

FCL*Capital*

February | 2017

Thesis - Long on Gannett Inc

Iconic brands and consistent cash generator selling at bankrupt level prices due to exaggerated hysteria about the “end of traditional media”.

1. The company

The simple fact that we can write about Gannett as a small cap stock - a company that is worth less than U\$ 1 billion dollars gives some pause for thought. Gannett owns, after all, one of the most iconic media brands in the world.

Gannett is one of the premier publishing companies in the United States. It publishes one of the country's top 3 newspapers by circulation, USA Today which alongside the New York Times and The Wall Street Journal forms the triumvirate of America's most important newspapers.

Besides the USA Today, Gannett owns hundreds of local media organizations in small and mid tier cities in both the US and the UK - often being the major source of local news, social events information and other community related and opinion content.

Among dozens of brands owned by Gannett besides the USA Today, are The Des Moines Register, Detroit Free Press and The Tennessean.

All in all, the company has some impressive numbers by its side: USA Today alone is reached monthly by more than 89 million unique visitors - a number capable of putting to shame many internet companies that enjoy stratospheric valuations. Its online traffic is consistently among the top 10 in the US, only trailing giants like Google and Facebook.

So let's see how the business is going for the past few years:

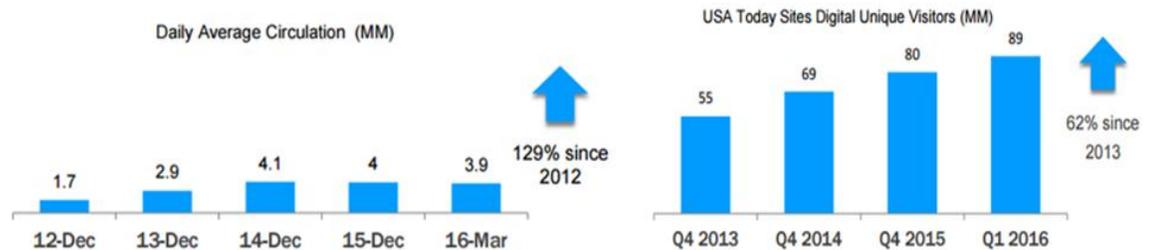
First of all, the reason the company trades at a sub USD 1 billion valuation is not a secret: even our grandmothers know that the media industry is going through one of the major transformations of its history due to the internet in general and social media in particular, that has given people habits like:

- a. Getting used to the idea of not paying for media, news and content at all since they can get a lot of it for free.
- b. Not distinguishing or even caring about the distinction between fake and real news/content.
- c. Looking for news and services online or in social media, and no longer using newspapers as a news source.

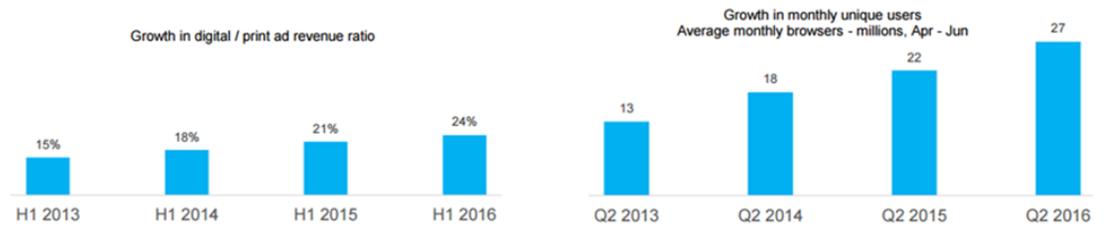
We think that all of these threats are exaggerated and that the current valuation does not do justice for the company's already ongoing new positioning as an online first, content generator media company.

First, although it is undeniable that as a secular trend, Gannett's subscribers will migrate to its online platforms and probably most will consume the company's media products online, the belief that this necessarily kills the company's profitable business model is a myth.¹

Chart 1



¹ As a recent Techcrunch article shows, millennials, already used to paying for different subscription services like Netflix and Hulu may end up viewing newspapers content like another regular subscription service <https://techcrunch.com/2017/03/04/why-newspaper-subscriptions-are-on-the-rise/>



Source: Company Presentation

https://gannett.investorhq.businesswire.com/sites/gannett.investorhq.businesswire.com/files/doc_library/file/Company_Overview_7-2016.pdf

As of now, the company is hugely profitable as it still has millions of subscribers. The only reason it trades at these levels is because investors are worried about the future. In other words, Gannett could be called the anti Tesla or anti Amazon: if these two are unprofitable companies that are worth many billions of dollars because investors are super excited about what the future will look like for them. Gannett on the other hand is profitable today but a small cap stock because investors are nervous this will no longer be the case a few years from now.

It is true that the industry has a painful transition ahead, one that will still probably see many layoffs and downsizing, but several media organizations around the world have already reached the light at the end of the tunnel - it seems that people will always pay for exclusive content that they are interested in and care about. As examples, The Economist and Financial Times, both London based publications specialized in financial news and both wildly

profitable and whose audience consumes its products mostly on tablets and smartphones.

