Give Him Liberty

The holdings John Malone didn't sell control of to AT&T may be worth a look

BY LESLIE P. NORTON • Now that John Malone is selling Tele-Communications Inc. to AT&T, investors are squinting at their cable stocks with delight and dread. Delight, because further deals are likely. Dread, too, because they fear that if Malone, the Darth Vader of cable TV, is willing to forgo further upside in TCI stock, the sector's year-long surge could be about to end.

But this time, if Malone resembles any *Star Wars* character, it's not Vader, but rather the Man in Black's boss: the emperor ever-intent on protecting and expanding his holdings. Already rich, Malone gets even richer from the deal with AT&T, and will now control around 1.5% of Ma Bell's stock. He'll also serve on AT&T's board. But the wily investor is keeping control of **Liberty Media**, TCI's publicly traded programming subsidiary. And, as he told anyone who would listen, he aims to devote 100% of his time to Liberty, which will merge with its sister company, **TCI Ventures**. So it's no surprise that the two shot up last week: Liberty by 8%, to 39, and Ventures by 15%, to 20. So did shares of other programmers. (Both Liberty and Ventures are "tracking stocks," or issues used by large companies to value a defined piece of their business. Investors don't own the assets outright. But if Liberty were sold, its shareholders would benefit.)

Despite the higher stock prices, some savvy investment pros were still buying Liberty and Ventures shares last week, reasoning that the two are worth still more. One was veteran media investor Mario Gabelli, a member of *Barron's* Roundtable (see page 35), who began increasing his Liberty position and buying Ventures the day the AT&T transaction was disclosed.

Others on Wall Street were similarly enthralled. Merrill Lynch pounded the table for the stock. NationsBanc Montgomery Securities made Liberty its favorite entertainment issue late last week, slapping a price target of $49 on the new stock, a cautious discount to its '99 estimated valuation. "It's Warren Buffett all over again," gushed Mario Gabelli.

Jubilant, too, was Rick Lawson of the Weitz Mutual Funds, a seasoned cable investor. "It just seems clear to me that this new Liberty will be worth a lot more than the underlying stock price," he observes.

Sure, the merger could fall through. A few years back, after all, TCI pulled up short in its walk to the altar with Bell Atlantic. But the combination of Liberty and Ventures seems bound to go forward even if that happens. Malone, a major voter of both shares, will make sure of that.

Liberty will exchange 0.52 of each of its A and B shares for one share of TCI Ventures. The programming unit of TCI owns assets such as the Discovery Channel, the pay-TV outfits known as Encore and Starz, a 9% chunk of Time-Warner, nearly 50% of the QVC network run by Malone's pal Barry Diller, and other Diller projects. Ironically, TCI Ventures, which houses a collection of non-cable assets, was spun out from TCI last fall as a tracking stock, in part to get better valuations for its assets *a la* Liberty. Among other things, Ventures owns a big stake in AT&T, obtained when AT&T bought Teleport, and a position in @Home, the fast-growing cable Internet provider. As part of the deal, AT&T will pay $5.5 billion for these stakes and some other Ventures assets.

Those who buy Liberty will need to get accustomed to some high-handed maneuvers. Though the asset sales to AT&T give Ventures shareholders tax-free cash, the deal raised the ire of some investors. With some justification, they believe they ought to get more Liberty shares than they're offered.

Some recent analysis suggested, after

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all, that Ventures was worth as much as $25, versus 17 just before the AT&T deal was announced. Thus, a J.P. Morgan analyst grumbled in a conference call last week that Malone might have chosen to give the proceeds to Ventures shareholders, not share them with Liberty. There's little recourse, however, given that Malone controls Liberty. With Ventures trading at such a discount, some were buying to get into Liberty cheaply.

