Value Investor INSIGHT
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Investor Insight: Sean Stannard-Stockton

Ensemble Capital's Sean Stannard-Stockton, Arif Karim and Todd Wenning explain why they think the highest-quality businesses can often be mispriced, the three main investment traps they look to avoid, the macro trend even macro-agnostic investors should heed, and why they see unrecognized upside today in Home Depot, NVR, Masimo and Netflix.

INVESTOR INSIGHT

Sean Stannard-Stockton
Ensemble Capital

Investment Focus: Seeks companies with predictable businesses and skilled management to defend and capitalize on demonstrable competitive advantages.

Sean Stannard-Stockton is perfectly comfortable owning companies "everyone knows" are competitively advantaged and earn high returns on capital. "The best companies have a bat signal on them saying we've got profits, come steal them," he says. "We think the market as a result systematically underestimates both the durability and magnitude of their excess returns."

Targeting high-moat businesses to hold for the long term, the Ensemble Capital equity strategy Stannard-Stockton manages – with $1.2 billion in assets – has since inception in 2003 earned a net annualized 11.2%, vs. 9.9% for the S&P 500. In what he calls today's "high-pressure" economy, he sees upside in such areas as home retail, home construction, streaming entertainment and medical equipment.

You're not alone in seeking out competitively advantaged businesses as investments. Why do you think, as you've said, that the market "systematically undervalues" such businesses?

Sean Stannard-Stockton: An equity investment allows you to invest in a stream of future cash flows, and the value today of those cash flows comes much less from what happens in the next year or two and much more from the decades ahead. We want to invest in competitively advantaged businesses quite simply because they're much better able to protect and grow that long-term stream of cash flows.

There are two primary drivers to future cash flows, the underlying growth of the business and the return on invested capital it can generate. In a highly competitive economy, both of those metrics face constant decay. One reason growth stocks over long periods have not proven to be great investments is that growth rates decay, sometimes pretty quickly. Returns on invested capital for competitively advantaged businesses decay much more slowly. We wouldn't argue the market doesn't understand that, but we think it can be slow to appreciate how long the high ROICs of the best businesses can persist, and maybe more importantly, the compounding shareholder value that companies earning 40%, 50% or 60% capital returns can generate.

We've owned Mastercard [MA] for a decade now. Everybody knew a decade ago that it was a lucrative business with secular growth tailwinds and tremendous operating leverage that was going to produce tons of cash flow. There's been disruption in the payments industry, but it's mostly occurred on top of Mastercard's and Visa's platforms as opposed to circumventing them and eroding the companies' growth and returns. The fact that the stock has outperformed as much as it has is evidence that the market – despite everyone supposedly knowing how great the business is – hasn't given the company full credit for its ability to fend off competitive challenge.

Does the opportunity to buy into such businesses mostly come from broader market or industry downdrafts?

SS: It can be that. We have long been fans of Booking Holdings [BKNG], for example, but guess what, its moat does not protect it from a pandemic slamming the brakes on global travel. Cash flows last year collapsed and took the share price with it, but taking a longer-term view we believed that the company would come out of the crisis with its competitive advantage intact and likely strengthened. They're now the most important player in the ecosystem for independent hotels who are desperate for the demand that Booking delivers. Competitive advantages give companies time to react to broader shocks as well as the resources to strengthen their market positions through them.

Very often it's the case that the investment opportunity arises because a company's stock goes sideways for a couple of years. Even the best business goes through periods where everything isn't firing on all cylinders, but the issues are fixable and the business is still building intrinsic value while the share price stagnates. Starbucks [SBUX] would be an example of that. The stock was a star performer up until late 2015 and then it was really kind of dead in the water through mid-2018. Same-store sales growth in the U.S. had slowed, and the expansion in China wasn't at the pace people expected.

