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The S&P 500 index ended essentially flat for the second quarter, gaining only 0.3%[1] during the last three months. Signs of a rebounding US economy coupled with a historically low volatility quarter[2] brought modest gains early in the quarter, only to be wiped away in the last couple of days by the drama of the Greek "crisis."

However, low volatility in the broad market does not indicate a lack of activity in all areas of the market. For instance, the media industry has experienced a much more volatile period, with performance greatly diverging among individual businesses. Netflix has surged over 92% year-to-date as investors flock to the newest media darlings of on-demand, over-the-top distribution services. In contrast, traditional content providers have struggled. Technological innovation has led to new forms of distribution, which have caused dramatic shifts in the industry and pressures on traditional cable programming fees and advertising revenue. However, quite often investors get too excited over the "next big thing", throwing the proverbial baby out with the bathwater as they dump the older cash cows in favor of the exciting and the new. This often leads to great opportunities to pick up quality businesses at attractive prices, such as content provider Discovery, which in contrast to Netflix is down 15% over the past year.

A Fine Discovery

Recently, we acquired a position in Discovery Communications (DISCK). Discovery Communications is a market-leading Pay-TV programming company that produces non-fiction media content for a variety of channels. These channels include the flagship Discovery Channel, Animal Planet, and TLC. Each of these channels currently has over 90 million subscribers domestically and over 300 million internationally. In addition, Discovery also has joint venture channels such as the Oprah Winfrey Network (OWN, a 50/50 venture with Oprah Winfrey) and Discovery Family (60/40 venture with Hasbro) as well as numerous other smaller domestic and international channels.

One of Discovery's main competitive advantages is the nature of its unique, wholly owned non-fiction content. Such content is generally cheap to produce, not hit or star-power driven, and has a broad appeal in large part because it is culturally neutral. As a result, over half of the content used on

[1] For information on the performance of our separate account composite strategies, please visit www.ycginvestments.com/performance. For information about your specific account performance, please contact us at (512) 505-2347 or email info@ycgfunds.com.

[2] The S&P 500 index had 9 consecutive weeks in Q2 without a price change greater than +/- 1%, the longest such streak since August of 1993. (Cook Street Consulting, Q2 2015 Market Brief)

international networks is sourced from the US network, allowing Discovery to leverage its fixed content costs over a larger subscriber base.

In addition to being a great business because of the nature of its content, Discovery is also a great business because its revenues are geographically diverse with more than one revenue source. Revenue is split almost evenly between advertising revenue (49%) and network fees or distribution revenue (47%), and more revenue comes from international markets (50%) than from US networks (47%). Furthermore, Discovery's exposure to emerging markets is quite strong, with over a third of international revenues coming from these regions.

Discovery's management is also quite strong. As a result of some moderately complex restructuring in 2008, media mogul John Malone owns a sizeable 29% stake of the company's voting shares. Fortunately, Discovery's management buys into Malone's style of capital allocation. This management style means there are no major off balance sheet items, a reasonable use of leverage (2.9x Debt/EBITDA with mostly fixed, long-term notes), and a heavy use of stock repurchases to return cash flow to shareholders. As earnings also increase, we would expect management to incrementally increase its leverage for share buybacks, further boosting shareholder earnings.

Recently, concerns over the effects on both advertising revenues and programming fees in the US market due to cable-cord cutting and online streaming services as well as concerns about potentially slower-than-anticipated international growth and current currency rate headwinds have weighed down the company's share price. However, we think most of these concerns are either short-term in nature or overblown.

The first main concern is the effect of cable-cord cutting and online streaming services on both US advertising revenue and US network fees. While it is true that Pay-TV networks face a significant long-term headwind in the form of changing preferences for the distribution of their content, we believe that Discovery is being over-penalized for this concern. First, even in an environment where Discovery's domestic advertising revenue is flat or even moderately declining, overall earnings can still grow at a fairly moderate rate, fueled in part by international growth. Second, while network fees may take a hit as cable providers seek to retain customers by cutting costs and squeezing content providers, what matters most when it comes to network fees is how much Discovery is extracting relative to consumers' desirability for its content. Recent research by Lazard Capital[3] notes that almost 30% of viewers said they would cancel or switch their service provider if Discovery channels were dropped from their network, and Discovery also ranks third in total TV network loyalty share by company (12.6% vs. Viacom at 13.3% and Comcast/NBCU at 18.1%). What is most compelling, however, is that the research suggests that Discovery currently undercharges relative to its channels' level of viewer loyalty, as Discovery only earns about 3.7% of all program fees. This research suggests that even in an environment where total program fees are being reduced, Discovery has the potential to keep its share of the pie and even has pricing power to grow its share of the network fees over time.

[3] See http://clearvoicefinancial.com/wp-content/uploads/2013/09/Lazard-Pay-TV-vs.-Content-2-18-13.pdf

The second main concern is about a potentially slowing growth rate in Discovery's international operating segment. Historically, Discovery has had fast and diverse international growth compared to competitors in part due to the nature of its content. However, more recently there have been some signs that the international growth rate may be in decline. Yet, Pay-TV penetration in international markets still has plenty of room to grow, as worldwide penetration of Pay-TV in households with television is estimated to grow from 53.6 percent in 2012 to 63.1 percent in 2018 (compared to penetration rates of 95+% in Scandinavia and 85% in the US).[4] In addition, this penetration rate may underestimate overall growth for Pay-TV as the total base number of TV-households continues to grow, both from growth in households and overall population as well as growth in the percentage of households that have TV. Over time, this should allow Discovery to grow earnings by both growing revenue as well as increasing operating margins as it leverages its content over a larger viewership base.

Also, quite interestingly, individuals generally have a poor intuitive understanding of the process of accumulation in "stocks and flows", which may affect a person's view of Discovery's international segment. As such, it is easy to correlate a slowing international growth rate with a slowing growth rate for the entire company. However, even if the international segment's growth rate is declining, the consolidated growth rate can still be increasing as the international segment becomes a larger portion of the overall business, thus offsetting the effect of a decreasing international growth rate. We believe DISCK will likely illustrate this principle by exhibiting constant or even accelerating revenue and profit growth over time despite slowing international growth rates.

Finally, there have been concerns about the current currency rate headwinds as the dollar strengthens. Due to its large international segment, Discovery is more affected by changes in FX rates as much of its content is produced in the US and then used to generate revenue internationally. As a result, a strengthening US dollar has a greater impact on Discovery's earnings than most of its peers. While we view the risk of further US Dollar strengthening as neutral in the short term, we believe that longer-term it is likely that currencies may strengthen relative to the dollar as international economies continue to develop, turning the current currency rate effect from a short-term headwind into a potentially long-term tailwind.

Overall, we believe that the market is over-penalizing Discovery for its US network problems and not sufficiently crediting the company for its potential growth in the international segment. Thus, we think that recent concerns have given us an opportunity to purchase a high-quality business at a good price.

Concluding Remarks

Despite relatively rich market valuations and an unpredictable macro environment, we continue to seek out investments in quality businesses with attractive prices. Our portfolio continues to be dominated by high return on capital, conservatively levered, steady growth, and geographically diversified businesses that we believe will provide the best risk-adjusted returns available in the market today. As investors

[4] See https://www.digitaltvresearch.com/ugc/households%202013%20sample%20pages%20pdf_sample_73.pdf

right alongside you, we will continue to be patient and objective as we diligently seek out the best risk-adjusted expected returns.

We thank you for your trust and loyalty. Please don't hesitate to call us if you have any questions or concerns. We appreciate the opportunity to serve you in any way we can.

Sincerely,

The YCG Team