Disruption and the Power of Consumer Relationships

A Thought Exercise, for Active Managers

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Introduction

Recently I have been trying to better understand seemingly unrelated strategic and global issues ranging from the decline in media valuations (in a bull market) to the fall of powerful political institutions. As financial managers and engineers, we now live in a world where active management is considered obsolete by some. Events such as the decline in media shares seem counter intuitive. Why would companies paying a 38% tax rate go down when Wall Street expects corporate tax relief?

My question “Is there a common cord that ties disparate entities and events such as Domino’s Pizza, Netflix, and the Elections?” Part of the power of active management is human understanding evolves whereas an algorithm only reflects fixed relationships and the decision making of the programmers. While tools like S&P groups and ETFs are great for capital allocation they are static and the world changes. After 20 years of Internet development the fundamental relationship between enterprises, institutions and stakeholders have changed.

In 2013, I suggested “Not only was Content is King, but Distribution is the Nobility and the Viewer is the Proletariat, thus a happy Kingdom needs balance.” As technology evolved away from traditional physical distribution channels the world as we knew it changed. Today content is just one aspect of experience and “Experience is King”.

The Test

Technology and the ability forge new personal relationships on a mass media scale while also eliminating the middleman defines technology winners in 2017. To test this view, we compared companies with the ability to sell direct to the consumer to like kind peers selling into distributer operated channels. We constructed a CRI or Consumer relationship index. The list is comprised of Companies that derive value from direct relationships with the consumer and have limited or no distribution partners. Initially we will compare this group with the S&P 500 and to a list of legacy enterprises that distribute competing goods and services to the consumers via middle men companies.

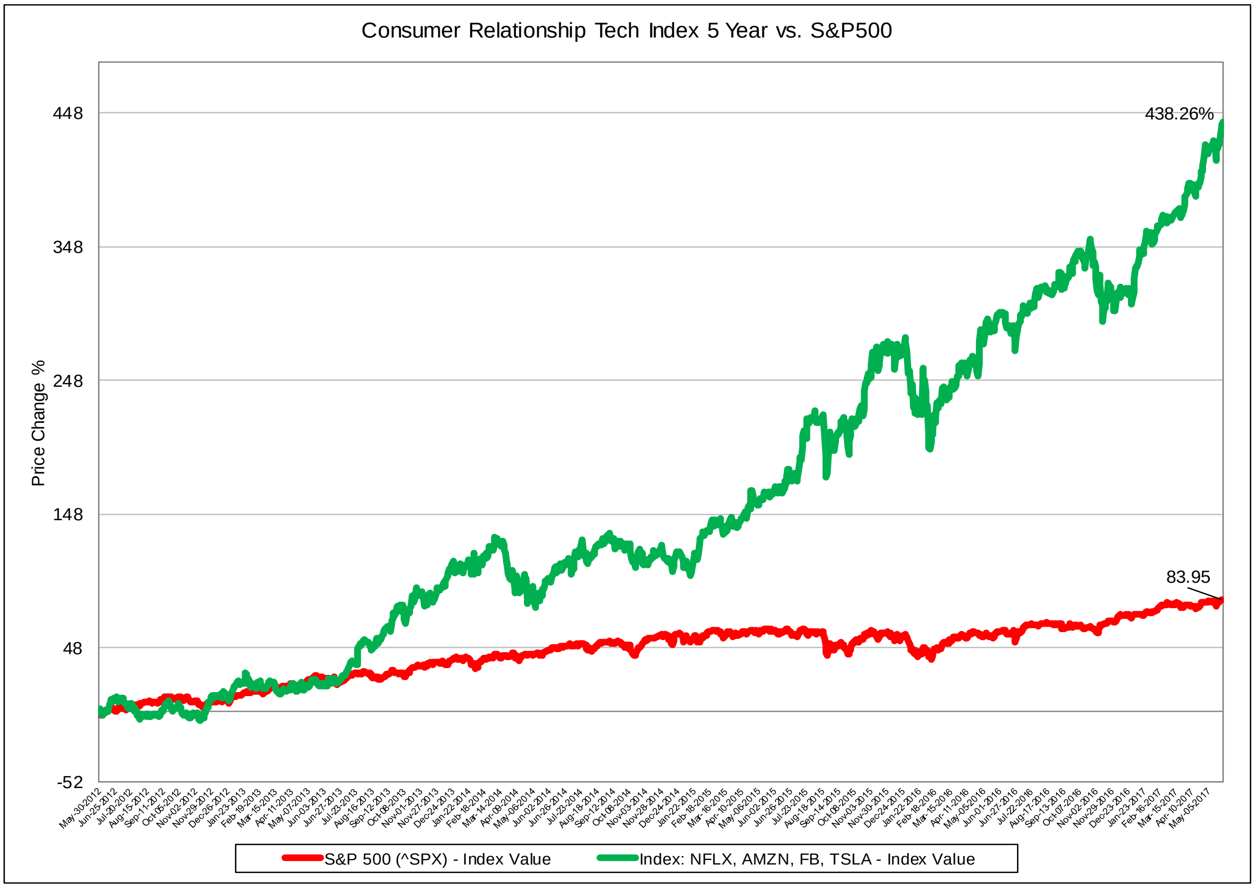
THIS IS NOT A WHITE PAPER ABOUT FAANG STOCKS.

