THE STAHL REPORT

November 17, 2011

The Walt Disney Company

(BUY)

Price:	$35.77	**Ticker:**	DIS
52-Week Range:	$28.19-$44.34	**Dividend:**	$0.40
Shares Outstanding:	1,909m	**Yield:**	1.1%
Market Capitalization:	$68,284m		

Data As of 11/17/2011
Valuations within this text are based on a $36.76 share price

Exclusive Marketers of The Stahl Report

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Investment Thesis

Preamble

The Walt Disney Corp. ("Disney") was recommended to our readers three years ago this week at a price of $21.36.[1] At the time, Disney traded at approximately 10x earnings, as investors had anticipated that the company would experience a dramatic erosion of profit in the wake of the recession that was beginning to take hold. Indeed, the company's earnings did fall, but much more modestly than was forecasted. Following a normal cyclical recovery that began in 2009, the patient investor would have earned a profit of over 70% from that low level reached in late 2008.

Current Thesis Review

The current price of Disney's shares reflects a somewhat similar sentiment, as investors believe that global economic pressures will inevitably lead to another U.S. recession that will harm the company's earnings. Disney now trades at 12.8x fiscal 2012 consensus earnings estimates, and 14.6x fiscal 2011 earnings that were just reported on November 10th. During the past decade, Disney has, on average, traded at a multiple of nearly 18x earnings, reflecting the quality of the company's assets, and its ability to produce earnings per share growth of over 12% per annum since 2004. The earnings of Disney, however, are cyclical, and sensitive to consumer spending, particularly with respect to the company's resorts and parks business. Ergo, with the prospect of another recession ever present on investors' minds, the current valuation suggests a 17.5% earnings diminution is likely to happen. This approximates the Disney experience from 2008-2009, in which the company's earnings actually fell by 22.5%. On a forward looking basis, the 2012 p/e of 12.8x is some 27.7% below the historic average of 17.7x. Bearing in mind that many would characterize that period as one of dire economic circumstances, the shares of Disney appear priced for another severe outcome.

The objective of this report, which should be read in conjunction with the original paper published in November 2008, is not to proclaim that Disney is no longer a cyclical franchise. It clearly is, although a fair amount of earnings variability in fact has been removed through the years by the steady expansion of its cable network business, which has produced remarkably resilient profits. The current objective is to assess the degree to which a possible recession is already reflected in the company's valuation. In this regard, let us undertake the following exercise.

In the recently completed 2011 fiscal year (ending in October), Disney produced $2.52 of earnings per share. As noted, the company's earnings declined from $2.27 per share in 2008 to $1.76 in 2009, representing a diminution of 22.5% during that recession. Let us presume that the United States were to fall into another recession, the subsequent pressure of which were to cause the Disney earnings to decline by 22.5% again, or to $1.95 per

[1] *The Scratch Report*: November 14, 2008

share. At the current $36.76 share price, the company trades at 18.9x these simulated earnings.

The historical p/e since 2004 has been 17.7x, with the pre-2004 period excluded from this calculation because the earnings multiple often exceeded 20x and 30x, due both to cyclically low earnings, and to rather inflated valuations during the Technology Bubble. If the historical 17.7x p/e were applied to the simulated $1.95 per share of earnings during a possible recession, the share price would be $34.52, or only 6% below the current price. It appears that one is well protected, on a valuation basis, against a possible disruption to the company's earnings progress.

As the reader can observe, the Disney shares are discounting a negative outcome. However, what if the company were viewed as a long-term investment through the rather attractive current purchase price? At its cyclical high in 2007, Disney earned a 15.2% return on equity, while, conversely, in 2009 it produced a 9.8% ROE. The company's recent historical average is approximately 12%, with reference to the current level of 12.9%. Let us imagine that Disney is capable of maintaining an average ROE of 12% over time. It pays a modest dividend, representing a current yield of 1%, which amounts to a payout ratio of 15.7% of total net income. Phrased alternatively, Disney retains 84.3% of its net earnings.

