ValueInvestor INSIGHT

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March 31, 2022

Back to the Future

In its current state, the market is likely to shoot first and ask questions later on any whiff of trouble, even from a big-tech superstar. Sean Stannard-Stockton examines whether that's been a reasonable response in the case of Netflix.

Many investors have likely experienced recently a dramatic share-price decline in one or more of their holdings. Markets have a way of serving those up on a regular basis, even more so when a strong bull run meets a variety of macro headwinds.

Netflix has provided that experience for Ensemble Capital's Sean Stannard-Stockton [*VII*, May 30, 2021]. He first bought into the streaming giant's stock in 2016 and enjoyed a charmed run with it as the share price got as high as $700 last November. But as interest-rate worries increased, sentiment shifted from high-multiple stocks, and the company offered a first-quarter forecast dubbed "borderline catastrophic" by one analyst, the shares in January fell below $360. They've recovered only somewhat, to just over $380.

"Any time a stock drops a lot, we need to understand how any new information changes our fundamental view of the company," says Stannard-Stockton, who set about trying to determine that in the case of Netflix. He identified three points of apparent concern: that it was saturating its available market, that new competition was taking its toll, and that the company's quarterly guidance was catastrophic and justified a 22% drop in the share price on the day after it was given.

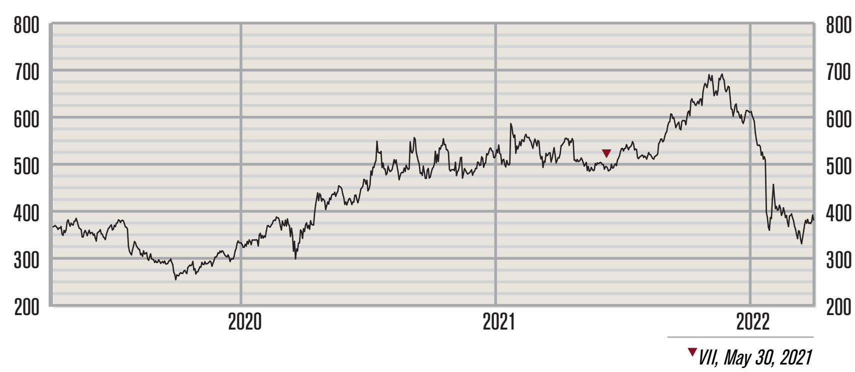
On the evidence, he concluded the market was overreacting in each case. Variability in new-subscriber numbers was within quarter-to-quarter historical ranges, and the year-to-year numbers were actually fairly good. The company has raised average global prices by 7% per year since 2015, subscriber churn rates are down, and per-subscriber hours watched are up – none of which is indicative of damaging competition. The first-quarter forecast was weaker than expected, but not out of line with the normal variability in quarterly growth that the company has seen during the past four years of strong subscriber additions. "This is not a catastrophe. It's how business works," he says.

He added to his position after the ill-fated January earnings call, and considers his long-term thesis for the stock fully intact. He believes Netflix can reach at least 400 million global subscribers, up from 222 million today, driven by heavy investment in locally produced content that it can deliver across an unmatched global

INVESTMENT SNAPSHOT

Netflix
(Nasdaq: NFLX)

NFLX PRICE HISTORY



Share Information (@3/30/22):

Price	**381.47**
52-Week Range	329.82 – 700.99

Valuation Metrics (@3/30/22):

	NFLX	S&P 500
P/E (TTM)	34.9	24.8
Forward P/E (Est.)	35.3	19.8

ORIGINAL BOTTOM LINE – May 30, 2021

The market isn't fully recognizing the company's competitive strength or the nature of its market opportunity as streaming services benefit from the ongoing decline of high-priced pay-TV bundles, says Sean Stannard-Stockton. Paying what he considers a discount for a company with this growth profile and ROIC, he says, is "a trade we're always likely to make."

NEW BOTTOM LINE

Sean Stannard-Stockton believes the market going from hot to cold on the company's stock is not justified by a careful assessment of the evidence, and that its still formidable growth prospects and strong pricing power will ultimately bear that assessment out.

Sources: Company reports, other publicly available information user base. Importantly, he believes the service remains significantly underpriced relative to the value it provides, meaning it can continue to raise prices faster than it spends on marketing and content.

To give a sense of its pricing-power leverage, he says that a more-than-reasonable $3 increase in the average revenue per global user on the current content base – from $12 to $15 – would deliver an additional $8 billion in net annual profit. Per-share earnings would go from the $11 or so expected this year to more than $26 – taking the current forward P/E from the mid-30s to the mid-teens. "If you think Netflix is maxed out on price, you don't want to own the stock," he says. "We'd just happen to disagree." VII

Disclosure

2022 Q1 Contributors and Detractors to Absolute Return Data

Description	Symbol	Average Weight	Contribution	Description	Symbol	Average Weight	Contribution
Nintendo Co LTD	NTDOY	4.50%	0.25%	ServiceNow. Inc.	NOW	1.91%	-0.41%
Charles Schwab Corp.	SCHW	3.62%	0.18%	Intuitive Surgical, Inc.	ISRG	2.59%	-0.43%
Costco Wholesale Corp.	COST	1.95%	0.03%	Starbucks Corp.	SBUX	1.83%	-0.44%
Paychex, Inc.	PAYX	1.73%	0.02%	Broadridge Financial Solutions, Inc.	BR	2.75%	-0.44%
Mastercard Inc. Class-A	MA	7.46%	-0.05%	Blackline, Inc.	BL	1.51%	-0.48%
Chipotle Mexican Gril, Inc.	CMG	5.24%	-0.07%	Ferrari NV	RACE	5.85%	-0.56%
Booking Holdings, Inc.	BKNG	4.48%	-0.11%	First American Financial Corp.	FAF	3.76%	-0.60%
Heico Corp. Class-A	HEI/A	2.55%	-0.11%	NVR, Inc.	NVR	3.67%	-0.91%
Fastenal Co.	FAST	2.97%	-0.19%	First Republic Bank	FRC	5.72%	-1.18%
Peloton Interactive, Inc. Class-A	PTON	0.78%	-0.20%	Home Depot, Inc.	HD	7.91%	-2.29%
Alphabet, Inc. Class-A	GOOGL	7.00%	-0.25%	Masimo Corp.	MASI	5.12%	-3.15%
Landstar Systems, Inc.	LSTR	2.48%	-0.31%	Netflix, Inc.	NFLX	7.88%	-3.42%
Illumina, Inc.	ILMN	6.13%	-0.37%				

For additional time periods please visit www.ensemblecapital.com/holdings

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