That impacted performance, but it was the result more of company execution that could be improved rather than a decline in the business's competitive advantage. Management responded in a variety of ways. In the U.S. they enhanced the focus on loyalty members, built out the cold-beverage platform and improved the product offer and marketing around the afternoon daypart. In China they ramped up new-store rollouts, recognizing the need to step up their game in a rapidly evolving market. Investors three years ago were recognizing what hadn't been going so well, but were slow to process the ability of a competitively advantaged company like this to react. As Starbucks has done that successfully, the stock has re-rated nicely. [*Note*: Below $50 at the beginning of June 2018, Starbucks' shares today trade at nearly $114.]

Arif Karim: The set-up is somewhat different, but Illumina [ILMN] would be another example of a company whose shares had gone sideways for more than two years when we bought into it last November. The company has become the dominant provider of gene-sequencing instruments and consumables, making critical medical research into the underlying genetic basis for disease more scalable and cost-effective and opening a giant wave of potentially innovative treatments.

While the potential for gene-sequencing research to revolutionize medical treatment was already established, we believe the arrival of the mRNA vaccines for Covid-19 – made possible by sequencing using Illumina equipment – has made that potential much more tangible. For example, its Covid treatment was the first one to receive FDA approval, but Moderna continues to develop mRNA vaccines for a number of other conditions as well. Sequencing could make targeted cancer therapies based on specific genetic markers possible. We think the research enabled by Illumina's equipment has inflected in relevance and this is just the beginning. The stock has done just okay on a relative basis since the pandemic hit – the longer-term story to us appears much better than the market has so far priced in.

ON THE "MACRO":

We think the shock caused by the pandemic has triggered a multi-year recalibration of supply and demand.

You've written about the importance of avoiding recurring traps investors are prone to fall into. Describe how you've refined your process for excluding ideas from consideration.

Todd Wenning: Three elements always have to be in place before we consider investing in a company: a competitive moat protecting it from competition, skilled and honest management, and what we call forecastability. We can represent those three elements as circles in a Venn diagram, with the area in the center where they all intersect defining our investable universe.

What we've identified as particular traps to avoid are those companies exhibiting two of the three elements. Management may be strong and the business easy to understand, but with a non-existent or narrowing moat we run the risk of falling into a commoditization trap. As Sean described earlier, in this case both long-term returns on invested capital and growth can decline faster than expected. Some investors will bet on a company's decline not being as fast as the market expects – that's another way to make money – but we think that's a difficult game and one we intentionally avoid.

The second trap is a stewardship trap. This is when there's evidence of a durable moat and an easy-to-understand business, but we don't have confidence in management. Warren Buffett has talked about liking business that "even a ham sandwich could run," but we don't think that's enough. In a hyper-competitive economy where capital is cheap and abundant and new advertising platforms have made it easier than ever for challengers to take on lazy incumbents and chip away at their business, it's more important than ever that management teams understand how to create sustainable value and intelligently allocate capital.

Complexity is the third trap we try to avoid. We may believe management is capable and that there's a durable moat, but we just don't adequately understand the business. Maybe we don't have the requisite domain knowledge in a specialized field. Maybe the financials are opaque, or the company operates in multiple businesses and we might not always understand the unit economics. Stock picking is hard enough, why make it more difficult by pursuing companies or businesses that are overly complex?

How do you define your opportunity set?

SS: We invest only in companies that are U.S.-listed, though not always U.S.-domiciled. We own Nintendo [NTDOY] and Ferrari [RACE], for example. In these businesses we believe we can understand why someone buys their products, and that the reasons they buy are relatively the same everywhere. That wouldn't be the case for a company like Flipkart, the big online retailer in India. Given our lack of local-market and cultural context, we recognize we're likely to be at a big disadvantage trying to understand its business relative to investors who are on the ground in India.

There aren't many more than a couple hundred stocks at any time that meet our criteria around moats, understandability and management. We want to own 20 to 25 of them that are each trading at a discount to what we believe is their intrinsic value. We appreciate the academic research that indicates you remove most of the idiosyncratic portfolio risk with that number of holdings, but we also naturally gravitated to that amount. It's about the number of stocks we usually find interesting on a risk-reward basis, and it's about the number of companies we think we can really know as well as we should to invest. The average equity mutual fund in the U.S. holds something like 150 names – that's never made sense with how we invest.

