Siena Market Line
2nd week of December 2016

## SeaWorld Entertainment

NASDAQ: **SEAS**

**Analyst:** Andrew Cote
**Sector:** Services

## BUY

Price Target: $27

## Key Statistics as of December 8th, 2016

| | |
|---|---|
| **Market Price:** | $18.66 |
| **Market Cap:** | $1.66 B |
| **Operating Margin** | 12.16% |
| **Net Margin** | 3.58% |
| **Short interest** | 5.6% |

## Catalysts

- More Effective capital allocation decisions by management
- Change in public perception of brand
- Progression towards improved capital structure
- Increase consumer spending power
- Activist investor interest

## Company Description:

SeaWorld Entertainment owns or licenses a portfolio of recognized brands including SeaWorld, Busch Gardens and Sea Rescue. They have built a diversified portfolio of 11 destination and regional theme parks that are grouped in key markets across the United States, many of which showcase our one-of-a-kind zoological collection representing more than 800 species of animals. Our theme parks feature a diverse array of rides, shows and other attractions with broad demographic appeal which deliver memorable experiences and a strong value proposition for our guests.

## Thesis

SeaWorld Entertainment has had a lot of issues including poor capital allocation decisions, negative publicity, legal issues, and bad management of financials; all of which making them less attractive to investors. Since the management shakeup in 2013, the executives have been on the path of recovery. A lot of progress has been made in a few key areas including their public perception, debt repayment, investment in new attractions, driving more revenue from existing attractions, and creating other streams of income. They have shown that they deserve to be valued similarly to their competitors which is between 20 and 22x forward earnings.

## Main Issues

### Negative publicity

The release of the film "Blackfish" in 2013 brought to light how Orcas were treated and bred in captivity which brought negative attention on SeaWorld Entertainment. Being that SeaWorld is famous for their Killer Whale shows, this undoubtedly hurt their public perception and brand. The negative publicity spread quickly with the popularity of social media and the film being placed on Netflix for their millions of viewers to access.

### Decreased attendance

Following the negative publicity, SeaWorld saw a 5.5% decrease in revenue in 2014 resulting from an obvious drop in attendance. Although attendance has since recovered, attendance is currently being affected by political issues in Brazil; they make up a large portion of their Latin American market.

### Poor Capital allocation decisions

Attendance in this industry is largely correlated with the innovation and invention of new attractions. Naturally, we would expect high capital expenditures for new attractions but what has ailed SeaWorld in the past is their poor execution and efficiency. High cost projects lowered their return on investment and they had fewer new attractions per year. Additionally, in 2013 they started to pay a dividend instead of deleveraging their balance sheet which would lower their operating interest expense and lower their future cost of borrowing.

### Highly leveraged

Their poor capital allocation decisions have led to a rapid growth in long term fixed debt. In the year 2012, SeaWorld had over $1.8 billion in long term debt which was 4x its total equity and 4.6x EBITDA. Also, during this same period, net interest expenses were over $110 million which was half of their operating income.

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| Operating Margin | 10.84% | 15.64% | 17.08% | 12.74% | 12.16% |
| Net Margin | 1.44% | 5.21% | 3.56% | 3.62% | 3.58% |

High interest expenses have eaten away at net margins as you can see from the difference in operating and net margins. The largest impact of the interest expense is its effect on free cash flow to the firm; in 2011 and 2012 FCF to the firm was negative.

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| FCF | $ (87.022) | $ (13.197) | $ 37.832 | $5.992 | $ 21.253 |

### Legal issues

Since the release of blackfish in 2013, SeaWorld Entertainment has been involved in a legal battle in which the plaintiffs, which are made up a basket of retirement systems and pension funds, claim that SeaWorld's management, board members, and underwriters mislead investors. They accused them of knowing or being reckless in not knowing that Blackfish was impacting SeaWorld's business but district court granted the defendants motion to dismiss the first complaint. The Plaintiffs then filed a second complaint not naming the underwriters and Board members as the defendants. SeaWorld Entertainment believe that the lawsuit is without merit and does not believe it will materially affect them.

Many other lawsuits SeaWorld are in involve animal activist groups who claim that they misrepresented the living conditions of the animals they care for.

## Re-positioning of Public Perception

### Increase Marketing Spend

Reacting to the negative image, management rightly began to grow the amount of marketing and image boosting activity. Since 2012, SG&A grew from 13.8% of sales to 15.6% of sales in 2015.

