Market Research #003

This is the third in a series of Independent research produced by the Murray Wealth Group Research Team. The purpose of this series is to provide insight into our portfolio construction and how our research shapes our investment decisions. We welcome any feedback or questions you may have on these monthly commentaries.

Investing in Growth Companies

Let's play a game. We are going to look at the financials data of three companies without naming the actual companies. Also, to preserve anonymity, we will avoid using raw values which could provide some insight into the companies. We will look at 2015-2020 values to capture both recent historical and anticipated growth (which drives current investment theses and share prices). All we will divulge, at this point, is that the three companies in question are quite large (market cap of tens of billions of dollars) with very high revenue growth and large capital expenditure requirements.

Let's start with Revenue (scaled to 100 in 2015).

Figure 1: Revenue (2015 = 100)

	Company A	Company B	Company C
2015	100	100	100
2016	127	130	132
2017	166	173	221
2018	221	237	370
2019	271	295	523
2020	326	361	630

Company C really stands out here. Revenue has already doubled and is expected to triple by 2020! Let's look at EPS to see how profitable these companies are. Remember, absolute EPS is not necessarily meaningful absent the share price, but the rate of growth in EPS *is* meaningful!

Figure 2: Earnings Per Share (2015 -2020E)

	Company A	Company B	Company C
2015	$ 1.25	$ 0.25	$ (2.30)
2016	$ 4.90	$ 0.43	$ (2.88)
2017	$ 6.15	$ 1.25	$ (8.70)
2018	$ 12.33	$ 2.86	$ (6.85)
2019	$ 19.02	$ 4.59	$ 2.37
2020	$ 31.00	$ 7.28	$ 8.16

Company A and B each grew EPS fivefold from 2015-2017 and should grow EPS fivefold *again* through 2020. Company C has had trouble reaching profitability, but forecasts expect it will generate significant earnings growth in 2019-20.

Lastly, we'll look at free cash flow per share, a measure of how much cash surplus to capital expenditure requirements is generated each year.

Figure 3: Free Cash Flow Per Share (2015 -2020E)

	Company A	Company B	Company C
2015	$ 15.37	$ (2.10)	$ (16.84)
2016	$ 20.05	$ (3.78)	$ (4.10)
2017	$ 13.14	$ (4.52)	$ (20.10)
2018	$ 30.73	$ (7.26)	$ (9.93)
2019	$ 45.56	$ (5.21)	$ (0.31)
2020	$ 63.19	$ (3.20)	$ 1.46

This table is potentially the most telling. Company A generates healthy, growing free cash per share. Company B, despite its profitability, is plowing all its profits and more back into the business. Company C is already losing money on its day-to-day operations, so it's no surprise it has less money left over after growth spending.

We will summarize by looking at the relative valuation levels of all three companies in 2020E.

Figure 4: 2020E Valuation

	Company A	Company B	Company C
EBITDA Margins	14.2%	19.2%	14.7%
P/E	50x	48x	36x
FCF Yield	3.89%	-0.91%	0.50%
EV/Sales	2.3x	6.4x	1.7x
EV/EBITDA	16x	32x	11x

We are using 2020 valuation levels to account for the large growth each company is expected to achieve in the next three years. Below, we summarize a brief thought on each line.

EBITDA Margins. All companies EBITDA (Earnings before Interest, Taxes, Depreciation & Amortization) margins are expected to be in the mid-high teens in 2020, Company B having the strongest level of the three. It is important to note that these margin levels are all trending higher, with Company C and B seeing the largest growth in this metric.

P/E. The price-to-earnings ratio on growth companies can always be tough to assess given that profits are depressed by high levels of investment in marketing and infrastructure. Thus, we are not surprised to see such large numbers even on year 2020 earnings estimates. Company C appears is be the most attractively valued on this basis

Free Cash Flow Yield. Free cash flow yield is defined as free cash flow as a percentage of market cap. Company A is attractive on a free cash flow basis (almost 4% of its value will be generated in cash available to shareholders in 2020). Company B will not be generating excess cash by 2020 due to high ongoing investment levels.

EV/Sales. This measure of enterprise value (combined value including both equity and debt) to sales is useful for high growth companies to see how much an investor is paying for a dollar of revenue. The measure is limited in that revenue growth rates, expected margin levels and re-investment rates are considerations for arriving at the proper multiple. We can see that Company B has a much higher EV/Sales multiple despite its poor cash generation.

