

WRONG FOR A YEAR, RIGHT FOR A DAY - PART II

Instrument (Inception)*	March 2018 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	-0.3%	2.4%	11.7%
Venator Investment Trust (September 2007)	-0.3%	2.6%	8.3%
Venator Income Fund (August 2008)	0.1%	-1.0%	11.4%
Venator Select Fund (September 2013)	1.0%	4.4%	16.1%
S&P/TSX Total Return (March 2006)	-0.2%	-4.5%	5.3%
Russell 2000 (March 2006)	1.3%	-0.1%	7.8%
S&P Toronto Small Cap (March 2006)	-1.2%	-7.7%	1.9%
S&P 500 (March 2006)	-2.5%	-0.8%	8.4%
Merrill Lynch High Yield Index (August 2008)	-0.6%	-0.9%	8.5%

March was one crazy month in recent historical context, as the volatility seen in February continued. Trump started a trade war with China (among others); autonomous driving suffered a major setback as an autonomous Uber hit a pedestrian (who appears to have seen the Uber coming and, I can only assume, thought a human driver would slow down); an auto-piloting Tesla crashed into a highway barrier; Nvidia suspended its autonomous driving program; Facebook finally got in trouble for its years long practice of selling user data; and cryptocurrency values fell to the point where they are no longer profitable to mine, which could be a major stumbling block. The froth is coming off the market, and whether this is temporary, or the start of a bear market is anyone's guess.

A few years ago, we wrote about how the problem with short-selling stocks is that you're typically wrong for a year to be right for a day. In other words, the market tends to ignore bad news, even if it has full knowledge of such news, until it's right on top of them. In a bull market, said stocks tend to get the benefit of the doubt on all hopes and dreams. The focus of our original write-up on this topic back in June 2013 was Redknee Solutions Inc. (RKN) which, despite some well-articulated issues, went up 50% following our writeup before subsequently declining by 80%, due largely to the issues that we outlined. Given the events of last month, we thought it was worth revisiting this phenomenon by examining some current 'in the news' household names that have benefitted from an investment community that has chosen to largely ignore the known risks of each respective business.

TESLA INC. (TSLA) – NOTHING NEW HERE

What is currently happening to Tesla is a perfect example of what we are talking about (we don't own the stock but follow it closely due to our position in its convertible bonds). Short sellers have taken a lot of pain over several years waiting for last month's 25% drop. The theses against Tesla were well known and threefold:

- **The Company faces increased competition over the next several years:** This is true, but not the existential threat the street was making it out to be. The competition is just too far behind in terms of battery range, charging network buildout, battery production capacity and branding for Tesla fans to worry about products that will be released in three years with specifications that are inferior to today's Tesla vehicles (they are still waiting for the competition to effectively counter Tesla's four-year old interactive console/navigation system).
- **The Company might never be profitable:** This issue is still a maybe. We can understand why the market would be concerned, but we believe that Tesla would be profitable in a lower growth scenario. The problem is that they are always building the next thing (solar roof tiles, a new roadster, semi-trucks, solar/battery powered power stations), which requires a ton of upfront capital investment for products that won't be available for several years.

- **The Company is burning cash at an elevated rate and is in constant need of raising money, or it might face bankruptcy (worst-case scenario):** This is a real concern owing to the previous point and is not atypical of high growth companies in capital intensive industries. The key is to get the street to believe in the future of the capital projects and give you money when the stock is high. Given the recent drop in the stock price, an equity raise is not likely. Furthermore, the recent drop in its bond prices makes the debt markets an expensive way to raise money too. The current convertible debt market, however, suggests that Tesla could raise \$1-\$2 billion of seven-year convertible debt, at a 3% rate, which is very manageable.

The key point here is that the issues now facing Tesla have been in place for two years, and it is amazing how a little narrative change (the Model 3 production rate), with nothing fundamentally altered, can flip a stock on its head, even when all the negatives have been well known for quite some time.

