Market Research #007

This is the seventh 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.

Netflix: Large market provides room to grow

One of our key considerations when investing in a company is that it represents an enduring growth opportunity. We believe markets generally underestimate the length of time that a company can sustain a high level of growth. Commonly, growth companies exhibit declining P/E multiples as EPS grow faster than share prices. However, eventually share prices have to start to grow at a rate similar to earnings or the valuation ratio will decline to unreasonable levels. Thus, owning companies with a long duration of rapid growth can provide excellent investment returns.

We believe Netflix fits the description of a company with such a profile and remains in the early innings. While it is true that a $100 investment in Netflix in 2008 would be worth close to $10,000 today, this level of early returns is not abnormal for best-in-class growth companies (Microsoft or McDonald's, for example). Netflix, as most are familiar, delivers a large selection of movies and television shows to consumers for a monthly fee. The company is a global success, with over 150 million customers worldwide.

Surely, most of the money has already been made in Netflix, right?

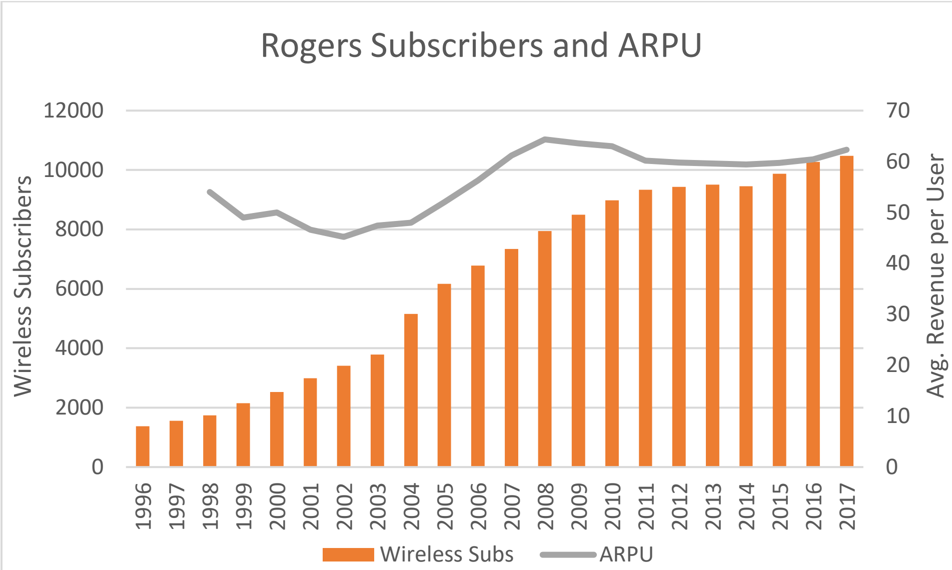
While we do not expect as dramatic a return in Netflix over the next decade, we believe strong share price returns can still be had. As a comparable, we look at the rise of cell phone technology, beginning 25 years ago, as it also represented a game-changing technology that has played out much longer and larger than anyone expected.

Rogers Wireless launched in 1985 under the name Cantel. The industry was very nascent, with early focus on paging services. However, by 1997, cellular telephone use was on the rise and Rogers Cantel boasted 1.5M customers, equating to a 5% market share if we assume 1 cell phone per person. At this point, Rogers had spent aggressively, using debt to build out a national network, and growth expectations were high. Below is an excerpt from Rogers' 1997 Annual Report…

