spending versus maybe providing to shareholders earnings growth that some of your shareholders would be looking for? And perhaps more specifically along the same topics, thoughts on changing the home video window to potentially boost interest in Disney+.

Bob Iger – *Chairman and Chief Executive Officer, The Walt Disney Company*

Thanks, Alexia. As I mentioned earlier in my prepared remarks, we have an event on April 11 when we're not only going to demonstrate the app, but we're going to talk in great detail about our strategy, the impact of our current businesses and the impact on our bottom line. And so I think we'll answer a lot of the questions then, but what we're basically trying to do here is invest in our future. And the investments that we're making in both the technology side and in creating incremental content are all designed so that long-term, this business will become an important part of Disney's bottom line and long-term strategy.

So I think you have to look at this, it's almost the equivalent of deploying capital to build out our theme parks when we could have deployed the capital in a variety of other directions. This is a bet on the future of this business. And we are deploying our capital basically, so that long-term, the growth of this company is stronger than it would have been without these investments.

In terms of making the decisions about where content goes near-term or today versus traditional platforms, first of all, since we are betting on this Direct-to-Consumer business long- term, we obviously have to fuel it with intellectual property. And so we're creating intellectual property incremental to the product that we're making for our traditional platforms, just so that we can launch this product. And then in some cases, we're moving product over that perhaps could have been on traditional platforms. And again, we're doing that because it's a capital allocation in the direction of long-term growth for the company.

I won't get into the issues as it relates to the windows, but we're not looking to compress the theatrical window here. There might be an opportunity down the road to adjust the windowing in terms of when we bring product from maybe the home video window into the so-called Pay window. But initially, we're approaching this under relatively traditional lines from a calendar perspective.

And then I think the last thing that I should add, and I think this includes the assets that we're buying from 21st Century Fox, is we have in The Walt Disney Company not only a collection of brands and we're adding National Geographic and FX and Searchlight, et cetera, and so on, but we have talent, both executive talent relationships and production capabilities that give us the ability to scale up nicely in terms of our output and not invest that much in overhead or infrastructure to do that. And so we're going to leverage the people and the capabilities of all our traditional media businesses we're doing today to grow the product, with some incremental expense obviously to produce the product, but very efficiently to grow product for the new platforms.

Alexia Quadrani – *Analyst, JP Morgan*

And I guess, just a quick follow-up on that, I believe you licensed a show, I may be wrong, from CBS TV studios for Disney+. Is the strategy, I guess, maybe just your earlier comment wherein some exceptions, you'll sort of look outside or make incremental expenses, is the strategy just to find the best content, doesn't have to be always internally sourced?

Bob Iger – *Chairman and Chief Executive Officer, The Walt Disney Company*

I think the strategy will be long-term, pretty heavily weighted to internally sourced versus externally sourced. There will be occasion when we would be glad to license from third parties. But because the Fox deal hasn't closed yet, so we can't take advantage of some of their output capabilities, and because we need to launch the service with some volume and it takes time to ramp up, we're buying certain products from the outside opportunistically, and we'll continue to do that. By the way, that’s something we've done in our Parks for a long time, where we license from George Lucas, Star Tours for Star Wars IP or the Indiana Jones IP or the Avatar IP. We'll continue to look at opportunities that we think we can leverage because there is a potential consumer demand for it.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

Thanks Alexia. Next question please operator.

Operator

Thank you. Our next question comes from Ben Swinburne with Morgan Stanley. Your line is now open.

Ben Swinburne – *Analyst, Morgan Stanley*

Thank you. Bob, can you give us an update on your outlook for Hulu? In particular, they reported some pretty strong subscriber growth last year, they made some pricing changes. How bullish are you on this business? And can you give us any sense for sort of the opportunity to turn this business profitable? Because while it's got real scale and subs in revenue, we all know it's generating losses today. And maybe you could tie Hulu into the broader go to market with Disney+. How do you think about leveraging Disney's sort of broad maybe global customer relationships you have today to get Disney+ off the ground quickly?