In connection with a 12% ROE, the current earnings reinvestment rate ultimately equates to an annual earnings growth rate of 10.1% (12% x 84.3%). If the company's current p/e of 12.8x were to remain constant, the investor then could expect to receive about 11% per annum of return from this investment, including the dividend income. While this is not an extraordinarily high rate of return, it should however be considered within the current equity and bond return environments. In other words, on an after tax basis, the owner of a Disney share might receive 7%-9% of return annually. In contrast, the owner of a high-quality corporate or municipal bond might expect a return of only 4% or so, and even less from a U.S. government bond. Given this reality, the relative pricing of Disney at under 13x earnings along with these return possibilities versus those available from alternative forms of investment appears enticing.

Of course, the more optimistic investor might imagine a sharp expansion in the company's valuation to more recent historic levels, which would require one to believe that the Disney earnings might ultimately be capitalized at 17x-18x earnings. This produces a scenario in which the share price could be nearly 40% higher. This normalization of valuation is a distinct possibility, given the ability of Disney to generate considerable earnings growth over time. Therefore, if the reader weighs the probability of a positive outcome against the occurrence of an adverse scenario, the latter already appearing to be suggested in the share price, in addition to the relative value being offered versus current low-yielding bonds, the decision to add Disney to one's portfolio becomes increasingly more appealing. Accordingly, these shares are recommended for purchase.

Brief Update of Businesses

For the purposes of this paper, the following is provided merely as an update to the original report issued in November 2008, which offers a more comprehensive study of the individual Disney businesses. Therefore, one is encouraged to read both reports for completeness of analysis.

At the onset, it is important to note that Disney has become a less cyclical company over the years. Historically, Disney's parks and resorts (i.e. Disneyland, Disneyworld, Disneyland Paris, etc.), along with its movie production business contributed roughly half of the company's entire operating income. Theme park attendance is clearly sensitive to consumer spending, while film production presents other variability risks, such as the inconsistency with which high-grossing box office movies are produced.

However, its position as a media content provider through its ESPN and Disney Channel cable networks, and to a certain degree through its ABC networks, Disney has been able to consistently increase its fees charged to cable and satellite providers over the past decade. These affiliate fees have been remarkably stable and increasing through the years. This has balanced some of the cyclicality associated with the advertising revenue generated from these media properties. Currently, media and networks are 67.3% of the company's overall operating income, thereby reducing overall earnings volatility. This is provided in the table below.

Table 1: Operating Income by Segment, 1998 Versus 2011

	1998		2011
Media Networks	38.2%	Media Networks	67.3%
Studio Entertainment	16.3%	Studio Entertainment	6.8%
Parks & Resorts	28.0%	Parks & Resorts	17.0%
Consumer Products	17.6%	Consumer Products	8.9%
Internet Group	n/a	Interactive Media	n/a

In the fiscal year just completed, the company's operating income rose from $7.6 billion in 2010 to $8.8 billion in 2011, for an increase of 16.3%. This growth was achieved through better results at the parks and resorts segment, but mainly through a 19.8% increase in media networks income. This business, as shown below, currently produces a 32.8% operating margin, which is the highest in recent history. In addition to ESPN and Disney Channel, it should be noted that the company owns interests in a variety of cable network franchises, such as The History Channel, Lifetime, and A&E.

Table 2: Disney Media & Networks Operating Margin

Year	Revenues	Operating Income	Operating Margin
2011	$18,714	$6,146	32.8%
2010	$17,162	$5,132	29.9%
2009	$16,209	$4,765	29.4%
2008	$15,857	$4,981	31.4%
2007	$15,104	$4,275	28.3%

In 2005, the company opened the Hong Kong Disneyland Resort located on the country's Lantau Island. This added to the Disney resorts located in the U.S., as well as those operated in Paris and Tokyo. It is not often remarked upon, but Disney is actually an owner of substantial land through the operation of its resorts. For instance, the Disneyworld Resort in Florida is situated on 25,000 acres of land owned by the company. On a much smaller scale, Disney owns 461 acres in Anaheim, California, where the famous Disneyland resort is located. These are assets most likely held at cost on the balance sheet, but which on a market basis are probably worth a considerable amount of money. In any event, Disney also operates vacation cruise lines and adventure vacation packages for its guests.