It is obvious the old model for the newspaper industry, one that relied on Sunday subscriptions and classifieds, is dying. But a new model - leaner, more cost conscious and whose audience is reached mostly through digital means is only being born. And good content will always have people willing to pay for it - just ask Bloomberg, HBO, The Economist or ESPN.

As for the second concern, the interesting fact is that recent political events, like Brexit and the election of Donald Trump, only showed the world that no matter which side of the political spectrum you sit on, nothing will ever completely replace professionally made news media. No matter how many hours a day a person spends on social media, being able to reach news events in a newspaper format - digitally or in written form - still does not have a complete substitute and it is still a very valuable proposition, like the planet's elites seem to attest.

Finally, as for classifieds, we think this development is not only already in the price but at the same time it may be offset by new possibilities - Gannett and other leading newspaper companies generate hundreds of millions of online accesses. Certainly once the transition to a new model goes in full swing, new sources of revenue will arise - maybe not exactly like the pre online days, but

at the same time, Gannett and its peers are only starting to experiment with this huge optionality.

To sum it up: Gannett is a company that owns an amazing brand, a brand that alone is worth far more than the company's price at the market, and many local media organizations that enjoy near monopolies in their markets and which structure could be replicated to deliver content - just look at how similar its different apps are² - and its economies of scale become clear. And all of this with a sticky and loyal customer base.

² <https://itunes.apple.com/us/developer/gannett/id404843797>

What will the Gannett of the future look like? Our best guess is a company that reaches as many people as it does now, partially with the help of social media, a leaner organization, not as dependent on classifieds, with an even more international readership and likely with its content being largely consumed in tablets and yet unreleased gadgets like smart glasses and watches. But the central point, professionally created content talking about local news or world affairs with insights from experts will probably live on and still command a premium from a devoted readership, just like it did in the past century and just like it does today even after a quarter of century of internet penetration.

2. The thesis

Our main thesis is that Gannett and other leading newspaper companies in the US will survive. They may have a somewhat smaller number of subscribers and their business models will change - less dependent on classified sections and more reliant on digital subscribers and ads gained from their huge online traffic - but overall the major dynamics won't change that much - a mass oriented product made by professional journalists that have access to sources and other scarce content not reached by major segments of the population and even most importantly, whose opinions have weight. Important journalists are after all influencers - and their columns and insights will still drive eyeballs - long before the Kardashians people like Paul Krugman, Martin Wolf or The Economist anonymous leaders, already moved hearts and markets and will continue to do so.

3. The Valuation

So how much a business like Gannett should be worth? There are several ways to do a reasonable guessing game.

First, we could simply estimate, in a very crude approximation, that after a few years of declining revenues and subscribers, the company's revenues will be in a decade or so, half of what they currently are. This seems a little harsh to us, since the revenue decline trajectory is already decelerating. But let's suppose, for the sake of argument that this happens and the company has to embark on a massive cost cutting program, that, economies of scale aside, leaves estimated future free cash flow half of where they are now, and maintaining the company's revenue to free cash flow ratio. It is, obviously, a very crude calculation but as good as any to estimate the future of the company.

- Gannett 2017 Estimated Free cash flow (Bloomberg consensus): U\$ 227,3 million
- Gannett current free cash flow yield: 24,14%
- Gannett perpetual estimated annual free cash flow: U\$ 113,65 million
- Gannett estimated perpetual annual free cash flow yield: 12,08%

The result would be a business with a 12% free cash flow annual yield and leading global consumer brands. Or, if we use a very reasonable 6% free cash flow yield as a “fair multiple”, a **100% upside**.

But let’s do a second calculation. Let’s take a business that is also notoriously declining, arguably on a faster pace than Gannett: the cable business.

Everyone knows that one of the millennial generation’s major tendencies is to “cut the cord”. Suddenly people are starting to realize that with so many entertainment options, not to mention Netflix, online porn, Facebook, and so on, they don’t need as many cable channels.

Let’s compare Gannett’s multiples with Comcast and Frontier, two cable providers, according to 2017 Bloomberg consensus:

	EV /Ebitda
Gannett	3.61
Comcast	8.59
Frontier	5.44

This would result in a **51% upside** if Frontier multiples are used or a **137% upside** if Comcast multiples are used.

Gannett upside if Frontier multiples are used: 51%

Gannett target price if Frontier multiples are used: \$ 13.15 per share

Finally, if you are still uncomfortable with the idea of comparing Gannett with any non newspaper company, then let's compare the company with its most direct peer: the New York Times.

The New York Times	2017
EV/Ebitda	7.9
Free Cash Flow yield	nil

Gannett	2017
EV/Ebitda	3.61
Free Cash Flow yield	24%

Source: Bloomberg consensus

This would result in a **118% upside** if The New York Times is used as a comparable.

4. Risks

We are a small deep value focused investment house. In our experience, the best investments are not only counter intuitive; they are usually the ones that make people's stomachs churn. They are the ones that we would even be a little embarrassed of suggesting. And indeed, they do carry some risks.

