QV UPDATE
Weekly Commentary | April 21, 2017
Mathew Hermary, CFA

QV Investors Inc.

## Disruptors and the Investors Who Love Them

Displacement and disruption have become prominent themes for investors in the last few years – and not without cause. By market capitalization, many of the companies driving large scale disruption in traditional business models are now among the largest constituents in the S&P 500. At over $400 billion, Amazon's disruptive effect on the retail industry is hardly a secret. Neither is Alphabet and Facebook's ~60% share of the digital ad market that has been syphoning dollars away from traditional advertising channels.[1] And don't forget the autonomous electric car. As General Motor's CEO Mary Barra has often admonished, "We are in the midst of seeing more change in the next five years than we've seen in the last 50." Is it surprising then that electric car innovator Tesla has a market cap which rivals GM's at almost $50 billion?

Investors are anxious to be on the right side of these structural shifts but are paying for the privilege. Amazon currently trades at 122x price-to-earnings (P/E) as its market cap has risen by $255 billion over the last two years. A basket of 81 traditional US retailers have seen their aggregate market cap fall by $230 billion in the same time.[2] Coincidence? Meanwhile, Tesla has left GM in its emission-free dust with an 8x enterprise-value-to-sales that represents an 1170% premium to GM's.

Disruption is real. Attractive future stock returns among disruptors may be more ephemeral. Below we question how Netflix, a TV and filmed media disruptor, looks as an investment compared to traditional peers.

Earlier this week, Netflix (NFLX) announced first quarter results as paid memberships rose 21% over last year, sales rose 35% and earnings climbed 566%. The company has auspicious goals to perpetuate their current trajectory. Domestically, it thinks it can grow from 49 million members to 60-90m; internationally, much more. Profits from the more mature US business will be used to subsidize international growth as aggressive expansion is prioritized at the expense of margin. Original content will be increasingly developed to lure new subscribers. But investing for the future will not be cheap. In 2017, management expects to spend six billion on content and over one billion in marketing on $11 billion in expected sales. With such elevated investment levels, they expect to generate negative two billion in free cash flow for 2017 and have guided to negative free cash flow for years to come.

In contrast, earnings have grown at 12.6% over the last five years for the median traditional media peer. Average operating margins are very attractive at 28%, free cash flow is plentiful and a large portion is annuity-like. While there have been fears that online TV and unbundling will disrupt linear TV, they have largely been at odds with the experience so far. In many cases, cord-cutting has been minimal and the expansion of virtual multi-channel video programming distributors is creating opportunities to capture new audiences. Sell-side analysts remain constructive on the group's future and expect average earnings to grow steadily over the next few years. Content is still king it appears, even if the palace does not shine quite as much as it used to.

NFLX currently trades at a P/E of 128x versus media peers' average of 14x. Given a very different life cycle stage, it deserves a different valuation than mature peers – it is still seeding the soil; they are harvesting. How different? This is a hard question to answer, but even using aggressive estimates, investing in Netflix seems risky at the current price. For example, one sell-side analyst predicts earnings to grow at a 52% rate to 2025 (a hard feat to sustain for any business). Assuming the company is much more mature by 2025 and trades at peers' long term median of 17.5x, shares would be worth $322 per share in nine years. This implies 9.6% annual returns, an unremarkable result to compensate for the great expanse of unknown between now and 2025 and the huge expectations which must fill it.

Don't get us wrong, Netflix is exciting. We can't wait for the next season of House of Cards. But as an investment, we prefer to turn the channel despite the likelihood that the business could have a Hollywood ending. Disruption often begets more disruption and extreme valuations built on high expectations can leave investors exposed if the future doesn't unfold as anticipated. In contrast, if traditional peers' proven models are not displaced as distribution mediums change, their large, stable cash flows and low valuations begin to look attractive.

[1] WSJ March 14, 2017

[2] April 10th, Bernstein