Following a decline in attendance at its parks during the recent recession, this business has been improving, on an operating margin basis, during the past two years. The current 13.2% margin is still, however, below the prior peak of 16.5% reached in 2008.

Table 3: Disney Parks & Resorts Operating Margin

Year	Revenues	Operating Income	Operating Margin
2011	$11,797	$1,553	13.2%
2010	$10,761	$1,318	12.2%
2009	$10,667	$1,418	13.3%
2008	$11,504	$1,897	16.5%
2007	$10,626	$1,710	16.1%

Presently, operating income of the studio entertainment segment appears to be the most depressed of all the Disney businesses. Last year, the company had considerable success with its *Toy Story 3* and *Alice in Wonderland* movie releases, while viewers were less enthused with current year titles *Cars 2* and *Captain America*. As a result, the $618 million of operating income that was produced this year was only half the amount generated by the company in 2007. Clearly, the results of recent Disney releases have been less than robust; however, throughout history, Disney has been one of the more successful movie producers, particularly of children's titles. This is simply a volatile business with little predictability, given that it is driven entirely by the changing sentiments of consumers.

Table 4: Disney Studio Entertainment Operating Margin

Year	Revenues	Operating Income	Operating Margin
2011	$6,351	$618	9.7%
2010	$6,701	$693	10.3%
2009	$6,136	$175	2.9%
2008	$7,348	$1,086	14.8%
2007	$7,491	$1,195	16.0%

Even though it is a source of earnings variability, studio entertainment, and to some degree, the cable networks, both provide content for various Disney consumer merchandise items. As a matter of practice, Disney merely licenses its properties to manufacturers, which produce a wide variety of products, such as toys, apparel, food, and consumer electronics. This is part of the company's integrated strategy in which all of its operating segments provide unique revenue opportunities throughout its different media formats. Given the modest costs associated with licensing, the consumer products segment is one of the company's most profitable, as shown below.

Table 5: Disney Consumer Products Operating Margin

Year	Revenues	Operating Income	Operating Margin
2011	$3,049	$816	26.8%
2010	$2,678	$677	25.3%
2009	$2,425	$609	25.1%
2008	$2,415	$778	32.2%
2007	$2,289	$631	27.6%

More recently, Disney has been pursuing the expansion of its media properties into the gaming industry. This has been done in a coordinated effort with its internet properties, which also offer online games for consumers. In 2010, the company purchased Playdom, Inc., which develops and produces online game titles for social networking websites. Currently, this overall strategy, known as Interactive Media, has produced annual losses of between $200-$300 million per annum for Disney. There does, however, appear to be a sufficiently large market for such products, and the conversion of Disney television or movie titles to gaming products seems logical, although presently unprofitable.

In the foregoing summary, it is clear that many of the Disney businesses are currently prospering. However, there is sufficient room for improvement within a few of its businesses, particularly within studio entertainment. For example, in recent years, Disney was capable of generating $1.2 billion of operating income from its movie titles. What if Disney could earn that level once again, which suggests a near doubling of current operating income? If possible, Disney would realize an additional $577 million of pre-tax earnings, or $375 million of net income. This would add $0.20 per share of earnings, or about $2.51 per share of market capitalization, based on the current 12.8x p/e ratio. Additionally, attendance is still recovering to prior levels at its parks and resorts locations. This might be interpreted as some support that Disney, in full success mode, possesses meaningfully higher earnings power than is currently in evidence.

Valuation Considerations

The Anticipated Earnings Decline

Although this discussion is focused specifically on Disney, investors in general are discounting a recession event for many large U.S. companies. Moreover, it might be asserted that investors have become increasingly skeptical of the ability of these companies to maintain current profit margins, which are now extraordinarily high on a historical basis. This is being reflected in the p/e ratio of S&P 500 companies, which now trade in aggregate at an 11.7x earnings multiple, based on the $107.85 per share of operating earnings forecasted by the analytical community.