In Gannett's case, there are a few obvious and a few not so obvious risks:

- First and foremost, unlike some other more specialized news sources, Gannett might not be able to pull a profitable transition from a paper centric content delivery to an online one, losing subscribers, and eyeballs, not to mention ad dollars along the way.
- Gannett did quite a few recent acquisitions in the past few years and also made a failed attempt to buy Tronc. Another risk is that the past acquisitions prove to destroy value, or, even worse in our view, the company embarks on a new value destroying acquisition.
- Finally, one of the many things Gannett still has to sort out is its unfunded pension's liabilities. Overall, due to the long term nature of the pension plan's liabilities, the conservative change in assumptions the company's CFO has taken and the forecasted environment of rising interest rates might help. We still don't consider its unfunded pension plan status a major risk or a factor

that for now leads us to dramatically change our assumptions. Furthermore, even if we adjust the unfunded part of the pension plan and treat it as debt, we would still arrive at amazingly cheap multiples on a EV/Ebitda basis.

Chart 2

In thousands

	Dec. 25, 2016	Dec. 27, 2015
Accumulated benefit obligation	\$ 3,153,811	\$ 3,179,094
Fair value of plan assets	\$ 2,411,007	\$ 2,558,627

Source: Annual Report

Therefore, \$ 1.217 billion in enterprise value, plus underfunded liabilities of 750.6 million equals an enterprise value of \$ 1.967 billion, or a multiple, on an EV/Ebitda basis of 5.90 according to the current Bloomberg 2017 consensus.

5. Our take

“Our goal is to build the perfect personalized newspaper for every person in the world,” “We’re trying to personalize it and show you the stuff that’s going to be most interesting to you.”

(Mark Zuckerberg)

Many people in the news industry were deeply scared by the above quote. In their minds Mark Zuckerberg seemed to signalize his attempt to replace traditional media. In our view, on the other hand, the quote was not only reassuring, but it also showed that Facebook will never completely collide with traditional media. Read it again and pay attention to the word “interesting”. That’s the key word. Facebook and other social media are interaction tools. Traditional media is a gatekeeper and a messenger of facts to segments of population: depending on your political views the truth may be different but you will still need a messenger apart from social media.

So where is the future for traditional media? Admittedly, the more specialized your content is, usually the easier it is for you to make the transition. Financial news sources, for example, that are used by traders to invest millions of dollars are already very well adjusted for their online future: Bloomberg is a private but hugely profitable company, while The Financial Times and The Economist can both count their online global subscribers in their millions.

Each news source will face a different transition. Some will test pay walls, some will try to go totally free and rely on ad dollars (like BuzzFeed and Business Insider), and some will come up with premium content and rely only on subscribers.

We do not pretend to know the perfect answer about how exactly Gannett will pull this rabbit out of its hat. But that's precisely the point: investors hate uncertainty and sometimes discount it too much.

Due to the quality of its journalism, due to its history, its sticky and loyal consumer base and most importantly, due to the power of its brands, it is a very safe bet in our opinion that a somewhat smaller but still very profitable Gannett will have a tremendous future 10 or 20 years from now. And going back and forth on the company's valuation and multiples it seems very hard to us in any plausible scenario, adopting any reasonable assumption to conclude that the stock is not severely undervalued TODAY, even adopting pessimistic assumption about its rate of subscribers and ad dollars decline.

As Warren Buffet once said, there are not any rules about which way you are supposed to make money in investing. It doesn't have to be in a thriving and growing company. It can perfectly be in a declining one as long as you pay the correct price for it and reinvest wisely its dividend dollars.

Our thesis is that Gannett does not only possess very good employees, assets and brands, but most importantly, a surprisingly undervalued stock and a compelling investment opportunity.

Sobre a FCL Capital

A FCL Capital é uma gestora de recursos sediada no Rio de Janeiro, cujo objetivo é maximizar o retorno de seus investidores. A FCL tem como nicho principal, mas não exclusivo, investimentos em empresas abertas, listadas em bolsa de valores (posições compradas e vendidas nos mercados acionários). Para saber mais sobre nosso trabalho, entre em contato conosco ou acesse nosso website: www.fclcapital.com.

Relacionamento com Investidores

fcl@fclcapital.com

info@fclcapital.com

Avenida das Américas, 500 - Bloco 3

Sala 125

Rio de Janeiro / RJ - Brasil

CEP: 22640-100

Telefone: (55) (21) 3268-7918

www.fclcapital.com

Auditoria



Custódia



Regulamentação



Administração



Advertência jurídica: Esta carta é publicada somente com o propósito de divulgação de informações almejando dar transparência aos nossos investidores e não deve ser entendida como uma oferta de venda do clube de investimentos FCL Capital ou de qualquer valor mobiliário nela citada. As opiniões e estimativas citadas nesta carta são considerações feitas até o momento da publicação e podem mudar sem nenhum anúncio ou aviso prévio. Performance passada não é garantia de performance futura. Fundos de investimentos não possuem garantia de seu administrador, do gestor, ou qualquer mecanismo de seguro de fundos. As performances exibidas são sempre líquidas de taxas de administração e performance, mas não do imposto de renda devido pelos cotistas. Para maiores informações favor acessar o Portal Educação Financeira da ANBIMA "Como Investir" (www.comoinvestir.com.br)