Insights, Tacit Thought | Weekly Investment Insights

What goes down must go up, right?

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Clients of Tacit will recognise the term ‘moat’ in the context of the investments we hold in our strategies.

Moat is a term that Warren Buffett uses to illustrate the competitive advantage of a company. Its definition in the dictionary is that it is “a deep, wide ditch surrounding a castle, fort, or town, typically filled with water and intended as a defence against attack”. So, the castle, fort or town is meant to illustrate a company. To prevent it from being easily attacked, it needs to have a moat around it. That moat in investment terminology is the competitive advantage of the company.

Economic moats protect companies from losing their market share easily, which would erode their earnings power over time. This is important for us as investors because we need the companies, we invest in to have their earnings grow over time – then the share price will follow. The core equity exposure in Tacit strategies is invested in companies with a strong moat and does not alter much from year to year.

One company that we have used as an example in considering moats has been Netflix, as we questioned the sustainability of its growth rates into the future with competition from Disney, Apple and Amazon. Morningstar, the US research company, assign Netflix a ‘narrow moat’ rating.

Netflix was the brand that defined streaming around the world, so it had first-mover advantage. Being in the vanguard of a new technology or business model does not, however, translate into an economic moat in nine out of ten historic examples, as competition can erode this advantage relatively quickly. Think of what streaming has done to Sky subscriptions in the UK as users increasingly decide that the Sky price point is too high for a system that now appears behind the times.

Netflix has a good product: very attractive graphics that make it easy to navigate, it has embedded itself into most TV hardware to make it easy to access from your remote, and it has multilingual content which is attractive to modern society. This means that, today, it is a viable business that generates cashflows month on month and invests these surpluses in new content to keep those subscribers tuned in to its app.

In a world where competition is rife and inflationary pressures are making users reassess their subscription needs it is inevitable that companies such as Netflix will face a difficult period. This does not alter the fact that Netflix is an innovator in the digital media sector and a pioneer in its field.

The question for us is that if you assess the company through our lens, its valuation has always been too high given its uncertain future in a highly competitive and fast-moving market of consumer taste. Coupled with this is the fact that many company valuations have been priced off interest rates remaining at zero into perpetuity and this is a risk we feel investors should not be exposed to. Analysis shows that if you reduce the subscriber growth rate for Netflix down to 10% p.a. (it has been running at an annual rate of 17%) and increase the interest rate at which investors discount future cash flows to 4% to ascertain a current present value, the 40% share price decline this week only just brings the valuation down to a fair value.

Not all things that go down will go back up in the new investment environment and we remain firmly committed to setting a high bar when considering new investments for our strategies. Netflix has not been a holding in our strategies for this reason.

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