FUNDS ON FRIDAY
by Glacier Research

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16 November 2018
Volume 984

Netflix and the credit cycle

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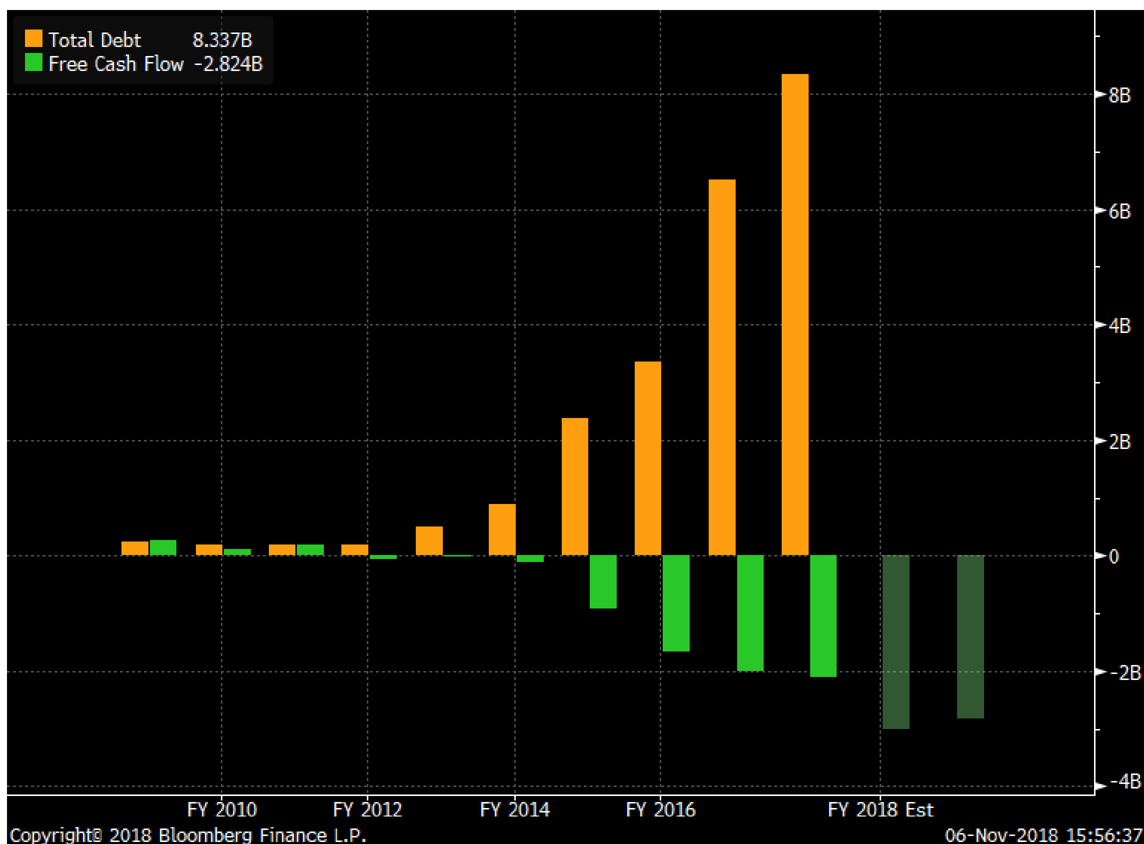
Netflix recently issued $2bn worth of new bonds to add to their existing $8.3bn worth of debt. These new bonds have a term of 10.5 years, so the return prospects of the bonds are tied to the long-term success of the company. The strategy of the company has been to spend massive amounts on original content (around $9bn per year at the current rate). This can't be covered by gross profits which is why they have had to issue $4bn worth of debt this year.

Free cash flow is expected to be negative $3bn per annum going forward, although they have consistently exceeded their forecasted cash burn. Netflix has explicitly told shareholders that it will be Free Cash Flow Negative "for many years". In 2017 CEO Reed Hastings said that: "In some senses the negative free cash flow will be an indicator of enormous success."

Quotes like this give flashbacks to the tech bubble. Talk of profit is irrelevant when the metrics are revenue and subscriber growth.



Netflix's risky strategy

The merits of Netflix's strategy are debatable. They are willing to spend lavishly on content in the hope of building a dominant media and streaming business. The cash that they are able to spend has already changed the media business. For example, stand-up comedy is a genre that they have totally upended in just a few years. Historically, the one-hour special was the ultimate achievement for a stand-up comedian. It is what elevated comedians like Eddie Murphy and Chris Rock into superstars.