Bob Iger – *Chairman and Chief Executive Officer, The Walt Disney Company*

The goal obviously is to operate Hulu profitably. We're not going to say how long that might take. That could shift a bit because at some point, we'll look more aggressively at some international rollouts of Hulu as well. And I think it's also premature to discuss much about Hulu because until the Fox deal closes, we only own 30% of it. We'll own 60% when the deal closes, and we'll be prepared to talk more perhaps about Hulu's strategy at that point. But what we said when we decided to launch ESPN+ and Disney+ is that rather than creating one gigantic fat bundle of sports, general entertainment programming and family programming, we thought we'd serve the consumer better by segregating all three.

Ultimately, our goal would be to use the same tech platform to make it easier for people to sign up for all three should they want to, same credit card, same username, same password, et cetera, but give the consumer the kind of choice that we think consumers are going to demand more and more in today's world. If they wanted to buy all three, we'd give them an opportunity potentially at a discount, or two for that matter. But if they wanted to buy one of them, we believe they should be able to. So somebody wants sports, they should be able to buy just sports and so on.

In terms of going back to the first part of the question in terms of profitability, well actually in terms of our belief in the platform, there's enough out there in your sector and ours, meaning in

Media and in the businesses that follow Media, that have been talking about direct-to-consumer growth. And we see that obviously with some of the big players in the space, notably Netflix. We think there's huge potential for Hulu to grow as well as for the other services to grow and plenty of room for other entrants in the marketplace. But we aim to take advantage of on the Disney and the ESPN side, our brands and our expertise. And on the Hulu side, we hope to take advantage of the fact that they've already launched successfully and their brand is starting to build some equity, but also in the production capabilities of the businesses that we have, including the businesses that we're buying.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

Ben thank you. Operator next question please.

Operator

Thank you. Our next question comes from Doug Mitchelson with Crédit Suisse. Your line is now open.

Doug Mitchelson – *Analyst, Credit Suisse*

One for Bob, one for Christine, I am going to boldly try to stay away from streaming questions. Bob, as sports gambling becomes legal in the U.S. state by state, is that something that can coexist within the family-friendly Disney brand that's the umbrella for the company? I'm asking in part because of the addition of the UFC and some of the Fox content like shows at FX and *Deadpool* are already pushing the envelope a bit perhaps. So maybe sports gambling does fit in, and could be an interesting long-term opportunity.

And Christine, on the impact of Star Wars lands launching, in the past, when you've launched lands, there was often a ramp in opex and marketing in advance of those lands. As we think about profitability or Parks margins for the year or the second half as they start to come in the West Coast and later in the year in Orlando, any comments as to whether those are -- start out profitable off the bat because it's your largest lands and big brands? Or is that something that we should really look towards fiscal '20? Thank you.

Bob Iger – *Chairman and Chief Executive Officer, The Walt Disney Company*

Doug, while I understand the sort of connection you made to gambling and *Deadpool*, I think -- we look at them in very different ways. I don't see The Walt Disney Company, certainly in the near-term, getting involved in the business of gambling, and in fact facilitating gambling in any way. I do think that there's plenty of room, and ESPN has done some of this already and they may do more, to provide information in coverage of sports as a for instance, that would be relevant to in particular interest to gambling, and not be shy about it, basically being fairly overt about it. But getting into the business of gambling, I rather doubt it.

We do believe there is room for the Fox properties to exist without significant Disney influence over the nature of the content, meaning that we see that there is certainly popularity amongst Marvel fans for the R-rated *Deadpoo*l films as a for instance. We're going to continue in that business, and there might be room for more of that. And there's nothing that we've really seen in the Fox either library or in the activities that Fox is engaging in today from a standards perspective that would be of concern to us, as long as we're very carefully branding them and making sure that we're not in any way confusing the consumer with product that would be sort of either Disney products or the more traditional Marvel product.

Christine McCarthy – *Senior Executive Vice President and Chief Financial Officer, The Walt Disney Company*

So, Doug, on the opening of the two Star Wars Lands, Galaxy's Edge -- in both the Disneyland Park initially at Anaheim, followed later in the fiscal year at Walt Disney World, we have not given any guidance or outlook on operating expenses that we'll incur in addition to the normal operating expenses as they ramp up. However, you've seen those expenses increase when we've opened lands, so that will be just embedded in their operating income and in their expense lines. Both of those will open in the balance of this fiscal year.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

Calendar year.

Christine McCarthy – *Senior Executive Vice President and Chief Financial Officer, The Walt Disney Company*

Calendar year…but it will be skewed to the second half.