To be clear while some FAANG Stocks sell direct to the Consumer Google, and Apple use a variety of distribution channels and there are also enterprises that are not FAANG stocks that have posted exceptional performance.

Full Disclosure

Investors should assume the author has a trading interest in any of the enterprises noted in this report and should not use the findings in this report as the sole basis for an investment decision.

The CRI or Consumer Relationship Index



In the chart above we plotted the relative performance of the S&P 500 and our CRI index which is comprised of Facebook (FB), Netflix (NFLX), Criteo (CRTO), Tesla (TSLA), Dominos Pizza (DPX), Live Nation (LYV) and Amazon (AMZN). The performance of equities has trended higher since 2012 however the CRI began to significantly outperform the S&P 500 in 1Q15. One catalyst for the greater price CRI momentum could be the availibility of broad band internet access.Broadband and Mobile Internet speads brought better consumer experiences for On Demand Media, Social Networks and eCommerce.

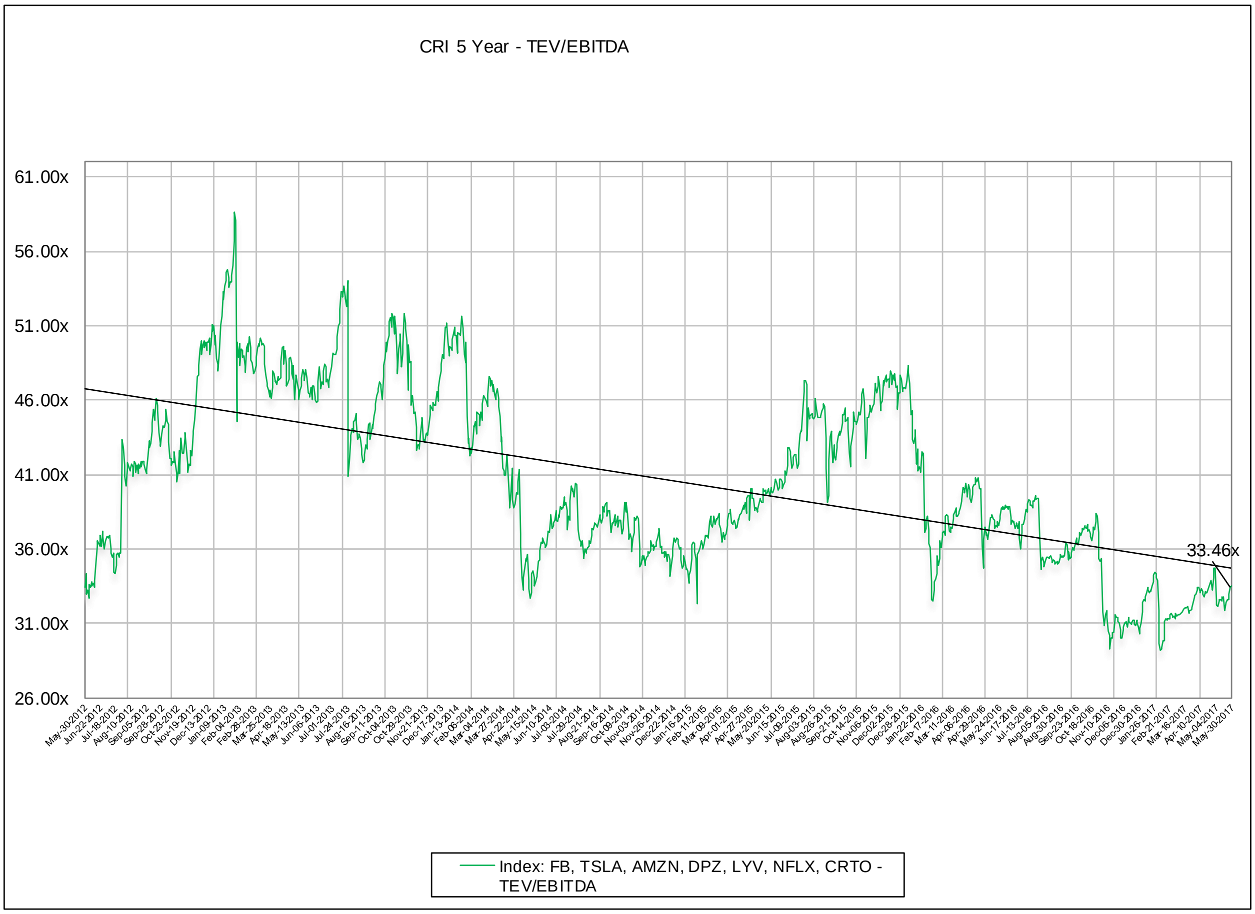
Return Delta %				
1yr	2yr.	3yr.	4 yr	5 Yr
(2.67)	50.97	103.43	238.54	355.54

In the 5 Year Period, beginning in May of 2012 the CRI index outperformed the S&P 500 by roughly 335%. A proportion of the CRI rally may be due to the “Trump Rally” we think the rally provided momentum to an existing trend as the index was up 238% pre Trump.