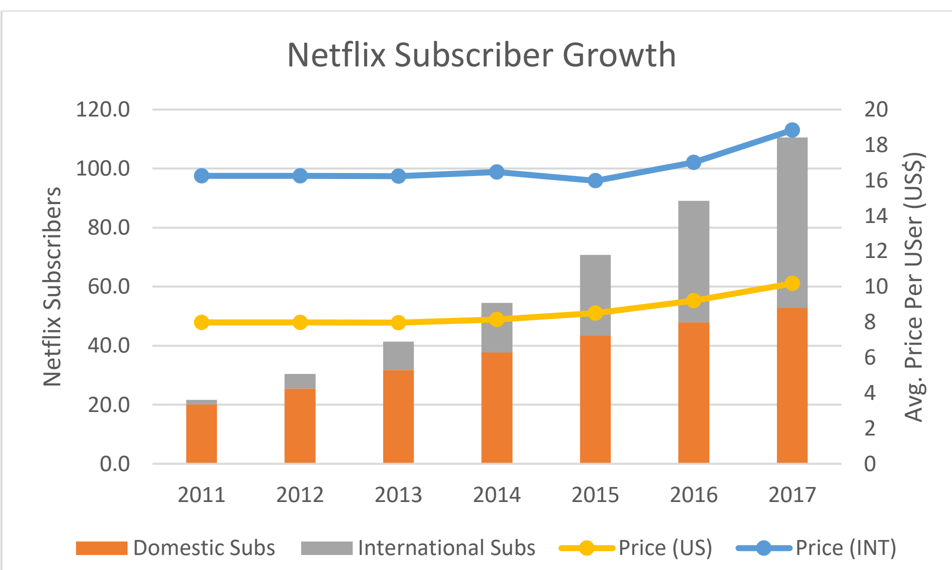
> *"Rogers cantel mobile communications inc. ("wireless") is Canada's largest national wireless communications service provider offering subscribers a broad spectrum of wireless communications products and services. It is currently the only company in Canada licensed to provide all of cellular, Digital PCS, paging and wireless data services nationwide. With over 1.5 million cellular and Digital PCS subscribers and 253,600 paging subscribers, Wireless' seamless cellular network covers 93% of the Canadian population with analog coverage and over 80% of the population with digital coverage."*

By 2002, Rogers had more than doubled its customer base to 3.4 million. Four years later, that base had doubled again to 6.8 million. Rogers now has 10.4 million users, with cell phone use in Canada continuing to grow despite almost everyone (kids and grandparents included) having a cell phone or iPad.

Average revenue per user (ARPU) has also increased over time with advances in cellular data usage.



Netflix is on an even stronger growth trajectory than Rogers owing to the greater size of its potential market. At the end of 2017, Netflix has 137.1 million subscribers, with 58.5 million in the United States and the remainder in international markets (including Canada). We believe Netflix still has a long runway for growth ahead despite its lofty subscriber totals. As of June 2018, 55% of the world's population has an internet connection. Facebook, as a comparable, has over 2.2 billion active users (neither Facebook nor Netflix operate in China). It is unrealistic to assume Netflix will reach a similar level of users since Facebook is a free service while Netflix requires ongoing monthly payments. However, it provides a glimpse of the total potential market. With 126 million households in the United States, Netflix serves 46% of households (and growing).



What is the ultimate market potential for Netflix outside of the United States?

If we assume that the total potential market for Netflix is the 2.2 billion Facebook users (as they represent the same market) and then back out 350 million Americans, we are left with a population of 1.85 billion in Netflix's International market, which equates to 700 million households. With 78 million subscribers internationally, Netflix currently has a market share of 11%. What market share can Netflix ultimately achieve? While it likely won't approach the 46% share it has in the United States, is 20%-25% a reasonable estimate? That assumption would leave Netflix with 140-175 million subscribers internationally. Along with additional penetration in the U.S. market and growing internet usage globally, Netflix could approach 300 million users over the long term, over double its current subscribers.

Much like Rogers, Netflix's content base, brand recognition and internet distribution provide it with an asset base on which to layer incremental revenue with few additional costs. There are also additional ways for Netflix to grow other than through increasing its subscriber base. Like Rogers, Netflix can generate more revenue per user through price increases and new pricing options. In addition, Netflix could expand into additional services such as video games or user videos (like YouTube). Lastly, advertising could represent a long-term revenue driver.

The growth of cellular technology has shown that major consumer changes take place over many years and that big ideas continue to develop into even larger ideas in the hands of the right management. We think Netflix's early success in streaming only scratches the surface when it comes to its ultimate potential, with many years of growth to come. High growth stocks are almost always volatile, and thus, Netflix will experience larger than normal volatility. However, we believe that through the turbulence there are sunny skies ahead for Netflix.