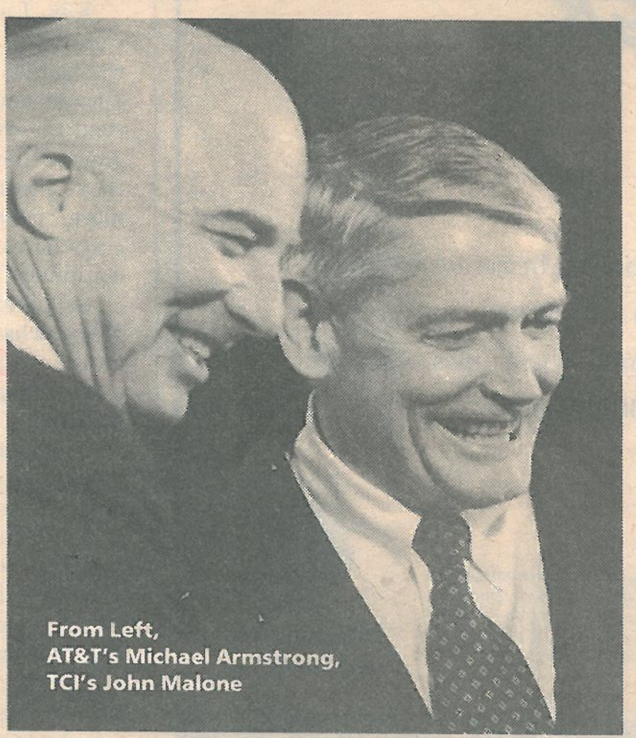
The new Liberty will keep trading as a tracking stock, albeit of the AT&T family. But Malone will control the board, and a huge chunk of shares. And if Liberty is sold, its shareholders, not AT&T, will benefit.

So, what's the new Liberty worth? In addition to its assets (see nearby table), and $5.5 billion of cash, Liberty inherits TCI's substantial loss carryforward of $1.7 billion. And Malone has negotiated a fascinating arrangement whereby AT&T, which can offset Liberty's losses against the $10-$15 billion of taxes it pays a year, will compensate Liberty for tax losses it generates. The new Liberty will also have huge leveraging capacity – something dear to Malone. Under the deal's terms, it can borrow 25% of its market cap at AT&T's superior double-A-minus credit rating, giving it some of the industry's lowest borrowing costs. The new group's market cap clocks in at about $21 billion.

Then there are the potential "synergies" with AT&T, which analysts gush will raise Liberty's profile among cable subscribers, making Liberty's programming attractive to AT&T's competitors.

Malone repeatedly described the new Liberty as a type of GE Capital, one of the biggest successes in financial services, which has created no end of value for shareholders of **General Electric**. Of course, the analogy is strained. GE Capital is hugely profitable. Liberty isn't – and won't be. But Malone has built value before by creating new media ventures. One was the hugely successful @Home.

What will Liberty do with its cheap capital? Robert Bennett, the company's chief executive, is mum. Historically, Liberty has invested directly in cable programming networks. Recently, it acquired Telemundo and launched Spanish-language programming. It's also redeemed shares. "We're very much a portfolio company and operate that



From Left,
AT&T's Michael Armstrong,
TCI's John Malone

HE LOVES HIS LIBERTY

Assets *	Valuation **
1. **Encore/Starz** (movie services)	$3.84
2. **Discovery** (Discovery, Learning Channel, nascent assets)	5.10
3. **QVC** (43%, and USA Networks)	3.76
4. **USA Networks** (19%, plus option to buy shares at $20/shr)	2.20
5. **Fox Sports** (25%-50% of national, international, regional networks)	2.64
6. **Time Warner** (9%, or 57 million shares)	9.45
7. **Other** (e.g. 35% of BET, 10% of E!, 50% of Court TV, 10% of United Video)	4.24
8. **Liberty net cash plus options**	0.77
9. **United Video** (34%, plans to buy TV Guide)	1.41
10. **TCI Intl** (85%, provides 50 cable and satellite services outside U.S.)	3.21
11. **Antec** (16%, fiberoptics to cable industry)	0.26
12. **Sportsline** (5%, interactive sports media)	0.03
13. **General Instrument** (10%, provides set-top boxes to TCI)	1.03
14. **TUNE** (TCI music subsidiary)	0.04
15. **Sprint PCS** (Will go public this year)	5.18
16. **Competitive local exchange carriers**	0.05
17. **Cash of $5.5 billion**	8.89
Total:	**$52.10**

* Items 1-8 from Liberty Media, 9-17 from TCI Ventures.
** On multiple of estimated '99 cash flow or, where cash-flow negative, on dollars per subscriber. Valuations of publicly traded companies assume 10% increase in '99 from Montgomery's year-end '98 target. On estimated 637 million shares outstanding after merger.