The CRI Rally is Arguably High Quality

After two bubbles one in 2001 and the other in 2008 many investors are jaded, which is an asset and a liability. The the current rally may be a bubble but its not in the same form as the bubbles of the early days of Silicon Valley which were largely diven by concept stocks and multiple expansions. We all marvel at AMZN's amazing share price growth but for every AMZN there are tens if not hundreds of failed eCommerce Companies. However, despite the share price expansion AMZN is cheaper today then it was in 2013.

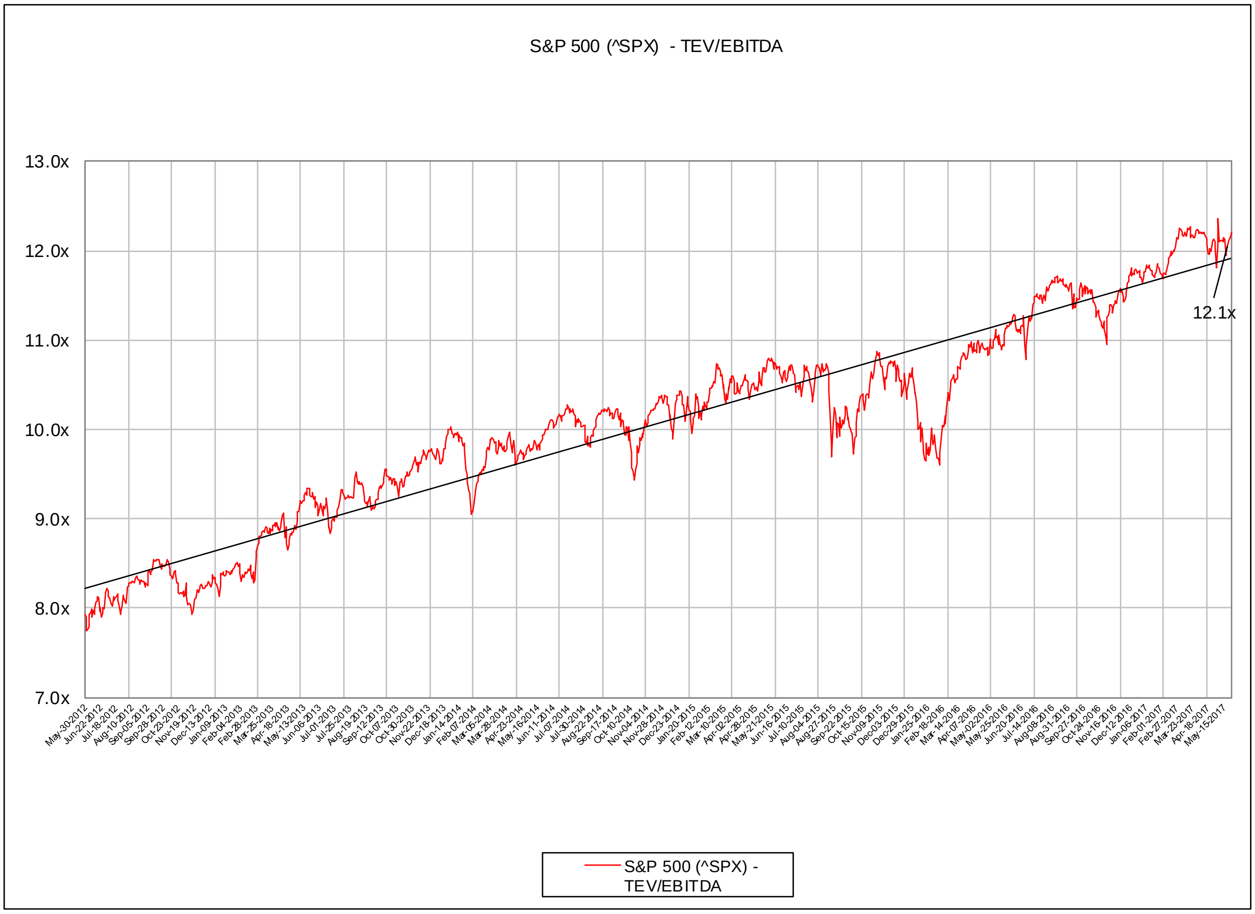
One difference today is the multiples of the CRI companies have actually contraced about 40% since 2013 as the multiples for the S&P 500 and the peer group of company's operating with market middlemen exanded by about 50%.