EV/EBITDA. This measure of enterprise value (combined value including both equity and debt) to EBITDA can help normalize any difference in taxation, capital structure and accounting values. Although the multiples are still elevated, they are more in the range of where larger growth companies tend to be valued.

The valuation metrics presented screen attractively for Company A and C, but less so for Company B despite having the strongest margin in the group.

So…armed with this data, can we draw some conclusions about these three companies?

Company A is poised to triple revenue over a five-year period. It is steadily growing earnings and is already generating more cash than it needs to fund growth. As operating leverage increases with revenue growth, this cash conversion cycle improves exponentially.

Company B is poised to triple revenue over a five-year period. It is steadily growing earnings, but unlike company A, it is not generating excess cash, requiring external capital to maintain its revenue growth.

Company C has the best revenue growth. It has no history of profitability or cash generation, but this is expected to improve in 2019/2020.

Company A is *Amazon*. Company B is *Netflix*. Company C is *Tesla*.

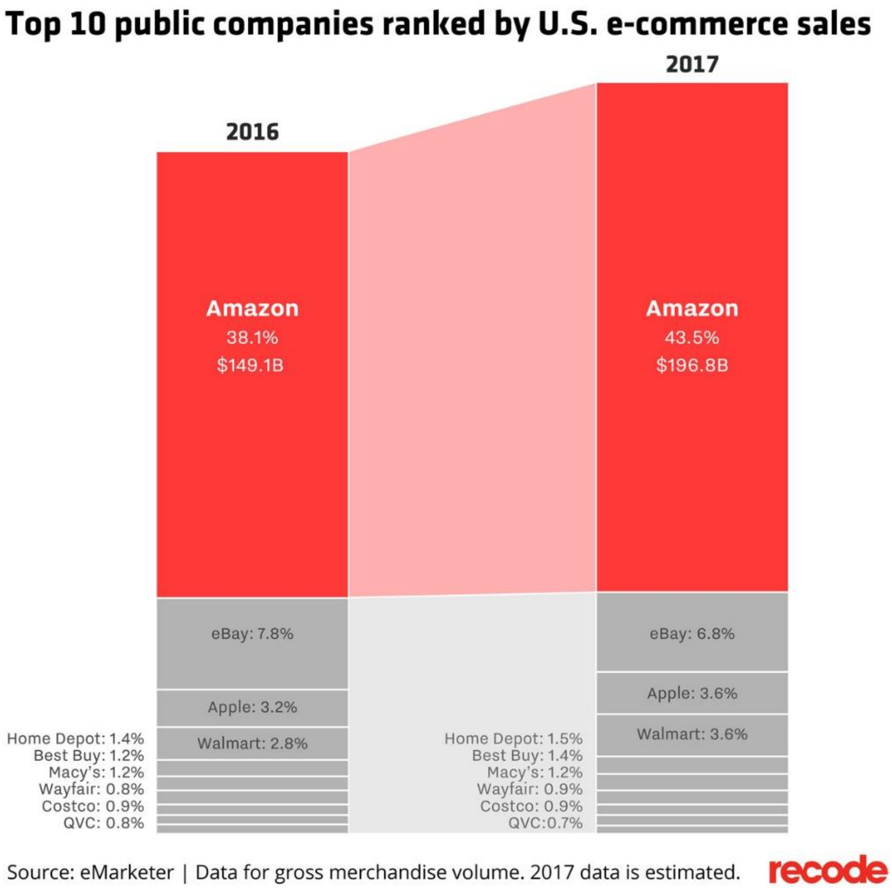
Three controversial growth companies…three companies that have made investors tremendous amounts of money over the past decade. Each company is led by a visionary CEO and is disrupting longstanding traditional industries with technology with a long runway for growth.

We own two of these companies in our Global Growth Fund: Amazon and Netflix. What do we see in these two companies that we don't see in Tesla? There are three characteristics both companies exhibit that we are skeptical Tesla can duplicate: market leadership, execution and pricing power. Below we present our thoughts on each company as it relates to these characteristics.