**Animal Rescue activities/Conservation Efforts**
SeaWorld Entertainment and their for-profit and non-for-profit subsidiaries have historically been proactive with safety and treatment of their animals and wildlife conservation efforts. They not only contribute, but are a leader in wildlife research, habitat protection, and animal rescue education. In addition, they operate one of the world's most respected rescue programs for ill and injured marine animals, in collaboration with federal, state and local governments. I see no reason to why the brand could not recover from one burst of negative publicity when they increasingly are proactive in their efforts. SeaWorld has already begun to see recovery from the drop in attendance in 2013. Attendance grew 30 basis points for 2014 to 2015 which represents a turnaround in the declining trend. For 2016 we see the upward trend continuing in domestic attendance but rather weak attendance from its guests from Brazil and other Latin American countries due to political unrest and the stronger dollar per management.

**Diversifying**
Becoming less reliant on their Orca shows and providing alternative educational and enjoyable experiences has become a priority since they have decided to cut the expansion of Orca shows in San Diego. New regulations under federal law outline how animals in captivity should be cared for and due to these new regulations so management has decided change their strategy and focus on other educational experiences. SeaWorld Entertainment also owns and has strategic alliances with well-known brands including Sesame Street and The Polar Express. Lastly, they have been involved in creating original content like television series and music for their theme parks and media enterprises which are for available for sale.

**Original Content**
Part of their diversification is the content they are creating for television. Broadcasted on ABC network, Sea Rescue and The Wildlife Does are both Emmy-nominated programs that have been approved for continuation. These types of investments by management are expected to continue but do not make up a significant portion of their revenue. It is the expectation that their content will increase brand visibility and consumer awareness which will not only help attendance in the future but will create different revenue streams.

## Adding Value

**Improving Capital Allocation Choices**
We do see a trend of more effective capital allocation decision in the recent year. They recognize that the number and quality of their investments in new attractions is wheat will help drive attendance. Per the 3rd quarter earnings call, they have capped CAPEX at $175 million a year for the future which is historically average for them. Also, and most important, they have begun to avoid investing in overpriced attractions to receive the same return. Managing the cost of projects has become a huge priority and has shifted slightly the types of attractions they invest in. SeaWorld is focusing on looking for lower cost attractions (not lower quality) to increase the overall number of new attractions per year. Some of the new attractions include virtual reality experiences and offseason/holiday events. Lastly, Management has thankfully decided to stop its dividend payments in the 3rd quarter 2016 and using the money to reinvest in attractions and more importantly using the money to pay down their high levels of debt.

**Increasing Revenue from Existing Assets**
SeaWorld's business is very seasonal with two thirds or their revenue coming in the 2nd and 3rd quarters. Some parks are closed during off peak times especially those located in northern half of the U.S. To drive attendance in the parks still open during non-peak seasons management has been implementing holiday specials with holiday themed attractions and experiences. This is important to maximizing profitability by generating more cash flow throughout the year to minimize the effects of seasonality.

## Competition

Principal direct competitors of our theme parks include theme parks operated by The Walt Disney Company, Universal Studios, Six Flags, Cedar Fair, Merlin Entertainments and Hershey Entertainment and Resorts Company. Their highly-differentiated products provide a value proposition and a complementary experience to those offered by fantasy-themed Disney and Universal parks. In addition, they benefit from the significant capital investments made in developing the tourism industry in the Orlando area.

### Risks

- SeaWorld Entertainment is managing large amounts debt on their balance sheet and them being able to meet the interest obligations on that debt is highly dependent on their ability to attract guests
- In this industry, companies are frequent targets of lawsuits and the outcomes of those lawsuits can have a material impact on their business.
- Macroeconomic pressures including the spending power of consumers fluctuates and does impact spending within the themed parks.
- Social media has increased the speed at which news spreads. Any negative attention they might receive may have an immediate impact on operations.

## Valuation

The best way to value companies in this industry is with multiples of earnings. I believe that in this case we should look back to before the negative publicity and management shake-up in the 2013/2014 years in which SeaWorld was trading at 20-22x forward earnings which was towards $30 per share. If management continues to add value like they have been and reduce overall debt, then I believe they will end in a better position than they started and the $30 per shar valuation is conservative.