Tidefall Capital Management Q1 2022 Letter

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Summary

- Tidefall is a concentrated, unconstrained investment fund that attempts to compound its capital at an attractive rate of return. Our investment advantage comes from our in-depth research, long-term time horizon and appreciation of biases.
- With Netflix stock down by more than 50% since its high in November (and 10% below Reed Hastings' $20m purchase in January) we re-entered the position in April.
- We believe the current price of Netflix shares creates a compelling long term investment opportunity.

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	Q1 2022	Year To Date	Since Inception (Jan 21, 2020)
TIDEFALL *(after fees)*	-1.2%	-1.2%	157.3%
S&P *(total return)*	-4.6%	-4.6%	40.9%
TSX *(total return)*	3.8%	3.8%	32.9%

With Netflix (NASDAQ:NFLX) stock down by more than 50% since its high in November (and 10% below Reed Hastings' $20m purchase in January) we re-entered the position in April believing we were being greedy when others were fearful. Unfortunately, its most recent results were well below expectations causing the shares to get cut in half (again).

(It's interesting to note that this is not the first crisis for the company. In 2011, Netflix broke out its DVD service and streaming into 2 separate offerings, with the DVD by mail option called Quickster, the resulting price hike and confusion saw millions of subscribers leave and the stock fell 75%. The company would ultimately reverse the decision and continue its global ascent.)

In Q4 2021, Netflix forecasted for 2.5m - 4m net subscriber additions but ended up actually losing 200k (adjusted for exiting Russia they would have gained 500k subscribers). Q2 guidance was even worse as Netflix is now predicting that they will lose 2m net subscribers although the company still believes it will have positive net subscriber additions for the full year. Recent price hikes and an onslaught of new competitors are no doubt creating a more unfavorable competitive environment. However, we think it is important to step back and look at what Netflix has built and the advantages it now holds.

As cable legend John Malone preaches, in the media sector it's all about scale. The more subscribers a streamer has, the lower the cost of acquiring and distributing that content per subscriber. Even after aggressive marketing campaigns, Netflix still has more streaming subscribers than Disney+, HBO Max and Apple TV+ combined. The benefits of this improving scale can be seen in Netflix's financials; since 2018 while revenue has doubled, operating income has quadrupled. The current narrative is that these new streaming entrants will be able to continue to steal subscribers, a view that we think is unlikely over the long term given the size of Netflix's library, the virality of its content and an average cost of just 39 cents per day. Even basic operational changes like releasing content weekly (instead of all at once) or providing annual payment incentives relative to its monthly price should further improve its industry leading retention ratios.

In addition, strong competition is nothing new for Netflix, since its 2007 launch the company has been competing with free services like YouTube and larger tech ecosystems like Amazon (AMZN) which gives away its video service to Prime customers. Despite this, Netflix has achieved 220m paid subscribers with an unrivaled international subscriber base that the majority of North American focused competitors are lacking.

As of today with the shares down 73%, Netflix has an enterprise value of $93b and is being valued at $425 per household or 3x revenue. At its current guidance of a 20% operating margin (which is less than the 25.1% they made in Q4 and less than the Q1 forecast of 21.5%) Netflix is trading for 18x 2022 expected earnings. Last quarter, Netflix also disclosed an estimated 100m users currently accessing the service via password sharing, a practice that other streamers are far more strict with and something Netflix now intends to crackdown on. If 20% of the estimated password sharing users are converted to paying users, at an 85% margin, the PE would drop to just 13x earnings.

(We understand that some analysts question the use of earnings over free cash flow but we do believe that there is residual value to their content and highlight that the majority of costs are amortized within two years, inline with peers like Amazon.)

The recent onslaught of streaming services (many with free trials) are unquestionably challenging but if Netflix is struggling with margin growth, we can only imagine how the management of these new subscale players are assessing their long-term commitment. With more than 2/3rds of screen time yet to transition from linear to streaming, a proven management team and an undemanding no growth valuation, we believe the current price of Netflix shares creates a compelling long term investment opportunity.

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Original Post (from lettersandreviews.blogspot.com)

Editor's Note: The summary bullets for this article were chosen by Seeking Alpha editors.

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