In the chart above, the ratio of Enterprise Value (MCAP+Net Debt) to EBITDA (earnings excluding interest, taxes and D&A expenses) for the CRI indext stocks has declined over the 5 year period. In 3Q12 the multiples peaked at over 56x EBITDA which compares to roughly 33x today.

In the absense of broad economic growth or a fundamental change in cost structure the S&P 500 rally since 2012 has largly been attributed to multiple expansion.

Valuations



Since 2012 (even more apprent in the “ Trump Rally”) the EV/EBITDA Multiple for S&P 500 stocks has expanded by nearly 50% from 8x in 2012 to 12x today. While the so called earning recession and weak FX rates may be the cause of expanding multiples the fact is, $1 invested today buys you 50% less in terms of S&P 500 earnings power today as compared to 2012.

Ultimately the series of charts may suggest a secular shift is at play.

The chart suggests technology when managed well produces alpha inexcess of the returns investors may expect. The CRI mean Beta is 1.25. The CRI Beta which implies annual returns in the 10 to 15% ballpark and 40% over the 5 year period based on S&P performance of 6% and 25% for the S&P 500 annual and in the 5 year period respectively.

How does CRI Compare?

The the trading multiples of the CRI componenets are compared to the S&P 500 they do not look very cheap. On average the trading multiples are roughly 2x the S&P 500. The most expensive of the group is FB trading at 13x Sales which compares to 2.4x for the S&P.

One of the cheapest in the group on a EV/Sales basis is Live Nation (LYV). LYV trades at 1x sales which again compares at 2.4x to the S&P 500, 4.8 for the CRI and 13.5 for Facebook.

S&P Capital IQ

Company Comparable Analysis > CRI (#NFLX) > Trading Multiples

Details	
Template:	Capital IQ Default Comps
Currency:	US Dollar
As-Of Date:	May-30-2017

Company Comp Set

Company Name	TEV/Total Revenues LTM -	TEV/EBITDA LTM - Latest	TEV/EBIT LTM - Latest	P/Diluted EPS Before Extra LTM -	P/TangBV LTM - Latest
Amazon.com, Inc. (NasdaqGS:AMZN)	3.3x	39.1x	116.4x	187.7x	26.7x
Netflix, Inc. (NasdaqGS:NFLX)	7.6x	112.2x	123.2x	211.1x	NM
Live Nation Entertainment, Inc. (NYSE:LYV)	0.9x	12.8x	40.4x	NM	NM
Domino's Pizza, Inc. (NYSE:DPZ)	4.8x	24.3x	25.8x	44.6x	NM
Facebook, Inc. (NasdaqGS:FB)	13.5x	25.0x	29.5x	38.7x	10.6x
Tesla, Inc. (NasdaqGS:TSLA)	7.2x	116.6x	NM	NM	12.1x
Criteo S.A. (NasdaqGS:CRTO)	1.8x	18.7x	28.4x	47.1x	11.1x

Summary Statistics	TEV/Total Revenues LTM -	TEV/EBITDA LTM - Latest	TEV/EBIT LTM - Latest	P/Diluted EPS Before Extra LTM -	P/TangBV LTM - Latest
High	13.5x	116.6x	123.2x	211.1x	26.7x
Low	0.9x	12.8x	25.8x	38.7x	10.6x
Mean	5.6x	49.8x	60.6x	105.8x	15.1x
Median	4.8x	25.0x	34.9x	47.1x	11.6x
S&P 500 (^SPX)	2.4x	12.2x	17.8x	24.2x	8.6x

Displaying 7 Companies.

Excel Comp Set ID: IQ432581714

Values converted at today's spot rate.

Fast Top Line Growth

Typically high multiples are atributted but not limited to one or more sources: Limited competition, Asset scarcity, High margins, and or High topline growth.

CRI revenue growth is impressive and secular; given most of these enterprises have been in operations for a decade or more. The double and triple digit revenue growth is imporessive and speaks to large addressable markets in legcacy industries; Media, Autos and Retail. When we compare the CRI to the S&P 500 the out performance performance has been due to revenue growth. CRI revenue growth over the last year is 32.7% as compared 3.7% for the S&P 500 while the Gross Margin is roughly the same at roughly 33%. The Capital structure also appears to be roughly the same with Debt to EBITDA at 4.1x for CRI and the S&P 500. Thus on the surface it appears CRI is generating its revenue performance from organic growth in end markets and not leverage as a group. However I caution while the mean is equal to the market the variance in the group is extreme.

Tesla is highly levered with $18 in debt for every $1 in EBITDA. While Criteo appears to have a clean balance sheet generating $1 in EBITDA as it borrows just $0.50 per EBITDA Dollar.

These are new business models and delayed costs are a risk.