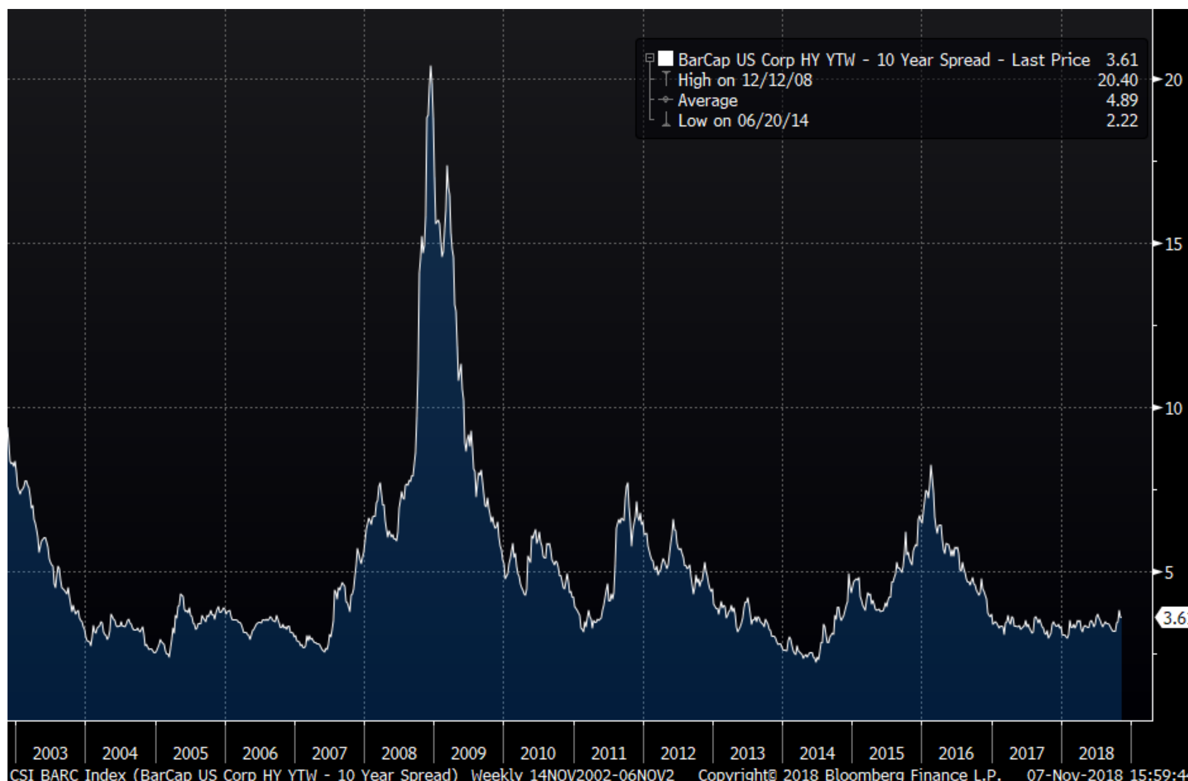
HBO generally did five or six comedy specials a year and Comedy Central did 10 to 15. This year Netflix has already released 66 comedy specials on their own with more to come. They are also paying comedians a multiple of what other media companies can offer. $40m to Chris Rock, $60m to Dave Chapelle and $100m deal with Jerry Seinfeld. No one can compete. If you are an equity holder, you are betting that the content that they are producing is valuable and there is a large potential upside if they succeed. Regardless of whether you believe in their strategy or not, what is not in doubt is that without positive cash flows or tangible assets this is a risky strategy.

Going forward, Netflix will face intense competition from established studios (Disney/Time Warner etc) as well as technology giants like Apple and Amazon who have competing streaming services. High risk strategies and intense competition are the reasons that many technology companies fail, while a few

survivors are very successful. Therefore technology companies have generally funded their capex with equity; either venture capital or via the listed market. This time around, companies like Netflix, Uber and WeWork are financing their cash burn in the debt markets.

Where are we in the credit cycle?

The ultra-low interest rate environment since 2008 has resulted in a chase for yield by investors. While rates have bottomed, spreads on high yield bonds are still close to record lows. This environment has allowed technology companies to fund risky investments with debt instead of equity. At this point in the credit cycle, investors are willing to accept low spreads for risky investments, but this can change if the cycle turns. The following chart shows the average spread for US Corporate Sub-Investment Grade bonds.



What does this mean for bond Investors?

The USD Netflix bond currently yields 6.1%, which is around 3% higher than the equivalent US Treasury bond. The potential outperformance over a risk-free investment is therefore 3% per annum (or 30% over a 10-year horizon). Investors in the Netflix bond are taking a lot of risk for only 30% worth of upside. If Netflix succeeds, they will be able to service and repay the bond, but the upside is limited to the credit spread. With limited upside, the downside scenario is what is critical for bondholders. If Netflix is not

successful, then the billions of dollars spent on content is likely to have little value and the bondholders will lose their capital in the same way as equity holders.

Investors should be wary of taking equity-type risk for limited upside.

One of the selling points of the recent Netflix bond deal was its $125bn market value, which is large relative to the $10bn debt level. This valuation is a function of their expensive (high PE) equity price. However, the current high market value is totally irrelevant in the downside scenario that is relevant for bondholders. I believe that bond investors should be naturally cautious. Equity investors have unlimited upside, so they can justify buying into high growth stories. The nature of fixed income investing is that your upside is limited to the yield pickup, while the downside risk is losing your entire capital. We are at the point in the cycle where equity market values are being used to sell bond deals and investors are ignoring fundamentals such as free cash flow and assets. This is the time to be extra cautious

Glacier Research would like to thank Rashaad Tayob for his contribution to this week's Funds on Friday.

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Rashaad is a portfolio manager at ABAX Investments. He joined ABAX in 2012 and has 17 years Investment management. He became a CFA charter holder in 2005. Rashaad started his career at Prescient Investment Management in 2002 and then worked at Aeon Investment Management for three years before joining the ABAX Multi Asset Team.