Gray Television Inc. (NYSE:GTN)  
Price Target: $13.00  
Rating: BUY

Investment Thesis & Recommendation

- Gray Television’s stations are top rated in their markets, with 38 or 39 news channels rated #1 or #2, providing a substantial competitive advantage as stations ranked #1 generally bring in 50% of the total political spending on ads in their respective markets\(^{(1)}\). Gray TV’s market presence within swing states increases the opportunity for political revenue, and political spending is expected to increase with the Supreme Court ruling to remove limits on political campaign ad spending.

- GTN is well positioned to begin an acquisition campaign that will expand its potential audience reach and increase advertising revenues for well into the future. GTN recently purchased channels from Hoak Media that will increase their U.S. households reached by 12% in 2014.

- DCF valuation reaches a $13.00 price target which is driven primarily by forecasted increases in GTN’s political segment. Relative valuation supports that GTN is undervalued using P/E, P/S, and TEV/EBITDA multiples, and GTN’s Free Cash Flow Yield is 2% over industry averages.

Company Overview

Gray Television Inc. (GTN) is a television broadcast company that owns and operates television stations and other digital media located primarily in mid-sized markets throughout the United States. GTN has 52 affiliations with the Big Four major networks (ABC, Fox, NBC, and CBS) as well as 58 additional program streams in over 30 markets. GTN’s programming ranks number one in twenty-three markets, with news programs having a number one rating in twenty-two markets. GTN’s operations hold a collective reach of approximately 6.5% of United States TV households.

Industry Overview

The television industry in the US is shaped largely by the geographic location and size of the competing companies. Because of this, many areas find themselves subject to what is in effect a monopoly or duopoly situation regarding their television broadcast provider. The geographic presence of a company greatly influences its potential audience reach and its demographics.

Demographics, audience reach, and channel ratings drive demand for advertising dollars, and make up the majority of revenues for such companies. In the midst of these demands, television remains the most effective and preferred medium for advertisers to reach its targeted audiences. As such, television broadcasting companies such as GTN continue to enjoy healthy revenue streams from advertisers.

Regulation is also a key part of the industry, as business operations can be substantially affected by FCC announcements: such as the April 4th announcement that joint-sales agreements (JSAs) will no longer be allowed between two local stations in the same market\(^{(2)}\). The FCC & Justice Department’s role in approving acquisitions also has a substantial impact on the industry landscape.

(2) Barrington Research, “Re-establishing Coverage Report.” December 12, 2013
Competitive Advantage

GTN’s focus is to pursue expansion and acquisition opportunities primarily in markets that are below the Top 50 recognized TV markets, with specific targets being state capitals and college towns. GTN believes these markets offer more favorable advertising demographics and more stable economics for broadcasting. Within these targeted markets GTN aims to be the #1 broadcasting station, as this is critical to acquiring political advertising revenue and incremental sponsorship.

Gray Television’s revenue mix consists of traditional advertising from local, national, and political sources, as well as Internet advertising sources. In addition, GTN enjoys a healthy amount of subscriber driven revenue from its retransmissions operations.

In both 2010 and 2012, GTN gained record revenues from political advertisements, earning $58 million and $86 million in each year respectively. Political revenue makes up a significant portion of GTN’s total revenue; and in the previous two presidential elections political revenue accounted for 15% and 21% of total revenue.

The share of revenue resulting from political advertisements may enjoy an even further increase with the Supreme Court’s recent ruling to remove limits on political campaign. 38 of 39 of Gray TV’s news channels are ranked #1 or #2, and Gray is able to capture over 50% of political revenue in #1 rated stations.

Political spending on elections has increased significantly over the past few election cycles, from a total of $4.1 billion in 2004 to over $6.2 billion in 2012(1). Presidential election spending actually decreased 6.4% to $2.6 billion in 2012 from $2.8 billion in 2008. Meanwhile Congressional spending has accelerated; the 2010 midterm alone realized a 46.6% increase in spending from the 2008 congressional spending levels.