Even the most macro-agnostic investors are likely trying to make sense of the macroeconomic outlook today. What's top-of-mind for you on that front?

SS: If the world was not as complex as it is, we'd love to be macro-agnostic. That's generally our approach, in that we're not trying to call cyclical turns in the economy. But we do think it's important to be aware of the macro factors that can significantly influence the sectors we invest in.

For a variety of reasons we think the 2008 financial crisis created an ongoing shortfall of demand in the U.S. that led to low real economic growth, low inflation and low interest rates. That led many people to assume that state of affairs was the new normal and would exist in perpetuity. We didn't believe that, but we never in a million years would have thought the massive demand shock caused by the pandemic would trigger what we now see as a multi-year recalibration of supply and demand. The demand support from the federal government and the Fed is mind-boggling – there's $3 trillion in American bank accounts that was not there before the pandemic – and in many industries we now see demand going from lagging supply to significantly outstripping supply. We think it's important to consider the relative winners and losers as the economy recalibrates.

Housing is a particularly interesting area right now. It's been a poster-child industry for sub-normal growth since the 2008 crisis, to the extent that we could argue the underinvestment in U.S. housing since the crisis is twice as large as the overinvestment that occurred prior to the bubble popping. As a percentage of GDP, fixed investment in private residential real estate – including new-home building and home-improvement spending – has been below the 70-year average rate of 5% for more than a decade. (It had been above that rate for four years prior to the crisis, from 2002 to 2006.) Freddie Mac estimates that the U.S. housing supply deficit relative to what's needed to meet demand is 3.8 million homes.

That's all changed in the past year. Home sales are going up. New housing starts are going up. Home-improvement spending is exploding. Home Depot is comping at 30% per year! Many investors seem to believe we're at peak growth and it's all downhill from here. To a certain extent they're right – I think it's safe to say Home Depot will not again in my investment career post a 31% increase in comp-store sales. But we think the recovery in the housing market is still in the early stages, fueled by demand stimulus and changing attitudes about household formation and what and where people want their homes to be. There's a long way to go to make up for the dramatic underinvestment in housing since the financial crisis. We have multiple holdings – including Home Depot [HD], homebuilder NVR [NVR] and title-insurer First American Financial [FAF] – that we believe will be beneficiaries of that.

ON HOUSING:

There's a long way to go to make up for the dramatic underinvestment in housing since the financial crisis.

Sticking with your interest around housing, describe your broader investment thesis for Home Depot [HD].

SS: We think about Home Depot as two businesses built on top of a single operational platform that allows it to leverage its cost structure. Roughly half the company is dedicated to serving do-it-yourself homeowners, with the other half selling to small contractors – which the company calls Pros – who depend on Home Depot as a mission-critical business partner.

The company doesn't report on the contractor business separately, but we infer from management comments that contractors make up just 4% of the customer base but about 45% of the annual revenue. Home Depot's focus on Pros helps it generate about 30% more revenue per store than competitor Lowe's, which hasn't built out its contractor business to as great a degree. Higher asset turns and similar margins in the Pro business also contribute to very high overall returns on capital of around 45%.

Everyone likes growth, but one way to think about companies like Home Depot that generate high returns on invested capital is that the businesses can grow without needing to invest as much as the average company. Over the last decade its number of stores has only increased by 2%, while revenue over the same period has nearly doubled.

Which is not to say the company doesn't reinvest back into the business. It invests in existing stores to keep them up-to-date and efficiently run. It invests in its supply chain to improve product availability and delivery capabilities. And, importantly in an e-commerce world, it invests heavily in technology, data analytics and in delivering a true omnichannel retail experience. That said, due to the nature of home-improvement spending, where parts are often needed the same day and many products are bulky and heavy, the store base is a clear competitive advantage. Well over 50% of Home Depot's online orders are picked up in-store, despite the availability of two-day delivery to 90% of U.S. households. That speaks to the unique nature of this category and why we don't view Amazon as a significant threat.