Bob Iger – *Chairman and Chief Executive Officer, The Walt Disney Company*

And I would say by the way, on the marketing expense side, don't expect much. I'm thinking that maybe I should just tweet, "it's opening," and that would be enough. I think we're going to end up with incredibly popular and in-demand product with these two new lands. They are large, they are beautiful and they're extremely innovative, and they obviously leverage the popularity of the Star Wars brand. And I think that we're going to have absolutely no problem gaining attention for them or to them, and it's not going to take much marketing to do that. That's a signal that I just sent to our parks and resorts people to keep that budget really low.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

Doug thank you. Operator next question please.

Operator

Thank you. Our next question comes from Steven Cahall with Royal Bank of Canada.

Steve Cahall – *Analyst, RBC Capital Markets*

So maybe a follow-up on that. Seems like you're really running the parks for yield. So was there anything specific in the quarter that contributed to the strong Rev PAR or per capita spend that we shouldn't expect to roll through the rest of the year, even with a little attendance lift from the opening of the Star Wars properties? And then secondly, Christine, I was wondering if maybe you can update us on what leverage is going to look like after the Fox transaction. I don't think you've done that since last summer. And a lot's changed since then, especially the divestitures. And maybe not to give us an exact view on what the RSNs go for, but you must have some idea of what net leverage looks like when you close the transaction.

Bob Iger – *Chairman and Chief Executive Officer, The Walt Disney Company*

Steve, on the first part, we've been witnessing over the last few years a substantial increase in the popularity of our parks. A lot of that has to do with how well they're managed and the kind of investments that we've made, not just operationally, but in expansion and the use of IP that's extremely popular. In doing so, what we're also trying to do is to use that popularity to manage guest experience a little bit better, in the sense that we know the crowding can be an issue, and when our parks are the most crowded, the guest experience is not what we would like it to be. And so we're leveraging the popularity to obviously increase pricing and to spread demand, to get much more strategic about how we're pricing. So the parks are still accessible, but in the highest peak periods, we're trying basically to manage the attendance so that the guest experience isn't diminished by the popularity.

And I think because of the nature of the investments we're making, we've been fairly vocal and transparent about those investments, the two big Star Wars lands, the Toy Story Land that just opened up in Florida, the work that's going on in Hong Kong and Paris and Shanghai and in Tokyo and all the great expansion in IP that we're putting in. That popularity is going to continue. And with that, it's going to come I guess, the enviable task of balancing that popularity with guest experience and price elasticity.

Christine McCarthy – *Senior Executive Vice President and Chief Financial Officer, The Walt Disney Company*

Steve, to answer your question on leverage, a couple of things I want to comment on. One is the 39% stake in Sky was divested. And while that cash is currently at 21st Century Fox, upon closing, that will move over to The Walt Disney Company. That will have a significant benefit in reducing our leverage back to the metrics that we have typically run the company, which is a single A credit.

The other thing that we are working on, and it's in progress so I'm not going to comment about it, but we are in the middle of divesting the RSNs. It is an auction process. There's a lot of chatter out in the market. I won't comment on it, just to say that not everything you hear is necessarily true, but it seems to be in the news pretty much every day currently. But that will also have a positive impact on decreasing our leverage.

The three rating agencies who cover us, Standard & Poor's, Moody's and Fitch, have all affirmed our ratings at the existing levels. And I think if you look at those, you'll see what their expectations are on the reduction of leverage, but we are looking forward to reestablishing our single-A credit metrics.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

All right Steve, thank you. Operator next question please.

Operator

And our next question will come from Todd Juenger with Sanford Bernstein.

Todd Juenger – *Analyst, Sanford Bernstein*

Oh hi, thanks. One very basic and one a little more broad. Christine, I suppose thank you for once again disclosing the Pay universe sub trends on your affiliate fee line. And it sounded like they ticked better again slightly in the 1% range. Just wondered if you could help reconcile for us at all when we see the reports from the cable satellite companies that look like they're shedding Pay-TV customers at a faster rate, but we're not seeing that in your numbers. So I don't know if you can help us reconcile that? Is there anything specific to the virtual MVPDs or to your specific portfolio of networks? That's supposed to be the fast question. Then the other one, I'll state it quicker, is just Bob, I'm wondering where do videogames fit into your whole thought process going forward? You've tried to bring it in house. You've got license agreements. You've got partners. It's clearly a form of entertainment that is gathering lots of engagement. You've got lots of IP. Just wondering with all your other things going on, if that's still on your radar? And any updated thoughts on how you might participate? Thanks.

