INVESTMENT VIEWS

# An update on the Netflix investment case following disappointing results

While the uncertainty has increased and the range of outcomes is greater, the long-term opportunity remains, with Netflix still being the clear market leader in an industry with strong structural tailwinds.

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**THE QUICK TAKE**

Netflix's results and expected subscriber decline of over two million accounts were disappointing.

In an uncertain world, we have to review and reconsider our investment views when presented with new facts.

The negative impacts of post-pandemic growth normalisation, competition in the market and pressure on consumers were greater than previously forecast.

However, many aspects of our thinking in the long-term investment case still stand

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ON THE 19TH of April, Netflix reported results that were worse than both our and the market's expectations. The results were accompanied by guidance that paying subscribers are expected to decline by over two million accounts in the first half of the year. Management attributed this to current high levels of streaming penetration in key developed markets and the negative impact of new streaming competitors. This was clearly a massive negative surprise, causing the share price to plummet by 35% the next day from a base level of already materially lowered expectations.

In light of this surprise update, it is important to start from a clean slate and ask honest questions as to whether the investment case has changed or not. We operate in an uncertain world, and if the facts have changed, we must be prepared to change our minds if needed.

We have spent much of the last week in intense scrutiny regarding our Netflix holding and our investment thesis. There is still additional work to be done, but our thoughts thus far are outlined below.

We did not expect Netflix to print subscriber declines at this point in its growth curve, and this has been a big disappointment. As a result, we have re-worked the growth potential for this business as it pertains to post-pandemic normalisation, the impact of competition in the market and the increasing pressure on consumers from broad-based inflation. The recent results point to all these issues having a far more negative impact than we had initially forecast.

So, where does this leave us? We still believe that the long-term opportunity remains largely intact and that the management team is still best in class. We believe they can navigate this difficult period successfully and point to the recently announced advertising tier as a new growth driver. But revenue and earnings growth will be lower than previously forecast, and we have lowered our long-term fair value for this business as a result.

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## RE-LOOKING AT THE NUMBERS

We expect future normal profitability to be lower, with a higher range of outcomes related to the ultimate shape of their free cash flow (FCF) trajectory.

Management has revised their margins expectations, now targeting margins stable at 19-20% until we see a reacceleration in revenue. This results in an approximately 20% cut to our near-term EBIT forecasts (FY23). We expect longer-term margins to normalise in the range of 25% to 30%, which is also a lower level than previously forecast. As a result of the lower margins and slower forecast revenue growth, our expectation for normal earnings going forward is reduced by up to 30%.

The FCF picture is more complex. Netflix currently spends more in cash on content ($17.5bn last year) than what is reflected in the income statement as an expense ($12.2bn last year). This is due to their annual spend growing towards normal levels and should normalise in time. Netflix spends the cash in the year in which the content is produced, but it is expensed over a number of years once it is released, often a year or more later. This means that currently, accounting earnings are above cash earnings and that while Netflix is comfortably FCF positive, its current FCF is far below normal.

FCF will likely expand massively off this depressed base (c.50% CAGR), but the shape of its trajectory is now more difficult to call considering slower revenue growth and the need to invest more in customer acquisition, which means that margins will be lower.

A mitigating factor is that there is undeniably some scope for more efficiency in their $17-18bn annual content spend.

## THE LONG-TERM INVESTMENT CASE IS STILL COMPELLING BUT WITH INCREASED RISKS

Despite these downward adjustments, many aspects of our thinking on the long-term investment case (as outlined in our recent article) remain supportive. Netflix is still the clear market leader in an industry with strong structural tailwinds as video consumption shifts online. The product is cheaper than legacy options and still has significant pricing power. Post-pandemic subscriber growth normalisation is expected, and our low single-digit subscriber growth forecasts in more mature markets like the United States have always been suitably conservative. Netflix can still grow and, despite this setback, remains well placed as the core streaming product in households that are likely to subscribe to multiple services.

While our fair value estimate for the company has reduced and the risks have certainly increased, the massive share price moves mean that we still see upside in the stock, adjusted for this information. As such, we continue to hold a modest position in Netflix but have not added to this position given the greater uncertainty as Netflix navigates through this challenging period. All our portfolios are actively managed, and we continue to evaluate the attractiveness of all our holdings in the context of what we deem a very attractive opportunity set and will adjust portfolio holdings accordingly. +

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