All of that plus the tailwinds we see for housing-related spending set the company up for what we believe will be an extremely promising decade ahead. As Americans emerge from the pandemic, they're re-evaluating their housing needs. People are

INVESTMENT SNAPSHOT

Home Depot
(NYSE: HD)

Business: Leading retailer in the U.S. of building materials and a wide range of home-improvement products, sold both to do-it-yourself and professional client bases.

Share Information (@5/28/21):

Price	**318.91**
52-Week Range	234.31 – 345.69
Dividend Yield	2.1%
Market Cap	$338.93 billion

Financials (TTM):

Revenue	$141.35 billion
Operating Profit Margin	15.8%
Net Profit Margin	10.4%

Valuation Metrics
(@5/28/21):

	HD	S&P 500
P/E (TTM)	23.3	37.2
Forward P/E (Est.)	21.5	22.5

Largest Institutional Owners
(@3/31/21 or latest filing):

Company	% Owned
Vanguard Group	8.2%
Capital Research & Mgmt	5.2%
State Street	4.5%
BlackRock	4.4%
Fidelity Mgmt & Research	1.7%

Short Interest (as of 5/15/21):

Shares Short/Float	1.0%

HD PRICE HISTORY

THE BOTTOM LINE
While the market seems to expect more of a return to the past decade's "normal" in U.S. housing-related spending, Sean Stannard-Stockton sees numerous tailwinds for such spending driving mid-teens annual percentage growth in the company's free cash flow. "We think this stock has more upside than almost anything else in our portfolio," he says.

Sources: Company reports, other publicly available information

buying and selling houses at an increased clip. Wage growth is increasing and unemployment is decreasing. Mortgage rates are still very low and equity in homes is rising sharply. The chronic underinvestment in housing stock means there's a lot of remodeling and repair work to do. People spending more time at home are creating office space, building decks and spending on landscaping. Bears would say much of that will be ephemeral and revert to the status quo of the past ten years. We fundamentally don't believe that will be the case, and that Home Depot will continue to be one of the primary beneficiaries.

With the shares now trading at around $319, how are you looking at valuation?

SS: Investors will look at historical P/Es and say the stock must be expensive because it's trading above averages in the past. But if a stock outperforms like this one over long periods of time, that tells you in retrospect it was cheap at those historical multiples. We think that will prove to be the case here as well.

The only way to truly value businesses is on discounted future cash flows, but rather than offer a precise fair-value estimate, there are other ways to express how cheap we find the shares. This is a business generating returns on invested capital approaching 50%. We think it's set up for high-single-digit annual revenue growth on average over multiple years, with free cash flow compounding at a mid-teens rate. Given those assumptions, we think today you could lock in a 9% market-type annual return on Home Depot's stock by paying as much as 40x the consensus 2022 EPS estimate of nearly $15. The stock currently trades at 21x that number – and we believe that consensus estimate is likely to be low and that the growth outlook over the next five to ten years has improved versus the past decade. We'll leave it to others to do their own math, but we think this stock has more upside than almost anything else in our portfolio.

It's important to add that Home Depot did right by its employees during the pandemic, spending $2 billion on increased pay and bonuses, half of which they've made permanent. We always think it's important that our companies treat employees well. Home Depot's line is that they put associates first so that associates put the customer first, with everything else taking care of itself. If we're in an environment where pricing power is shifting to labor, companies with the best relationships with their employee base should have an advantage. We've already seen this play out in our portfolio with employee-centric holdings like Home Depot, Starbucks and Chipotle. They simply are not having the same challenges with hiring that so many retailers are experiencing.

Impacted by some of the same general trends, why are you also specifically optimistic about the upside for NVR?

SS: We've concluded for the most part that the publicly traded homebuilders are really land speculators first, which we don't think is a sustainable thing companies can get right over and over. NVR decided not to be in that business, instead focusing only on homebuilding. They option land, giving them the right but not the obligation to buy any parcel, and then build homes only to custom order. That gives them super-fast asset turns and allows them to generate returns on invested capital far higher than those of competitors.