For example, Netflix has a Debt to EBITDA Ratio of 5x which is marginally above the S&P 500 4.1x but resonable given the growth. Netflix also has roughly $14 billion in content liabilities not included as debt. Thus Netflix has to maintain fast top line growth and high gross margins otherwise equity investors may have to transfer Enterpise value to bond holders in the form of new debt or to Hollywood in the form of equity dillution.

S&P Capital IQ

Company Comparable Analysis > CRI (#NFLX) > Operating Statistics

Details

Template:	Capital IQ Default Comps
Currency:	US Dollar
As-Of Date:	#########

Company Comp Set

Company Name	LTM Gross Margin %	LTM EBITDA Margin %	LTM Total Revenues, 1 Yr Growth %	LTM EBITDA, 1 Yr Growth	LTM Net Income, 1 Yr Growth %	LTM Total Debt/EBITDA	5 Year Beta
Amazon.com, Inc. (NasdaqGS:AMZN)	35.6%	8.6%	25.71%	34.49%	121.44%	1.8x	1.48
Netflix, Inc. (NasdaqGS:NFLX)	33.6%	6.8%	32.74%	101.75%	166.38%	5.2x	1.25
Live Nation Entertainment, Inc. (NYSE:LYV)	27.3%	7.2%	16.74%	15.92%	-	3.8x	0.84
Domino's Pizza, Inc. (NYSE:DPZ)	31.1%	19.5%	13.49%	13.68%	20.71%	4.4x	0.63
Facebook, Inc. (NasdaqGS:FB)	86.4%	54.0%	53.23%	75.07%	134.90%	-	0.68
Tesla, Inc. (NasdaqGS:TSLA)	23.6%	6.2%	101.01%	-	-	18.2x	1.18
Criteo S.A. (NasdaqGS:CRTO)	35.7%	9.3%	33.86%	37.73%	21.79%	0.5x	2.71

Summary Statistics	LTM Gross	LTM EBITDA	LTM Total Revenues, 1	LTM EBITDA, 1	LTM Net Income, 1 Yr	LTM Total Debt/EBITDA	5 Year Beta
High	86.4%	54.0%	101.01%	101.75%	166.38%	18.2x	2.71
Low	23.6%	6.2%	13.49%	13.68%	20.71%	0.5x	0.63
Mean	39.0%	15.9%	39.54%	46.44%	93.04%	5.6x	1.25
Median	33.6%	8.6%	32.74%	36.11%	121.44%	4.1x	1.18
S&P 500 (^SPX)	32.6%	19.3%	3.70%	3.83%	15.67%	4.1x	-

Displaying 7 Companies.

Excel Comp Set ID: IQ432581714

Values converted at today's spot rate.

The remarkable performance is about business process and technology rather than sector

The enterprises in CRI sell into diverse markets.

- Tesla is a designer and manufacturer of solar electric necessities.
- Facebook operates a communications and information service.
- Netflix distributes scripted VOD content.
- Live Nation is a Live Entertainments producer
- Criteo does on line targeted advertising
- Amazon does eCommerce and is a technology enabler
- And Dominos is a fast service food provider

The common string that ties the DNA in all these CRI companies is between 2001 and 2008 management and their respective boards of directors decided they would use technology to meet consumer needs. Some are continually innovative like Facebook, some are disruptive like Netflix and Criteo and others are post disruptive like Dominos and Live Nation.

Each of the CRI enterprises use technology to reach markets directly, distribute products directly to the market, and acquires data on the market which it uses to forecast and address additional or future needs of the market. In other words, each owns relationships with the consumer or market.

Tesla knows how its owners drive their cars and what options they value. Netflix knows what programs you watch (which is not all that uncommon) what is uncommon is Netflix's commitment to delivering content based the on subscribers paying the bills and not the Hollywood Zeitgeist.

I would classify Live Nation and Dominos as post disruptive enterprises. Post disruption is defined as an Enterprise using technology following a wave of disruption to fundamentally redefine its business. Live Nation uses technology in all aspects of concerts such as ticket distribution via TM+, Concert Promotion, Venue Selection, and even in pricing a concert tour. Dominos uses data from its app to enable new products, faster ordering and is experimenting with drone Delivery.

Source: Dominos UK

CRI enterprises are focused on using technology to serve their customers and this focus is valued on the C Suite and Board Level. Sure AMAZON, and Facebook are perhaps easy examples because these enterprises are defined by their direct link to the market. Others such as Netflix, Tesla or Live Nation could have gone the easy route and inked distribution deals. Surely, GM would like to distribute Tesla Cars, surely LYV could have ceded the secondary ticket market to PayPal's Stub hub, and surely Netflix could be just another SVOD service on Comcast with 60% 40% economics.

However, management and the boards of these companies have decided to sacrifice near term revenue and earnings for longer term revenue growth based on the unique experiences they provide. Executives at these firms in contrast to their DRI (Distributed Relationship Index) peers are compensated based on metrics such as GRUs, Subscription Sales and Ad unit performance. DRI executives are compensated on measures more loosely linked to the consumer and markets such as TV Affiliate Fees, Upfront Ad Revenue, Vehicles sold to dealers. The difference is subtle but critical.