Christine McCarthy – *Senior Executive Vice President and Chief Financial Officer, The Walt Disney Company*

Okay. I'll take the first one, Todd. As it relates to subs, the difference between what the cable operators report and what we report is it's a two-month lag. We get the -- they're giving you more up-to-date information. Ours is on a two-month lag. However, as I mentioned in my comments, we're had six consecutive quarters of improved sub numbers, and we've had the dynamic of the loss of traditional subs decreasing and the increase of digital MVPDs increasing. So the net-net of those are both going in the right direction, so we have seen that of the sequential improvement. But the difference between what DirecTV may be reporting or AT&T may be reporting as it relates to direct or to their traditionals, it's not apples-to-apples on timing.

Bob Iger – *Chairman and Chief Executive Officer, The Walt Disney Company*

Yes, on the videogame business, we're obviously mindful of the size of that business. But over the years as you know, we have tried our hand in self-publishing. We bought companies, we sold companies. We bought developers, we've closed developers. And we found over the years that we haven’t been particularly good at the self-publishing side, but we've great at the licensing side, which obviously doesn't require that much allocation to capital. And since we're allocating capital in other directions, even though we certainly have the ability to allocate more capital, we just decided that the best place for us to be in that space is licensing and not publishing. And we've had good relationships with some of those we're licensing to, notably EA, and the relationship in the Star Wars properties. And we're probably going to continue to stay in that side of the business and put our capital elsewhere. We're good at making movies and television shows and theme park attractions and cruise ships and the like, and we just never managed to demonstrate much scale on the publishing side of games.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

Thank you, Todd. Next question please.

Operator

Our next question comes from Tim Nollen with Macquarie.

Tim Nollen – *Analyst, Macquarie*

I have 2 questions as well, please. First Christine, if I can double check, I think you said ESPN ad sales was up 3%, but if you include addressable advertising, which is on the DTC line, it was up 5%. Can you just tell us a bit more on where that's coming from. Is that all on traditional -- on linear ESPN with some better dynamic insertion or anything more addressable? Or is it more on the ESPN+ service? And then a second question on the parks side. I think this is the second quarter out of the last 3 or 4 that we've heard about Shanghai attendance decline. Could you please comment a bit more on that?

Christine McCarthy – *Senior Executive Vice President and Chief Financial Officer, The Walt Disney Company*

Okay. On the ESPN advertising, you're correct that the linear was up 3% and that is reported in the Media Networks segment. The addressable advertising is recorded -- reported in our direct to-consumer segment. The increase that we saw this quarter was because there were more ESPN impressions that they were able to monetize based on a higher level of user engagement. So they saw a nice uptick. So when you incorporated that, and this is just domestic, that doesn't include international, and I can comment on that in a minute. But the domestic, when you include that, equates to a 5% increase. The categories that were most frequent in the addressable advertising were from studios, videogames and telecom. And that's pretty much what you would expect, given that it's addressable or digital. On the international side, there was a slight downtick, but that had everything to do with foreign exchange. ESPN's international business is very much based in Latin and South America, and the foreign exchange, the currency fluctuations there are what impacted that.

Bob Iger – *Chairman and Chief Executive Officer, The Walt Disney Company*

On the Shanghai side, we've seen some attendance softness this year. We're still running a profitable business and we're still investing to grow it. But some of the issues that China has been facing, a slowdown -- or a decrease in consumer confidence, which has resulted in fewer Chinese people traveling within China, has had an impact on our business. That has made it less profitable than we hoped it would be at this point. But still a very successful business and one that we believe in long-term.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

Operator, we have time for one more question.

Operator

And our final question comes from Dan Salmon with BMO Capital Markets.