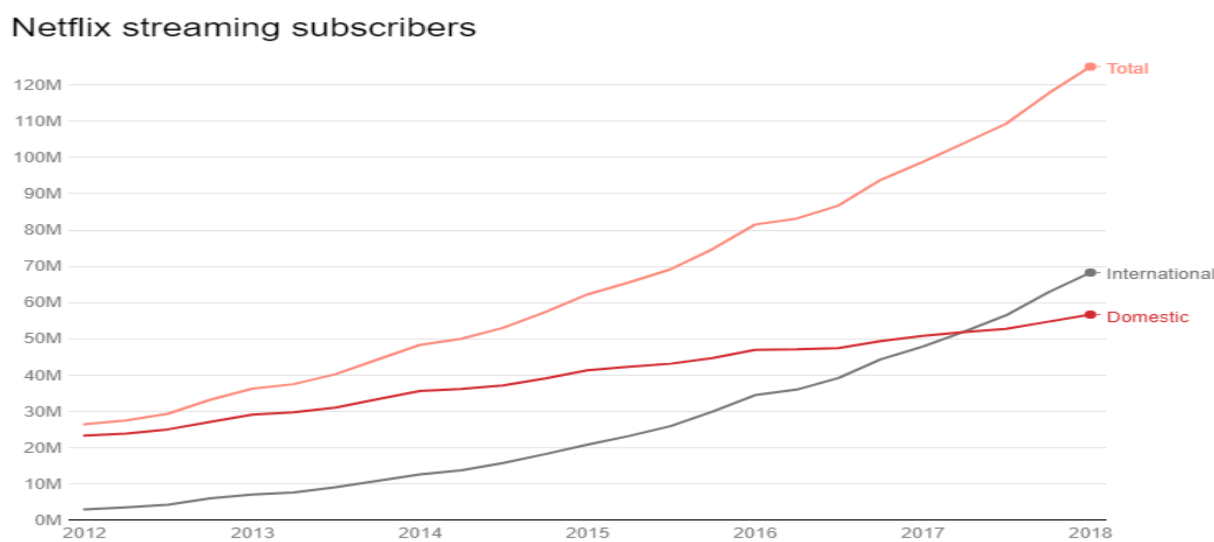
Market Leadership

No doubt Tesla is a leading electric vehicle manufacturer and has very strong brand awareness. It is the dominant electric car company in North America and sold 80k electric cars in 2017. However, relative to total car sales of about 19M in Canada/US, this remains a 0.5% market share. BMW sold a similar number of electric vehicles globally. Although that includes Hybrids, it's tough to argue that they are really much behind Tesla in terms of technology to say nothing about their competitive advantage in manufacturing. Some analysts even argue BMW and Mercedes have better electric vehicle technology than Tesla.

Amazon, on the other hand, completely owns online retailing with a 43% market share, with no competitor in the ballpark. Furthermore, its above-market growth rate suggests this lead will continue to widen.



Netflix is also a dominant player in its business, with 125M subscribers globally. In the US, Netflix has about half as many users as total paid TV subscribers (cable/satellite/traditional providers). This gap will no doubt narrow as Netflix continues growing and expanding its service offerings while traditional TV companies lose customers. While there are more entrants on the way into the streaming business (Disney, for example), Netflix has continued to grow its share even in the face of launches from existing competitors YouTube, Amazon and Facebook.



Source: Netflix Reporting

Execution

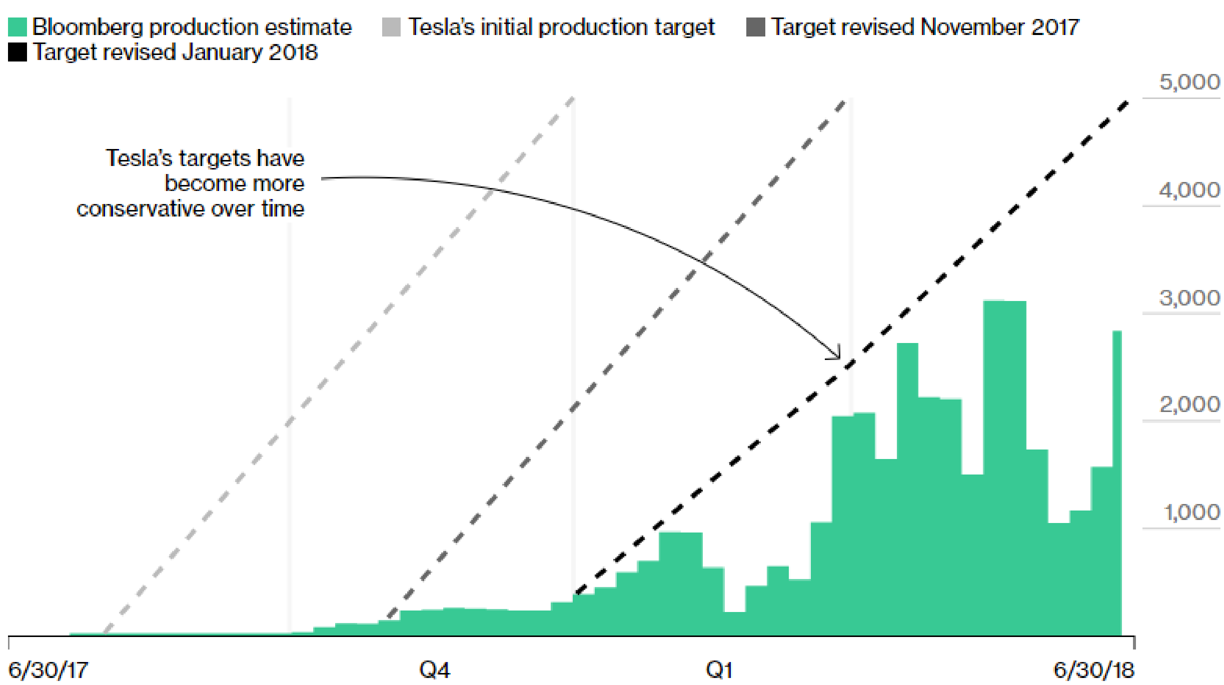
Execution is the process of *setting* expectations and then *meeting* them. Most companies can set expectations, painting a vivid picture of swiftly growing volumes, revenues and earnings. It's the ability to meet those expectations (or better yet, exceed them) that makes a great stock.