Source: Nationsbanc Montgomery Securities way," says Bennett. "We expect Liberty to continue to be a high-growth business. It is managed by people who have large equity positions."

Still, Bennett indicates, it's unlikely that programming will generate sufficient tax losses. "We'll be looking to shelter income, and because there's no big equipment investment, no depreciation for tax purposes, the programming assets aren't effective. We want to invest in good businesses that can also generate taxable losses, so we can be part of the fully taxable AT&T family."

To find those investments, Gary Howard, now head of Ventures, will run what is expected to be a GE Capital-like operation. GE Capital, Bennett notes, originally sought to create investments with tax characteristics favorable to its parents. They would be funded with cash flow from General Electric's mature businesses and with money borrowed at the low rates available to a premier credit like GE. Now GE Capital is the world's largest equipment lessor and handles a host of significant businesses.

Malone's willingness to sell @Home and the AT&T shares suggests that these could go even if the AT&T deal falls through.

No surprise then, that Malone says one path for investment is leasing. Of course, GE Capital has a big advantage; it can lease GE machinery. But TCI could lease its set-top interactive boxes, though Malone, master of off-balance-sheet financing, has also tried to make partners like Bank of America subsidize them.

Comments Bennett: "Leasing gives you tax depreciation and a very reasonable return on your capital, so it becomes very profitable. Related to our core business would be digital set-top boxes, equipment for cable companies, and capital spending by communications companies that would encourage use and distribution of our programming products. Here we could take the depreciation from Day One."

There may also be divestments. Malone's willingness to sell @Home and the AT&T shares suggests these could go even if the AT&T deal falls through. Another piece likely to be dumped is Sprint PCS, which will go public later this year, because **Sprint** is an AT&T competitor. And nobody knows what Liberty intends to do with its huge position in **Time Warner**. But Salvatore Muoio, a New York City-based value investor, includes Time Warner when he calculates Liberty's cash. And Liberty could conceivably raise more funds by selling convertible debt against its assets.

While Time Warner is the most valuable part of the entity now, there are several promising pieces. Bill Nygren, a canny stockpicker at Oakmark Funds and a big cable fan, values Liberty at $42 a share this year and $48 next year. Nygren likes Liberty's Discovery operations, growing nicely as new channels gain fans. But he's especially excited by Fox Sports, a venture with **News Corp.** and **Cablevision**. It's luring local fans by integrating a national sports network with regional channels. Indeed, Nygren hazards that in a couple of years, Fox Sports could surpass ABC's ESPN. Right now, he values Fox Sports at $2 billion, or $3.50 a share. That's more than most people estimate, he admits. But estimates of ESPN's value run as high as $11 billion.

The most inviting piece of the pie, however, is the cash. What to do with it? Many expect a buyback. And analysts are fantasizing about the purchases. What kind? Sports teams, says Paul Kagan, a Carmel, California, media analyst. Kagan says Liberty could easily buy "several" professional teams *a la* Rupert Murdoch, whose recent purchase of the Los Angeles Dodgers for $311 million was "the steal of the century. You buy the rights in perpetuity, and if you're a media guy, you appreciate that."

Ken Londoner, who runs Red Coat Capital, a New York City hedge fund, thinks that Liberty could make Starz and Encore more attractive by merging with rival Showtime, owned by Viacom. "You gain behind-the-scenes economics and they won't compete head-to-head anymore," rationalizes Londoner. "That takes costs down and enhances the deal to the consumer."

Or Liberty could buy Viacom outright. That's what Sal Muoio, the New York investor, thinks is probable. "It's a terrific exit strategy for [Viacom chief] Sumner Redstone," says Muoio.

Eventually, AT&T will either decide it needs to own Liberty outright, and pay a premium to do so, or spin it off. That's what Malone said last week. Whatever happens by then, it seems likely that programming stocks could be in for a bout of speculative frenzy. It's worth noting, however, that cable stocks were struggling not too long ago. Obviously, investors are hoping this time it's different. And that Darth Vader hasn't lost his touch. ■