They're also focused geographically, targeting well-placed markets in the Middle Atlantic and Southeastern U.S. where they can maximize regional market share. They broadly avoid competing in top metro areas and build more in secondary and tertiary metro areas like Richmond, Virginia and Greenville, South Carolina. A key factor in homebuilder profitability is finding cheap but still desirable land. That generally means ex-urban locations, 25 miles or more away from the metro area, and NVR has shown a knack for identifying promising areas for development. Fortunately for them, that geographic niche is in high demand right now as remote work opportunities have made secondary and tertiary cities more attractive.

A less appreciated part of NVR's business model is its pre-fabrication factory network. It has seven factories that prefabricate framing, panels, doors and other building components for its developments. Most of NVR's communities are within 100 miles of its factories and we think the network provides a number of advantages in driving strong local market share. It solidifies deep local and regional connections with suppliers, who can deliver directly to the factories. Work can be more consistently done regardless of the weather. This all helps increase supply-chain and manufacturing efficiency so NVR can build at a structurally lower cost in its markets than competitors.

How would you characterize the balance sheet and how it's managed?

SS: We don't see much need for improvement there. By optioning land and turning inventory faster, the company can use less balance-sheet leverage to achieve strong returns on equity and doesn't see its profits crash in housing downturns. During the housing crisis, NVR was the only major homebuilder to make a profit every year. That plus the conservative balance sheet allows them to invest when others can't. As an example, the company expanded into Florida in 2009 when most everyone else was retrenching. That's the way management thinks.

Another anecdote that I think speaks to how the company operates: As lumber prices have spiked, most homebuilders have stopped building to order because they didn't want to lock in a price when such an important cost element was so uncertain. NVR said, we're a homebuilder, this is what we do and part of that means managing input costs. Business as usual. They play the long game, which we think is the best way to stay ahead over time.

How do you see the positive dynamics for the company and industry translating into upside for the shares, now trading at around $4,890?

TW: We think 2021 and 2022 are going to be very strong years for NVR's new-home orders and average selling prices, which should then hold at those higher levels. Over the next five years we expect compound revenue growth of 10% and for operating leverage to drive annual free-cash-flow growth in the mid-teens.

Homebuilders tend to trade at low valuations because they're capital intensive in

INVESTMENT SNAPSHOT

NVR
(NYSE: NVR)

Business: Construction and sale of single- and multi-family homes in U.S. markets east of the Mississippi River, under such trade names as Ryan, NVHomes, Fox Ridge and Heartland.

Share Information (@5/28/21):

Price	**4,887.23**
52-Week Range	3,050.00 – 5,308.47
Dividend Yield	0.0%
Market Cap	$17.68 billion

Financials (TTM):

Revenue	$8.02 billion
Operating Profit Margin	15.8%
Net Profit Margin	12.1%

Valuation Metrics
(@5/28/21):

	NVR	S&P 500
P/E (TTM)	19.7	37.2
Forward P/E (Est.)	13.3	22.5

Largest Institutional Owners
(@3/31/21 or latest filing):

Company	% Owned
Vanguard Group	9.8%
Capital Research & Mgmt	7.9%
BlackRock	6.1%
Wellington Mgmt	4.6%
State Street	4.2%

Short Interest (as of 5/15/21):

Shares Short/Float	1.1%

THE BOTTOM LINE
The company is uniquely well positioned strategically, operationally and geographically to benefit from the multi-year surge in U.S. homebuidling that Sean Stannard-Stockton expects. Even without that surge he believes its stock should warrant a high-teens forward P/E multiple, rather than the pedestrian 13.3x the market is assigning it today.

Sources: Company reports, other publicly available information owning a lot of land. We obviously think NVR with its business model and returns on equity should trade at a premium to peers, more like a best-in-class manufacturer or even a retailer. In a normalized economy we'd argue the shares should trade at a high-teens forward P/E. With the multi-year surge in building we expect and the resulting growth in free cash flow we see for NVR, the market should price the shares at a premium even to that. That isn't the case today – the shares trade at 13.3x consensus 2022 earnings.