When we contrast Sony and Netflix Sony is making its decisions on what Netflix or AMC Networks needs and not necessarily by Sony's relationship with movie goers or TV audience. As a result, Sony's is to a degree separated from the market and the viewers. Can Sony change its strategic fundamentals with VUE, it is possible but the board must compensate management for VUE growth and underweight the value Sony Pictures and Sony TV Production. If there is no change in the status quo management will over allocate resources to the old business model compensating the C Suite and VUE will not develop the consumer branding and mind share it needs to dominate the market in an Amazon or Netflix way.

Source: Sony Entertainment

If Sony was dedicated building relationships with the consumer and had the resources and contractual flexibility (which frankly they may not) they should pull OTT and VOD distribution of is content and make it exclusive to VUE. You do not see Netflix in North America distributing House of Cards, or Orange is the New Black to HULU?

I will note we do see tactical decisions at Netflix recently. Cancelling Sense 8 is OK if cancelling high profile shows and ceding distribution in China to TenCent are tactical and not strategic decisions.

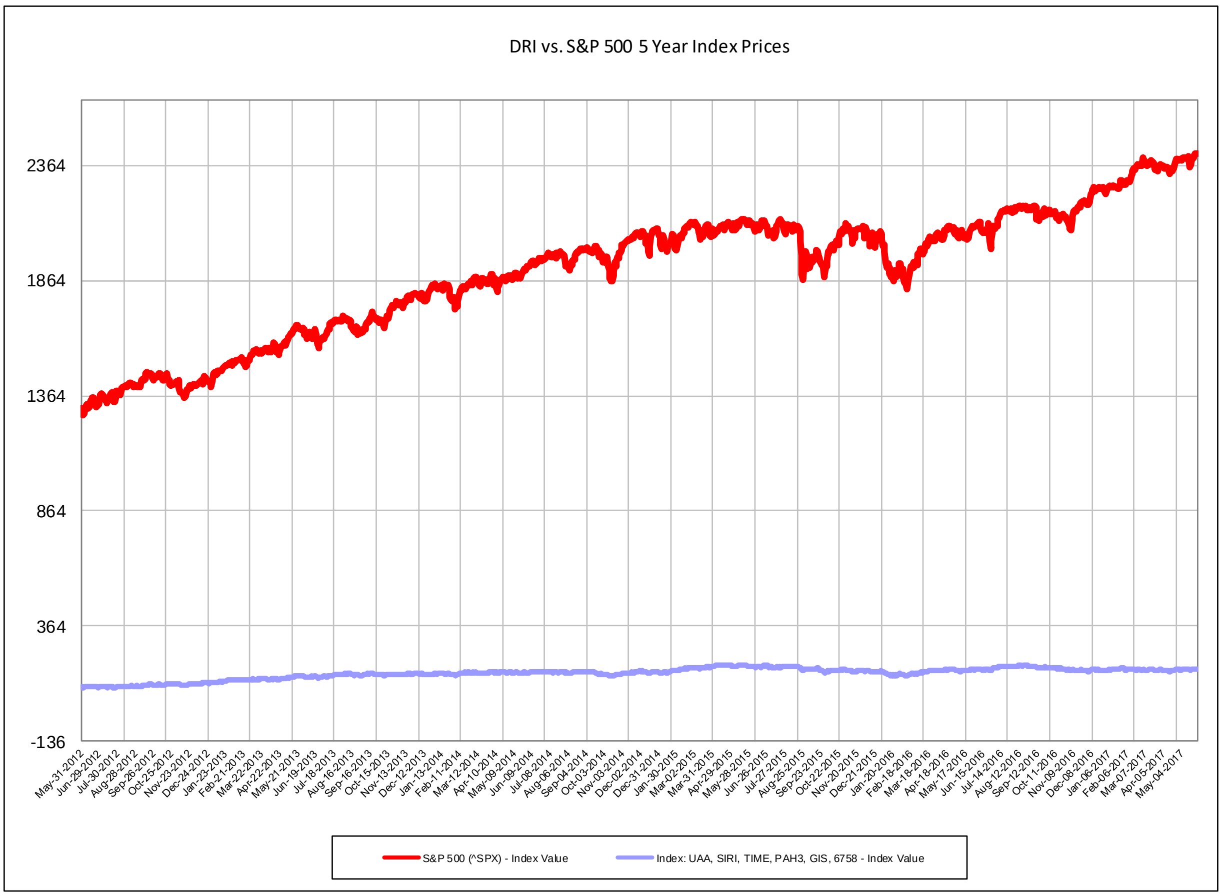
Our DRI comparison is unfair and used only to further illustrate the point

To be fair owing to the breadth, as CRI services roughly 40% of the US economy (excluding healthcare, financials and energy) the S&P 500 is the best index to benchmark the CRI.