Presently, Disney is expected to produce $2.88 of earnings per share in the coming 2012 fiscal year. At the current $36.76 share price, the company trades at a 12.8x p/e. One might recognize that Disney trades at a premium to the market, as defined above; however, few would argue the high quality of Disney's assets, and the modest premium that is likely justified. This observably low earnings multiple should be compared to the longer-term average, which as shown below is 17.7x (excluding abnormally high ratios from 2001-2003).

Table 6: Historical Disney P/E Ratio

Year	P/E
2011	14.6x
2010	18.4x
2009	18.3x
2008	10.0x
2007	14.4x
2006	21.5x
2005	19.5x
2004	25.0x
2003	36.0x
2002	27.0x
2001	40.9x

On a year-forward basis, then, Disney trades at a level that is 27.7% below its historic average. This suggests that investors clearly do not believe Disney can achieve this $2.88 earnings estimate. Using this logic, the recently completed fiscal year would have represented the company's earnings peak of $2.52 per share. On a trailing basis, Disney trades at a 14.6x p/e, which is 17.5% below the historical average of 17.7x. This is the presumed degree to which Disney's earnings are anticipated to decline.

Let us assume that Disney experiences the exact same earnings fate as during the 2008-2009 recession. The year over year decline in this period was 22.5%, or from $2.27 to $1.76 per share. Against Disney's 2011 earnings per share of $2.52, the company would realize $1.95 per share of earnings, if such a circumstance were to occur. Currently, the shares trade at 18.9x this scenario. Similarly, this suggests Disney is only capable of generating a 10% ROE ($1.95 ÷ $19.58 per share of book value), the level that was last recorded in 2009.

One might make two observations at this point. First, investors have essentially concluded that the Disney earnings are not sustainable, which is expressed through the low p/e ratio. Secondly, this anticipated decline is predicted to be similar in magnitude to the severe recession of only a few years ago. Given the dreadful circumstances of that time, one appears to be receiving a rather wide margin of safety at the current valuation.

Actual Risk vs. Perceived Risk

As documented, Disney is susceptible to lower earnings on occasion. This is the actual risk, on a fundamental basis, of owning shares of the company. It might be noted at this point that the fundamentals-based risk appears confined to normal cyclicality, rather than more severe financial risk, such as balance sheet leverage. Presently, Disney reports $10.792 billion of net debt, the interest payments of which are exceeded 24x by the company's annual operating income. In fact, Disney has reduced its debt by over $300 million since 2006.

However, the manner in which investors price risk is altogether different. This is referred to as the perceived risk, and is manifested through equity valuations. In determining the potential loss one might suffer if in fact Disney were to experience earnings difficulty, the reader should view both the p/e table presented on the previous page, as well as the historical price-to-book ratio, which is shown below.

Table 7: Historical Disney Price-to-Book Ratio

Year	P/BV
2011	1.9x
2010	1.9x
2009	1.8x
2008	1.4x
2007	2.2x
2006	2.2x
2005	1.9x
2004	2.2x
2003	2.0x
2002	1.4x
2001	1.9x

To begin with, Disney traded at a decade low of 10x earnings in 2008. Employing a normal multiple for Disney of 17x, investors had predicted the company's earnings would fall by over 40% during recession. It is now known that the actual experience was -22.5%. Similarly, Disney has traded as low as 1.4x its book value twice in the past 11years - 2002 and 2008 - both during years of recession. On average, Disney has traded at 1.9x book value over time. In other words, investors had forecasted a 26% decline in the company's return on equity from 2008 to 2009. The actual difference in return on equity in those years was -28.5%.

Hence, the difference between perceived risk and actual risk can be striking. Purely for illustrative purposes, what if Disney were to trade at 10x earnings or 1.4x book value? On an earnings basis, using the consensus 2012 estimate, the share price would be $28.80, or 21.7% below the current price. Alternatively, considering $19.58 of book value per share, the potential decline would be 25.4%. These two scenarios might be considered as the extreme end of perceived risk, in that both are based on the mindset of investors in late 2008. Importantly, should such a decline occur, the long term investor would recognize this as merely a short-term unrealized loss that ultimately might be reversed through a recovery of the company's earnings and subsequent valuation.