Dan Salmon – *Analyst, BMO Capital Markets*

I'll try to stay away from streaming as well and leave that for April, so just two questions. Bob, you noted in your comments about the National Geographic family of business is contributing to Disney+ as one of the Fox businesses coming in. Could you maybe give us an update on how you foresee the FX brand working within the Disney portfolio of businesses? And then second, you've made a lot of changes on the ad sales front lately, integrating across the ABC and ESPN side, moving the addressable into the direct-to-consumer business. I'm just curious to get an update on how those integration efforts are going. And just to clarify that addressable, even though it may be reported separately in a different segment, doesn't necessarily always mean it's being sold separately. I'd just love to go a layer deeper on that as well.

Bob Iger – *Chairman and Chief Executive Officer, The Walt Disney Company*

We, like audiences in the United States and other places, are extremely impressed with FX and what it has managed to do in terms of its programming and its relationships with the creative community, and we intend to fully leverage that in both the traditional side of the FX business, but also in our new businesses. And we foresee FX developing and producing product for the Hulu platform in particular, probably not the Disney platform because we talked earlier to Doug Mitchelson's question it's not the kind of programming we typically see in a family environment. But there is ample opportunity for FX to produce more programming and to leverage its relationships in the creative community and its ability to manage creativity specifically for Hulu as we expand Hulu.

On the ad sales front, there has been a significant amount of change. You've talked about it. In fact, just last month, there was basically a company-wide ad sales executive retreat, in which all of the ad sales executives gathered in one place with Kevin Mayer, who those people are reporting to in our new structure. I'd say we're just at the beginning of not only integration, but looking at this business differently, particularly since there's been a lot of disruption in the way that advertising is being created and the way that advertising is being spent. And we want to make sure that our organization reflects all of that change. I think it's just too early to be more specific than that.

You asked the question about addressables. We kept that revenue under the direct-to-consumer businesses just so we could be a little bit more transparent about what the bottom line of those businesses are as we invest in and grow those businesses. So we wanted to put the revenue, the advertising revenue that came directly from consumption on the new platforms--that's really ESPN.com primarily--because there's little advertising on ESPN+, but we just wanted to be more discrete about how it was reported.

Christine McCarthy – *Senior Executive Vice President and Chief Financial Officer, The Walt Disney Company*

The one other thing, Dan, that I would add on that is that as we have combined the ad sales force into a unified entity, that the same team is selling both addressable and linear, and so it's much better coordinated. It's early days, but we're optimistic about how it will perform.

Lowell Singer – *Senior Vice President, Investor Relations, The Walt Disney Company*

Dan, thank you. And thanks again, everyone, for joining us today. Note that a reconciliation of non-GAAP measures that were referred to on this call to equivalent GAAP measures can be found on our Investor Relations website. Let me also remind you that certain statements on this call, including financial estimates and statements as to the expected timing, completion and effects of the proposed transactions may constitute forward-looking statements under the securities laws. We make these statements on the basis of our views and assumptions regarding future events and business performance at the time we make them, and we do not undertake any obligation to update these statements. Forward-looking statements are subject to a number of risks and uncertainties, and actual results may differ materially from the results expressed or implied in light of a variety of factors, including factors contained in our Annual Report on Form 10-K and our other filings with the Securities and Exchange Commission. This concludes today's call. Have a good afternoon, everyone.

Forward-Looking Statements

Management believes certain statements in this call may constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are made on the basis of management's views and assumptions regarding future events and business performance as of the time the statements are made. Management does not undertake any obligation to update these statements. Actual results may differ materially from those expressed or implied. Such differences may result from actions taken by the Company, including restructuring or strategic initiatives (including capital investments or asset acquisitions or dispositions), as well as from developments beyond the Company's control, including:

- changes in domestic and global economic conditions, competitive conditions and
- consumer preferences;
- adverse weather conditions or natural disasters;
- health concerns;
- international, political, or military developments; and
- technological developments.

Such developments may affect entertainment, travel and leisure businesses generally and may, among other things, affect:

- the performance of the Company's theatrical and home entertainment releases;
- the advertising market for broadcast and cable television programming;
- demand for our products and services;
- expenses of providing medical and pension benefits;
- income tax expense;
- performance of some or all company businesses either directly or through their impact on those who distribute our products; and
- completion of the pending transaction with 21st Century Fox.

Additional factors are set forth in the Company's Annual Report on Form 10-K for the year ended September 29, 2018 under Item 1A, "Risk Factors," and subsequent reports.

Reconciliations of non-GAAP measures to closest equivalent GAAP measures can be found at www.disney.com/investors.