The DRI index below was compiled to represent companies directly and indirectly competing with CRI but distribute goods and services using partners or middlemen. For Example, Porsche has dealers, SIRI uses OEMs, and TIME uses distributers. Our DRI index is comprised of Time Inc, SIRIUS Satellite, Porsche AG, Viacom, Under Armor, and Gannett

The DRI Underperforms the S&P 500

In the 5-year period, we use for the comparison the DRI underperforms the S&P 500 by roughly 7% over the five-year period. The S&P 500 expanded roughly 85% since 2012 as compared to the DRI which is up roughly 78%.

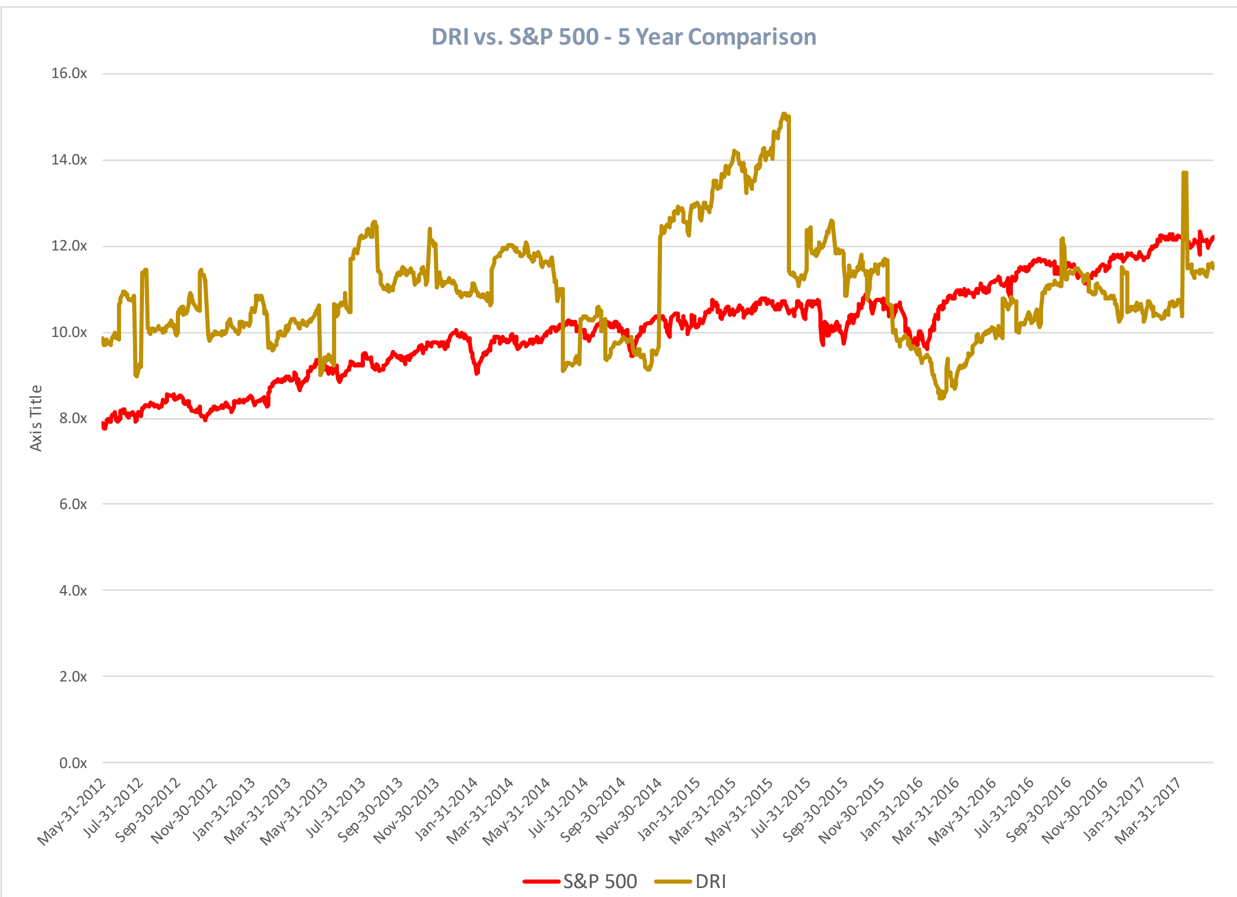


Valuation Multiples are volatile as compared to the S&P 500

Multiples for DRI enterprises expanded since 2012 but the expansion was outpaced by the expansion in S&P 500 multiples. The EV-to-EBITDA multiple for the DRI group has expanded to roughly 11x today from roughly 10x in 2012. The pace of expansion underperforms the S&P 500 which expanded to 12x from 8x.

Over the 5 year period the DRI multiple has been volatile. During the 5-year period, roughly 50% of the time the DRI has traded with a multiple under 10x and several times the DRI traded with a premium multiple more than the S&P 500 with should be the case because DRI includes large National and Global brands such as Porsche and Under Armor.