The midterm elections in 2014 are already projected to exceed all previous political spending records. Cycle-to-Date spending (as of April 6th 2014) is approximately 3x over the cycle-to-date spending in the last midterm elections in 2010(4).

The removal of caps on spending by Political Action Committees (PACs) by the Supreme Court may lead to unprecedented levels of election spending during this cycle; allowing GTN to grow its political and retransmission revenue streams rapidly over the length of the election cycle. We are projecting political revenue to grow 20% over every two years and the retransmission context to grow 10% over the next 5 years. The political growth is mainly driven by the new acquisitions that allow GTN to enter new markets and take advantage of being the number one local broadcaster.

The number one broadcaster can grab more than 50% of the political budget for the market. In 2012, GTN’s television political revenue to total revenue ratio was 21.2% compared to their competitors like Sinclair with only 9.6% and Nexstar with 10.4%. We see GTN’s political revenue stream to be a huge competitive advantage for the company in the future. GTN’s retransmission revenue has had an 83% CAGR from 2008-2012. The majority of the contracts GTN enjoys expire in 2014 and 2015, meaning they will be able to renegotiate at more attractive rates, thus potentially leading to more growth for this specific revenue stream.

Risks & Threats

The television broadcasting industry is a federally regulated industry, and as such, subject to heavy scrutiny from both a content and service standpoint. Also, mass media of any kind can be affected, both positively and negatively, by interpretations in the law regarding free speech. It must be noted that these developments are often far beyond the control of any broadcasting station, but can nonetheless affect their operations substantially.

In the long term, the television industry should be watched with apprehension, as consumers continue to demand more and more control over their content. The rise of online services and digital content has started to move the direction of broadcasting towards a more online oriented format. In the future, advertisers may be less sure that their products are reaching the eyes and ears of consumers, and may therefore move on to other mediums, taking with them their potential revenues. What is comforting about GTN is that management at the moment appears to be willing to put substantial effort and resources into developing digital content along with their television broadcasting, capitalizing on both mediums in the process.

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(2) Barrington Research, “Re-establishing Coverage Report.” December 12, 2013
Valuation

Gray Television’s has consolidated its strong presence in the industry over the past few years. Out of all its competitors, GTN is the most well positioned to avoid the negative aspects of the new JSA regulations announced by the FCC. Because of this, we feel that growth in revenues will continue its strong upward trend. The one segment in which we see GTN having the strongest growth is in political advertising revenue. We expect that there is a very high probability that the Supreme Court will continue to rule in favor of increasing election spending. Under that assumption, we expect that political spending will increase 20% in the next 4 years. Other key considerations for GTN’s operations are its acquisition opportunities. A prime example of this is GTN’s recent acquisition of channels from Hoak Media. GTN spent $335MM in this transaction, substantially impacting its FCF for 2014. However, these new channels should allow GTN to increase its reach to US households by 12%. Due to this increase in reach, we forecasted an extra 12% growth in revenues for year 2014.

Relative & Precedent Transaction

For comparable metrics we chose companies that operate within the US and are roughly the same size (between 50% and 400% of GTN’s market capitalization). All of our metrics had a very small gap between averages and medians, leading us to believe we have a good sample. GTN is undervalued under all metrics tested, including forward P/E, EV/EBITDA and P/S. Furthermore, we looked at the industry’s FCF yield and compared to that of GTN.

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The industry has a FCF yield of 2.28%, compared to GTN’s 4.48%. Again, this metric gives the impression that GTN is probably undervalued.

The recent acquisition of channels from Hoak Media offered a great opportunity for a precedent transaction valuation. GTN paid $335MM, equivalent to 6.8x average EBITDA for 2013 and 2014 (similar to market cap/EBITDA). Using that metric on GTN gives us a market capitalization of $1,035MM or a price per share of $17.8.