Amazon has a culture of efficiency and continues to find ways to improve speed, service and prices through technology and innovation. It has parlayed its own infrastructure use into a big business as itsAWS cloud services division now generates $20B in revenue every year. Its advertising business presents yet another compelling high margin revenue opportunity. Both businesses have grown out of the legacy online shopping business.

Netflix similarly continues to grow its user base at an impressive rate. Its only serious misstep in the past decade came when it tried to raise prices too aggressively in 2011. The company won back lost customers by formally apologizing and restoring price levels. Recently, it implemented a relatively large price increase of $1 per month and it appears that it has been easily accepted by the market. Its strategy of investing heavily in original content appears to be working and should protect it as new competitors look to use their own content for streaming service.

Tesla proved that electric cars are commercially viable and designed an award-winning luxury car that is appreciated by car enthusiasts. However, the driver of its share price in the mid-term will be its success in producing and selling its new Model 3, a mid-level sedan that is competitively priced at $35k for a base model. Despite strong demand, production issues have caused a slower than expected ramp up to its target of 5,000 cars/week. Tesla has barely achieved half of this rate. Delays of this matter are costly, and until Tesla proves it can profitably produce cars at the prices it is indicating, its share price will continue to speculatively trade on the ebbs and flows of its news cycle.

Tesla's Production vs Tesla's Targets



Source: Tesla, Bloomberg

Pricing Power

Pricing Power refers to the ability to raise prices without sacrificing much volume. For example, oil companies have no pricing power since their product price is set by the international oil markets.

Amazon sells millions of products in an intensely competitive environment. Through its large search, sales and inventory, Amazon can get a good sense of what products are increasingly interesting to customers and may be in short supply elsewhere. It also has the dynamic ability to adjust its prices (usually through sales/markdowns) when required.

Netflix sets its own prices, and as noted above, has already implemented some increases to its monthly rates. Increases will be gradual, but as Netflix takes more share from traditional cable companies and opens up its proprietary content offering, it should have the ability to take a larger share of the consumer wallet. New potential product lines such as live sports and gaming may provide additional revenue opportunities.

Tesla is attempting to be the low-cost electric vehicle company and boast a head start over the incumbent automakers. However, competition is coming and in 5 years, consumers will have a large number of choices for electric vehicles. If the electric car market is anything like the current car market, blue book values and price shopping will require automakers to compete of value and quality.

Summary

Evaluating high growth companies is challenging, given that traditional methods often yield astronomical valuations for companies generating negative cash flow, but the rewards can be quite compelling as all three of these companies have demonstrated. However, any slowdown in growth rates or corporate missteps can cause swift losses in investment value. Thus, it is imperative to look beyond just current financials and evaluate the long-term potential of a company *and* the ability of management to execute on its growth potential. Both Amazon and Netflix have been fantastic executors and their share prices have doubled since their inclusion in our portfolio. We continue to look for companies that have strong track records and outsized growth opportunities that will benefit our investors.