FACEBOOK (FB) – BAD NEWS, BUT SHOULDN'T HAVE BEEN A SURPRISE

We are seeing a similar story unfold with market darling Facebook, although it didn't have the same short interest as Tesla. While its users wouldn't necessarily be aware of the extent of Facebook's collection and monetization of user data, educated investors have known this for years. In a well rehashed interview from earlier days, Zuckerberg referred to users as '*dumb f*#^s*' for voluntarily handing over their personal data in exchange for the use of Facebook. Of course, this was the real genius of Facebook, as it was just a better marketed version of similar products that already existed. Zuckerberg was the first person to recognize and capitalize on the value of personal data that people, historically, were not willing to hand over due to privacy concerns. I recall a recent interview with a former member of a government agency that laughed off 'big brother' concerns of government data, responding that Facebook had more information of individuals than the NSA.

I would say that less than one-third of Facebook users are aware that Facebook uses and monetizes the data that its users hand over, and less than 10% of users are likely aware that Facebook sells/shares this data with third parties (I would also guess that less than 10% of Facebook users realize that Instagram is Facebook). Regardless, informed investors have been aware of this risk and its potential backlash for several years; it was just a matter of time before an issue like Cambridge Analytica became public. It's also worth noting that the Cambridge issue was not a 'data breach', but rather how Facebook has always done business.

Clearly, in the hyper-sensitive social news flow world that Facebook practically created, situations like this can result in disproportionate negative reactions. Facebook's current issues are far from catastrophic but will likely cause some adjustments to its business model that could put a 12-18-month damper on growth.

NETFLIX (NFLX) – WHY IS THE MARKET NOT DISCOUNTING PENDING DISNEY COMPETITION?

Perhaps the best example of a company with a major negative catalyst on the immediate horizon that the street is fully aware of, yet choosing to ignore for now, is embodied in Netflix's pending competition with the combined Disney/Fox/Hulu. The Street knows it's coming, but for whatever reason seems surprisingly unconcerned. In my opinion, Netflix and its stock market fans should be far more worried about Disney than Tesla should be about General Motors, and here's why:

- **It all starts with Content:** Netflix has been spending billions of dollars per year on original content (\$8 billion this past year alone) in hopes of moving towards 50% exclusive content. While the street sees this as an offensive move, it's really a defensive maneuver. Content is a hard game, and even Netflix' results to date can be best described as hit and miss due to a lack of strong franchises. Netflix also keeps its ratings to itself, and its subscription model likely inflates ratings since people might be watching poorly rated movies like *Bright* because

they already get it as part of their subscriptions, even if it probably would have bombed at the box office. Even more telling of the hit-and-miss nature of content is the number of high profile shows that have been cancelled before their multi-season runs have been fulfilled (such as *Bloodline*, *Sense8*, and *Marco Polo*).

Franchise Brands		
<u>NETFLIX</u>	<u>DISNEY</u>	<u>FOX</u>
Stranger Things	Star Wars	X-Men / Wolverine
Orange is the New Black	Marvel <i>Avengers, Captain America, Black Panther, Spiderman, etc.</i>	Deadpool
House of Cards		The Simpsons
Riverdale	Disney Classics <i>Beauty & the Beast, Cinderella, Peter Pan, etc.</i>	Family Guy
The Crown	Disney Animation <i>Moana, Big Hero, Frozen, etc.</i>	The Americans
Black Mirror	Pixar <i>Toy Story, Finding Nemo, The Incredibles, etc.</i>	X-Files
Making a Murderer	Indiana Jones	Glee
Series of Unfortunate Events	The Muppets	24
Dark	Pirates of the Caribbean	American Idol
Narcos	Mary Poppins	Planet of the Apes
Mindhunter	Disney Channel <i>Bizaardvark, Descendants 2, Good Luck Charlie, etc.</i>	Avatar
		Die Hard
		Home Alone
		Titanic
		Fox Searchlight Studios: <i>Shape of Water, Juno, Birdman, Sideways, etc.</i>