SS: Other people might view the surge in the business as a surge above trend that you should pay a low multiple on because it's clearly going to decline. Again, we think the big step up is more stepping up to normal as opposed to a surge above normal. That's why understanding the macroeconomic context is so important.

Explain your investment case for pulse-oximeter company Masimo [MASI].

TW: We've all seen the graphs and charts showing how Americans spend so much per capita on healthcare, but our outcomes are worse than average. Inevitably, through market or government forces, we think that will realign. So as a basic requirement for us to invest in a healthcare company, we have to fully believe its products and services both improve patient outcomes and help reduce system-wide costs. Masimo is on the right side of both of those things.

The company's core business is built on its proprietary signal extraction technology, which first received FDA approval in 1998. The technology is primarily used in pulse oximeters, which are small, portable devices that can be clipped on a patient's finger to noninvasively monitor levels of blood oxygen and pulse rate. It has proven to be a superior product, delivering much more accurate readings when patients are in motion and when oxygen levels are very low, both of which are common in emergency situations. It took quite a long time – which speaks to the switching costs and the inertia in healthcare settings like this – but Masimo's pulse-oximetry sensors are now the standard of care in most of the country's operating rooms and intensive-care units.

How do its products reduce system-wide costs? The higher accuracy of its sensors reduces false alarms that waste staff time and often result in costly unnecessary procedures. Non-invasive sensors take away one need to extract blood via syringe, which entails added risks of infection and requires incremental lab testing. In general, its sensors help streamline patient monitoring, which can shorten times in emergency-room and ICU beds, saving money but also precious time in caring for patients. It's not surprising to us that customer renewal rates are around 98%.

The company had a tremendous 2020, driven by pandemic-related demand by hospitals. Are you assuming those benefits aren't entirely transitory?

TW: We are. We believe 2020 was also a transformative year for the company, unlocking new addressable markets and new applications for its technology.

Stepping back, Masimo in 2019 developed as part of an FDA innovation chal-

INVESTMENT SNAPSHOT

Masimo
(Nasdaq: MASI)

Business: Global development, production and sale of non-invasive medical monitoring devices and equipment based primarily on proprietary signal extraction technology.

Share Information (@5/28/21):

Price	**215.60**
52-Week Range	203.81 – 284.86
Dividend Yield	0.0%
Market Cap	$11.92 billion

Financials (TTM):

Revenue	$1.17 billion
Operating Profit Margin	21.5%
Net Profit Margin	19.5%

Valuation Metrics
(@5/28/21):

	MASI	S&P 500
P/E (TTM)	54.7	37.2
Forward P/E (Est.)	49.1	22.5

Largest Institutional Owners
(@3/31/21 or latest filing):

Company	% Owned
BlackRock	12.2%
Vanguard Group	8.3%
Fidelity Mgmt & Research	4.0%
Ownership Capital	3.4%
State Street	3.0%

Short Interest (as of 5/15/21):

Shares Short/Float	2.4%

MASI PRICE HISTORY

THE BOTTOM LINE

The company had a great 2020 fueled by pandemic-related demand, but Todd Wenning argues that it was also a transformative year for unlocking new markets and applications for its technology. He argues that the stock price today reflects only its core traditional business, with the new "unlocked" opportunities providing significant upside optionality.

Sources: Company reports, other publicly available information lenge a product called Opioid SafetyNet, which is still pending regulatory approval. Using the core signal extraction technology, it's a sensor that clips to your finger and can remotely monitor breathing and blood-oxygen levels and alert medical professionals if someone starts crashing, which is a real risk in opioid patients.

When Covid hit, hospitals didn't have enough intensive-care beds and over a period of a few weeks the company altered the SafetyNet product developed for opioid patients to remotely monitor people with the coronavirus. That could mean elsewhere in the hospital or at home if the patient wasn't at as high a risk. The product worked, and by earlier this year more than 200 hospital systems were using Masimo's Patient SafteyNet single-use products that cost only about $150 apiece.