Potential Positive Outcomes

Since the earnings of Disney are in acceleration mode, making a normal reversion to mean profit outcome analytically irrelevant, let us approach one's potential return in the following manner. The Disney return on equity has varied mightily since 2001, but has been steadily increasing for the past eight years. For instance, the company's return on equity in 2004 was 9%. Prior to that, this measure was closer to 5%. This has less to do with financial leverage, since Disney utilizes modest amounts of debt, and is mostly attributed to the impact of the highly profitable cable network business coming to dominate overall earnings. For instance, the net margin in 2004 was 7.6%. Currently, it is 11.8%, but still below the peak of 13.2%, all of which is presented below.

Table 8: Disney Historical Return on Equity and Net Margin

Year	ROE	Net Margin
2011	12.9%	11.8%
2010	10.6%	10.4%
2009	9.8%	9.1%
2008	13.7%	11.7%
2007	15.2%	13.2%
2006	10.4%	9.8%
2005	9.8%	8.0%
2004	9.0%	7.6%
2003	5.6%	4.9%
2002	5.3%	4.9%
2001	4.7%	4.2%

Disney appears capable, excluding recession years, of consistently producing a 12% ROE. If the company were able to maintain this, and reinvested 100% of its annual net income, one could expect the earnings to also increase by 12% per annum. However, Disney pays a modest dividend, which amounts to 15.7% of its net income. Therefore, on an annual basis, the company retains 84.3% of its earnings. The multiplication of a 12% ROE to this reinvestment rate equals an expected net earnings growth rate of 10.1%. Obviously, the investor will also earn the 1% annual dividend yield as part of the total return equation.

If Disney's shares were to trade no higher or lower than the current 12.8x p/e, the investor would earn 11.1% per annum. If one believed that the Disney shares should trade more commensurately with their historical valuation range, the 17.7x p/e applied to $2.88 per share of earnings suggests that another 39% of return might be added to the base case vis-à-vis valuation expansion. In this way, Disney represents an intriguing profit opportunity, with downside protection already being offered through the low valuation, this resulting from investors' perception of an inevitable recession.

Lastly, these remarks might be qualified through the following example. The current price-to-book value ratio of Disney is 1.9x, or a 190% premium to stated book value. If the Disney shares were considered in bond terms, they might then be characterized as trading at 190 cents on the dollar. If one accepts the above base return outcome of 11.1%, is the "premium to par" justified?

In Disney, one is essentially paying 190 for a bond with a 12% coupon (the normalized ROE), for an effective ROE of 6.3%. A corporate bond with similar pricing and coupon features would trade at an effective yield of 6.3%. However, this bond would ultimately depreciate in value to par, or to 100, lowering the effective yield-to-maturity. The shareholders' equity of Disney, though, is perpetual and retains its valuation optionality. The company's book value, given the normalized ROE and earnings reinvestment rate, would increase by 10.1% per annum. Thus, if the share price remained unchanged, the price-to-book ratio ultimately would decline. Let us assume that this occurred over a number of years to the extent that Disney traded at 1x book value. At that point, this book value, which would have compounded over the years, would still be capable of producing a 12% return, such that if Disney were again to trade at its normal 1.9x multiple, the investor would earn this 90% possible rate of return. The buyer of the aforementioned corporate bond receives no such return.

Therefore, in accepting the equity-related risk of owning a Disney share, it appears that the current premium to book value is clearly warranted, given the inferior return or yield provided in the current bond market environment.

Investment Summary

Disney is one of the more visible companies in the S&P 500. Its businesses, such as cable network properties and an increasing number of themed resort parks worldwide, are both well-known and analyzed by investors. In aggregate, these assets can produce periodic earnings variability, such that Disney is clearly a cyclical company. Throughout various times in its history, Disney has been priced in a manner that reflects the possibility of an impending recession, as economic weakness nearly always disrupts the company's earnings growth to some degree. At the moment, the shares trade at a 27% discount to their historic average, as investors have expressed their view of a possible U.S. recession through a low Disney valuation. This margin of safety appears sufficiently wide, thus serving as protection against potentially lower Disney earnings, while also providing considerable return possibilities irrespective of the forecasted recession. As a result, the shares are suitable for purchase.