- **The double-whammy:** If it isn't enough that Netflix is going to have to compete against a slate of very popular and established franchises, to make matters worse, that same content will be pulled off Netflix over the next several years. I would imagine that '*Star Wars: The Force Awakens*' received more views on Netflix than *Bright*, even though almost everyone had already seen Star Wars previously in the theatres. Which brings us to our next point . . .
- **Profitability and the sunk cost of content:** There is a huge financial advantage to the blockbuster Disney model. Disney can spend \$500 million on a *Star Wars*/*Toy Story* movie, turn a huge profit at the box-office, and whatever they get for future revenue on their streaming service is just gravy. Put another way, their streaming service is basically going to be a near 100% profit proposition, with a higher quality of production. Disney could probably undercut Netflix pricing by 50% and still generate twice the incremental/variable profit margin. On the other hand, Netflix would be hard pressed to spend \$500 million on a movie for their streaming service, as their model would make it tough to generate much incremental revenues since subscribers are already paying for the service. Netflix's model is about attracting new subscribers and retaining existing ones, rather than a direct content-for-profit equation.
- **Streaming Infrastructure:** Disney already has some limited streaming and therefore has the capability to compete from a network perspective. More importantly, however, the Fox deal gives them control of Hulu, which is about one-third of the size of Netflix domestically. I can see Disney buying out the minority Hulu partners (Comcast and Time Warner), or alternatively folding its service into Hulu in exchange for a further bump in

ownership.

- **Global brand:** Netflix has a great global brand, which makes it difficult for upstarts to compete. That said, Disney is still *THE* brand in global entertainment (unlike Google or Amazon, which are well financed but have yet to make a dent in Netflix's momentum).
- **Pricing:** Another issue where Netflix could run into some trouble depends on Disney's view towards pricing its new service. If it looks to maximize short term profits, Disney will price close to Netflix's current levels, however, if it attempts a share grab, Disney can afford to price its more extensive and high-quality content library at a substantial discount to Netflix, since the streaming revenues are all profit post the box office profitability of the content. Disney content at \$5 per month vs Netflix at \$10+ per month could force consumers to make some choices.

While Netflix might be reporting an accounting profit, it's also worth mentioning that the business is burning cash at a Tesla-like rate. This is owing to Netflix's depreciation accounting for content, which received some scrutiny last year. At issue is Netflix's practice of depreciating the cost of its content equally over several years (including cancelled projects which are generally not written off), while its original content is consumed disproportionately within 6-8 weeks of release (as opposed to studio-fare which monetizes over several years from box office, pay-per-view, home viewer sales and syndication through TV and streaming). In other words, there is a decent chance that Netflix's annual multi-billion-dollar cash burn is its actual loss, and not the accounting profit it reports. Adding content doesn't necessarily add profit, as the subscriber base is fixed for a content release. That said, a content bomb doesn't necessarily result in a direct accounting loss from un-subscribers (as it would for a box-office bomb that grossed \$50 million on a \$200 million budget), it just ends up being an internal waste of money, indistinguishable to the outside world from a well viewed publication from a profit/loss perspective.

Currently, the market gives premium valuations to recurring revenue models like cloud software for business, but some companies (like Netflix) have low switching costs (simply hit "unsubscribe") and possibly negative ones if Disney undercuts Netflix pricing with a pumped-up Hulu. Not all recurring business models have equal customer lock-in.

As with Tesla's cash burn, and Facebook's selling of personal data, there is nothing about Netflix's multi-billion-dollar cash burn, Disney's streaming service or its acquisition of Fox mentioned above that is not already known by the street. The only question is when this narrative starts to get the streets attention and impacts the stock price.

As always, we reserve the right to change our mind!



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