So a core part of our thesis is that the company can capitalize on this success by expanding its addressable market for continuous-monitoring applications. That would increase penetration in the general floors of hospitals beyond intensive-care settings. That would also mean increasing use at home and as part of telemedicine protocols. If the core product can be customized for more effective treatment of Covid and opioid patients, it's likely it can be adapted similarly for other chronic conditions as well. What's absolutely critical is that Masimo has established a reputation with medical professionals that it has superior technology they can rely on.

The shares don't appear optically cheap at today's $215.60 price. How are you thinking about that?

TW: The traditional sensor and monitor business is quite forecastable, with highly recurring revenues and set replacement cycles. We think it can generate on the order of 10% annual revenue growth and maintain roughly 70% gross margins. Our DCF of that business gives us a value right around the current share price.

Then there's the optionality of the SafetyNet product line. As we work through various potential scenarios for it, we don't think it's unreasonable that this could be a $1 billion annual-revenue business within the next ten years, generating comparable 70% gross margins. We hesitate to cite a specific value for it, but it's fair to say that if we're right about its potential, the compound returns on the stock would be quite a bit in excess of a 9% market return.

I haven't yet mentioned the founder and CEO, Joe Kiani, but he is a big reason we're so high on the company's prospects. We believe he's very much a visionary and has created a culture that reminds us somewhat of the one Steve Jobs created at Apple. The money matters, but they're trying to solve big problems and improve both the efficacy and efficiency of the healthcare system. We think that having that culture makes it more likely they'll actually continue to do so.

ON MISPRICING:

The market is slow to appreciate how long high returns on invested capital of the best businesses can persist.

It's been some time since we've had someone recommend Netflix [NFLX]. Why do you consider its shares attractive today?

AK: There's clearly been an uptick in competition from new streaming services, and there appears to be concern that such competition will impair Netflix's growth and margins as prices for the best entertainment content go up. We're not indifferent to the fact the market has gotten more competitive, but we don't believe other investors are recognizing the company's competitive strength or the full nature of its market opportunity.

Netflix until fairly recently had for almost ten years built out its content, geographic and technological footprints with very little competition. Other media companies were typically tied to more narrow, non-Internet distribution channels and had to worry about protecting legacy cash-flowing businesses. That allowed Netflix a long head start in developing its global subscriber base and global content library. It now has over 200 million subscribers, providing it with unmatched breadth and scale that make its unit economics significantly better than the competition. Once the content is paid for, it can be sold over and over again. That allows them to sell a subscription in India, say, for $3 per month to build awareness and the customer base, still at almost 100% incremental margin. Competitors without the same breadth and scale will struggle to have that kind of flexibility.

We also see the broader competitive dynamic going forward as less of a war among streaming services and more about the accelerating decline of the high-priced traditional cable and satellite bundle, starting in the United States. Covid-19 may have accelerated this, but we don't think it will be long before economics dictate that Disney offers its full ESPN sports content via streaming, which is likely to hasten cable's demise while global leaders in streaming content flourish. It's a huge, global market and there's room for four or five of the big streaming companies – including those leading with technology like Apple and Amazon or media giants like Disney – to do well. Netflix is decidedly in the lead, and we think it can at least double its global subscriber base from here, to 400 million.

The stock is off 15% from its 52-week high. How are you looking at valuation from today's share price of around $503?

AK: We believe Netflix's service is underpriced relative to the value it provides. That's supported by its $1-per-month annual price increases since 2014 as the content slate has expanded and subscriber engagement has increased. The scale economics here are powerful. As the company continues to increase per-subscriber prices and flattens out per-subscriber content spending, we think profitability is inflecting. Operating margins that were 18% last year we believe within the next five years can be in the mid-30s. We think revenue

INVESTMENT SNAPSHOT

Netflix
(Nasdaq: NFLX)

Business: Provider of online streaming video-on-demand services sold on a monthly subscription basis; currently reach over 200 million subscribers in over 190 countries.

