The Educated Investor

Bringing Sexy Back: Playboy shares have hidden beauty - Buy

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The Michael Price Student Investment Fund (MPSIF) is a family of funds managed directly by NYU Stern MBA students. In each issue of the Stern Opportunity, MPSIF will share a stock recommendation based on the recent work of a current MPSIF Analyst.

This edition features the research of MPSIF Small Cap Fund Analyst Michael Glickstein. He recommended the purchase of Playboy shares (NYSE: PLA) in late February. The MPSIF fund purchased 2,950 shares at an average price of $8.07. Based on Glickstein's valuation of $11.00 share, he places a 12-month target price for PLA at $11.00. This represents upside potential of nearly 24% from the current price of $8.89 (as of 3/25/2008). The purchase was recently highlighted in an Investment Club Watch article on the website TheStreet.com.

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Playboy is a global multimedia entertainment company, best known for its flagship magazine, that operates through three segments: entertainment, publishing, and licensing.

Investment Thesis

Playboy is a leading global brand whose shares are materially undervalued, according to Glickstein, based on the stand-alone value of the licensing business, the mansion, the artwork, and film library, which also acts as a floor value for the shares, limiting downside risk.

An abysmal stock price performance during the past decade (currently trading lower than the IPO price in 1971) is one reason the market currently hates the bunny. Recognized factors contributing to this poor performance include: (1) the dramatic red ink in Playboy's publishing business as circulation numbers and advertising spending decline, (2) the intense competition pressuring its entertainment business, as the shift from linear TV to Video-On-Demand reduces operating profit levels in its cable TV business, (3) the online pornography business suffering from low barriers to entry and free online content grabbing attention from Playboy's other entertainment sources, and (4) the risk of a global slowdown in consumer spending hurting its licensing business.

While these obstacles have plagued PLA, Glickstein believes the stock has been beaten down so badly that the price hardly recognizes a conservative valuation of its businesses nor does it acknowledge tremendous opportunities to leverage
its still very strong brand. Highlighted below are a number of factors he believes may work to change sentiment on this out-of-consensus stock.

Key Investment Points:
1) Materially undervalued
A sum-of-the-parts analysis suggests that the licensing business plus hidden assets offer a material upside. RBC analyst David Bank recently published an analysis estimating the stand-alone value of the licensing business. He argues that the licensing business alone, given an average annualized growth rate of 30% in sales for the last three years and an even higher percentage growth in EBIT as well as an increasing EBIT margin of over 60%, is worth very close to the current stock price of the company. With adjustments assuming that the publishing business is worth nothing, conservatively giving no credit for the entertainment group (segment income of $21mn in '07), and Glickstein adding the value of the "hidden assets" (listed on the balance sheet at cost for less than $2mm), which include the mansion (worth at least $50mm), the artwork ($20mm), and, where he has the least visibility, the library assets ($30mm), Playboy shares are worth $11.64.

2) More good news for investors - the Street has oversold the stock
The sell-side hates the bunny (2 "Sell" and 3 "Hold" ratings) and PLA has a 10.4% short interest as a percentage of shares outstanding as of February 22, 2008. Research by Charles Schwab shows that stocks with the lowest earnings growth forecasts and worst ratings beat those with the highest. PLA fits such negative criteria, supporting its potential as an outperforming stock. Any change in the tremendously negative sentiment attached to Playboy will likely move the stock upwards via short covering, analyst upgrades and/or new investor purchases. In addition, Glickstein considered historical valuation metrics such as Price/Book and EV/EBITDA and the stock is currently trading well below historical averages. While investors should not buy contrarian stocks on analyst ratings alone, Glickstein believes that investors would be rewarded much more greatly for a smaller relative proportion of risk, given the overly negative sentiment in the stock.

3) What will make the bunny jump - many potential catalysts
As many value investors understand, "waiting for the catalyst to appear before buying an undervalued stock will result in the purchase of a fully valued stock."
Any of the following developments would rejuvenate Playboy's stock price:
- Announcements of further location-based-entertainment licensing (e.g., additional hotspots using the Playboy brand in addition to the already existing Palms Las Vegas Playboy Club and planned Macao Playboy Club, such as a possible development in Atlantic City) and additional merchandise licensing deals, such as the recent announcement of Playboy Cologne and "Rock the Rabbit" line of apparel fusing rock, hip-hop, and fashion.
- Pending Penthouse $250mn IPO should attract investor attention to Playboy. Playboy should trade at a higher multiple than Penthouse given its stronger brand and higher class reputation.
- Licensing out, selling or drastically cutting costs in the publishing division.
- Licensing out the cable-TV business.
- Hugh and/or Christie Hefner giving up control (voting shares for the former and management for the latter) of the business (one sell-side analyst noted that Hugh, 81, passing away (not something anyone watching the stock hopes for) might cause the stock to double in price.
- Bringing expenses in-line with other global media companies.
- An MBO, LBO, or an activist letter. The Hefners might be tired of being criticized by Wall Street and get backing for an MBO at a premium to the current share price. An LBO or an activist could clearly encourage any of the value-creating events discussed above (expenses, publishing division, LBO deals) or possible asset sales to invest in growth businesses.

Risks to Rating
Negative Sentiment Worsens
The negative trends discussed above could continue or worsen during the 12-18 month investment time horizon. In particular, the publishing and Cable TV business could underperform today's already conservative projections, given the challenging consumer environment.

Licensing Business Deals and Other Catalysts Fail to Materialize
The licensing business could fail to exhibit the strength and growth that underlie this valuation framework (i.e., inability to find new licensing deals). Other potential catalysts might fail to materialize within this investment time horizon. Additionally, hidden asset values could decline materially.

Additional Trading Strategies while Implementing Buy Recommendation (not appropriate for the MPSIF fund)
Hedge for macro risk - buy puts on the consumer discretionary sector to protect against consumer weakness hurting PLA’s licensing business and/or buy puts on publishing stocks to hedge against secular declines in the magazine business. Sell covered calls on PLA - Since a key risk highlighted is that the potential change in sell-side and investor sentiment may not occur in our stated investment time horizon, one way to generate income in the near-term would be to sell out-of-the-money covered calls on the stock. Of course, this will cap the upside on just being long the stock.

About MPSIF
The Michael Price Student Investment Fund (MPSIF) is a family of funds managed directly by NYU Stern MBA students. The fund, part of the overall NYU endowment, was established in 1999 through a generous gift from Michael Price, managing partner, MFP Investors, LLC and former chairman of Franklin Mutual Series funds.
With roughly $1.9 million currently under management, MPSIF provides Stern MBA students interested in pursuing a career in asset management with hands on experience managing a real fund with significant assets.
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