THE WALT DISNEY COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(unaudited; in millions, except per share data)

	Quarter Ended		Nine Months Ended	
	July 2, 2011	July 3, 2010	**July 2, 2011**	July 3, 2010
Revenues	**$ 10,675**	$ 10,002	**$ 30,468**	$ 28,321
Costs and expenses	**(8,229)**	(7,723)	**(24,554)**	(23,116)
Restructuring and impairment charges	**(34)**	(36)	**(46)**	(212)
Other income	**-**	43	**75**	140
Net interest expense	**(88)**	(89)	**(266)**	(322)
Equity in the income of investees	**184**	139	**463**	382
Income before income taxes	**2,508**	2,336	**6,140**	5,193
Income taxes	**(845)**	(831)	**(2,133)**	(1,846)
Net income	**1,663**	1,505	**4,007**	3,347
Less: Net income attributable to noncontrolling interests	**(187)**	(174)	**(287)**	(219)
Net income attributable to The Walt Disney Company (Disney)	**$ 1,476**	$ 1,331	**$ 3,720**	$ 3,128
Earnings per share attributable to Disney:				
Diluted	**$ 0.77**	$ 0.67	**$ 1.93**	$ 1.60
Basic	**$ 0.78**	$ 0.68	**$ 1.97**	$ 1.63
Weighted average number of common and common equivalent shares outstanding:				
Diluted	**1,912**	1,978	**1,924**	1,951
Basic	**1,883**	1,945	**1,891**	1,917

THE WALT DISNEY COMPANY
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited; in millions, except per share data)

	July 2, 2011	October 2, 2010
ASSETS		
Current assets		
Cash and cash equivalents	**$ 3,519**	$ 2,722
Receivables	**6,212**	5,784
Inventories	**1,542**	1,442
Television costs	**693**	678
Deferred income taxes	**1,051**	1,018
Other current assets	**626**	581
Total current assets	**13,643**	12,225
Film and television costs	**4,312**	4,773
Investments	**2,505**	2,513
Parks, resorts and other property, at cost		
Attractions, buildings and equipment	**35,222**	32,875
Accumulated depreciation	**(19,591)**	(18,373)
	15,631	14,502
Projects in progress	**2,440**	2,180
Land	**1,136**	1,124
	19,207	17,806
Intangible assets, net	**5,094**	5,081
Goodwill	**24,136**	24,100
Other assets	**2,208**	2,708
Total assets	**$ 71,105**	$ 69,206
LIABILITIES AND EQUITY		
Current liabilities		
Accounts payable and other accrued liabilities	**$ 5,602**	$ 6,109
Current portion of borrowings	**4,062**	2,350
Unearned royalties and other advances	**3,102**	2,541
Total current liabilities	**12,766**	11,000
Borrowings	**9,176**	10,130
Deferred income taxes	**2,905**	2,630
Other long-term liabilities	**5,336**	6,104
Commitments and contingencies		
Disney Shareholders' equity		
Preferred stock, $.01 par value		
Authorized – 100 million shares, Issued – none	**–**	–
Common stock, $.01 par value		
Authorized – 4.6 billion shares, Issued – 2.7 billion shares	**30,159**	28,736
Retained earnings	**37,288**	34,327
Accumulated other comprehensive loss	**(1,809)**	(1,881)
	65,638	61,182
Treasury stock, at cost 879.8 million shares at July 2, 2011 and 803.1 million shares at October 2, 2010	**(26,692)**	(23,663)

Total Disney Shareholders' equity	**38,946**	37,519
Noncontrolling interests	**1,976**	1,823
Total equity	**40,922**	39,342
Total liabilities and equity	**$ 71,105**	$ 69,206

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