Share Information (@5/28/21):

Price	**502.81**
52-Week Range	404.25 – 593.29
Dividend Yield	0.0%
Market Cap	$223.41 billion

Financials (TTM):

Revenue	$26.39 billion
Operating Profit Margin	21.2%
Net Profit Margin	14.2%

Valuation Metrics
(@5/28/21):

	NFLX	S&P 500
P/E (TTM)	60.9	37.2
Forward P/E (Est.)	38.7	22.5

Largest Institutional Owners
(@3/31/21 or latest filing):

Company	% Owned
Capital Research & Mgmt	13.3%
Vanguard Group	7.1%
T. Rowe Price	4.4%
BlackRock	4.3%
Fidelity Mgmt & Research	4.2%

Short Interest (as of 5/15/21):

Shares Short/Float	2.1%

NFLX PRICE HISTORY

THE BOTTOM LINE

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 Arif Karim. 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."

Sources: Company reports, other publicly available information

growth – more from pricing in the U.S. and more from subscriber growth outside the U.S. – can still grow at a mid- to high-teens annual rate for many years.

One way we look at valuation is to ask at what multiple of the consensus 2025 EPS estimate of $26 would the stock trade at today if it was fairly priced, again meaning to deliver a roughly 9% annual return. We think that multiple today would be around 30x, while the stock currently trades at 19x. If we can pay what we consider a discount for a company with this growth profile and what should be 40% returns on invested capital over time, that's a trade we're always likely to make.

You've been very active, including with social media, in talking and writing publicly about your investment process and research. Thank you for that. How do you find all that benefits you?

SS: I have actually thought a lot about that. If you look back, prior to 2000 you can make the case that we as investors operated in a world of relative information scarcity. Getting your hands on the right information at the right time could potentially drive a lot of alpha. But with the arrival of the Internet and the S.E.C.'s Regulation FD (for Fair Disclosure) – which made clear that the use of non-public inside information is actually illegal – that shifted the equity analyst's job profile. In a world of information ubiquity and consistent access, the analyst's job is less to uncover information and more to filter and process it. The amount of signal hasn't changed, but the amount of noise has dramatically increased. You need to create filters that help you screen out the noise and focus on the signal.

We find that writing and speaking publicly about our process and ideas challenges us to better refine and focus our thinking. At the same time, it has allowed us to develop a global network of investors who make us better. They want to compare notes about ideas. They might have a meeting set with the CEO of one of our companies and want our input in preparing. They introduce us to people who know a lot about a company or industry we're interested in. To the extent we're putting all this informational value out there, we're getting even more back. We think that's a competitive advantage. VII

Disclosure

2021 Q1 Contributors and Detractors to Absolute Return Data

Description	Symbol	Average Weight	Contribution	Description	Symbol	Average Weight	Contribution
Home Depot, Inc.	HD	8.25%	1.24%	Starbucks Corp.	SBUX	3.15%	0.09%
Alphabet, Inc. Class-A	GOOGL	6.87%	1.11%	Fastenal Co.	FAST	2.04%	0.07%
Charles Schwab Corp.	SCHW	4.99%	1.06%	Broadridge Financial Solutions, Inc.	BR	3.34%	-0.03%
First Republic Bank	FRC	5.76%	1.00%	Heico Corp. Class-A	HEI/A	1.63%	-0.07%
NVR, Inc.	NVR	4.69%	0.69%	Costco Wholesale Corp.	COST	1.95%	-0.11%
Landstar Systems, Inc.	LSTR	2.40%	0.51%	Netflix, Inc.	NFLX	9.10%	-0.34%
First American Financial Corp.	FAF	3.29%	0.34%	Blackline, Inc.	BL	1.83%	-0.35%
Booking Holdings, Inc.	BKNG	4.69%	0.22%	Nintendo Co LTD	NTDOY	3.49%	-0.41%
Paychex, Inc.	PAYX	2.79%	0.22%	Ferrari NV	RACE	4.96%	-0.50%
Chipotle Mexican Gril, Inc.	CMG	2.12%	0.14%	Intuitive Surgical, Inc.	ISRG	5.90%	-0.56%
Illumina, Inc.	ILMN	3.36%	0.13%	Masimo Corp.	MASI	4.96%	-0.71%
Mastercard Inc. Class-A	MA	8.24%	0.13%				

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