Interesting also is DRI has underperformed the S&P 500 since May 2016 when the US economy started to accelerate past the 1.5% to 2% GDP growth which was the old normal in the 2012 to 2016 period.



DRI, Some Interesting Comparisons

The DRI with below market valuations and below market performance should have inferior operating statistics, right? The DRI has a better mean gross margin then the S&P 500; 46% for the DRI as compared to 32%

Balance sheets are stronger too. The DRI Debt to EBITDA ratio is 2.3x at the mean which compares to the S&P 500 4x.

We attribute DRI strong financial metrics to strong brand: Under Armor, Porsche, Time Inc, and Sony are all very strong global brands. Using distribution channels to sell products does has advantages benefitting the DRI group's gross margin and as the gross margin cash flows from the income statement it benefits the Balance Sheet.

In terms of BETA, DRI performance was in line with the BETA, 0.89, however given the volatility investors must be very careful when investing in this group since the reward side of the risk reward relationship may be may be capped.

The reason why this group has attractive margins and subpar performance is low revenue growth. Revenue for the group expanded 3% which compares to 3.7 % for the S&P 500.

S&P Capital IQ

Company Comparable Analysis > DRI (IQ432600077) > Operating Statistics

Details

Template:	Capital IQ Default Comps
Currency:	US Dollar
As-Of Date:	##########

Company Comp Set

Company Name	LTM Gross Margin %	LTM EBITDA	LTM EBIT Margin %	LTM Net Income	LTM Total Revenues,	LTM EBITDA, 1	LTM EBIT, 1 Yr Growth	LTM Net Income, 1	LTM Total Debt/Capita	LTM Total Debt/EBITD	5 Year Beta
Sony Corporation (TSE:6758)	25.5%	9.6%	5.8%	0.96%	(6.20%)	9.23%	20.36%	(50.41%)	27.91%	1.7x	1.5
Sirius XM Holdings Inc. (NasdaqGS:SIRI)	51.2%	35.1%	29.7%	15.27%	8.96%	11.10%	13.13%	35.40%	118.18%	3.3x	1.07
General Mills, Inc. (NYSE:GIS)	36.4%	21.6%	18.1%	10.34%	(7.04%)	(1.17%)	(3.10%)	8.21%	64.84%	2.9x	0.6
Time Inc. (NYSE:TIME)	57.7%	12.6%	8.7%	(2.18%)	(2.86%)	(8.37%)	(8.65%)	-	46.95%	3.2x	0.72
Porsche Automobil Holding SE (DB:PAH3)	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Under Armour, Inc. (NYSE:UAA)	46.3%	11.1%	8.0%	4.81%	16.38%	3.12%	(6.17%)	(1.87%)	29.89%	1.6x	0.09
Gannett Co., Inc. (NYSE:GCI)	36.1%	10.0%	5.6%	0.35%	11.83%	(19.09%)	(38.33%)	(92.76%)	31.16%	1.2x	-

Summary Statistics	LTM Gross Margin %	LTM EBITDA	LTM EBIT Margin %	LTM Net Income	LTM Total Revenues,	LTM EBITDA, 1	LTM EBIT, 1 Yr Growth	LTM Net Income, 1	LTM Total Debt/Capita	LTM Total Debt/EBITD	5 Year Beta
High	100.0%	35.1%	29.7%	15.27%	16.38%	11.10%	20.36%	35.40%	118.18%	3.3x	1.5
Low	25.5%	9.6%	5.6%	(2.18%)	(7.04%)	(19.09%)	(38.33%)	(92.76%)	1.06%	1.2x	0.09
Mean	50.5%	16.7%	12.6%	4.93%	3.51%	(0.86%)	(3.79%)	(20.29%)	45.71%	2.3x	0.89
Median	46.3%	11.9%	8.3%	4.81%	3.05%	0.98%	(4.63%)	(1.87%)	31.16%	2.3x	0.89
S&P 500 (^SPX)	32.6%	19.3%	13.3%	9.01%	3.70%	3.83%	4.37%	15.67%	52.77%	4.1x	-

Displaying 7 Companies.

Excel Comp Set ID: IQ432600077

Values converted at today's spot rate.

Multiples

DRI multiples are cheap as compared to the CRI Index and the S&P 500. The DRI is cheap primarily because revenue growth is slower than the CRI peers a subpar revenue growth may be a risk. DRI EV/Sales is roughly 1.3x and significantly lower than the S&P500 2.4x and the CRI 4.8x.

Enterprises like Viacom have proven to be value traps as the businesses has not posted the growth they once did. However, LYV was a slow growth company in 2011 and over the period LYV posted high single double digit revenue growth despite the collapse of the EDM Festivals bubble in 2015. I think LYV was playing ahead of the puck and anticipated weaker festivals performance because the enterprise is so in tune the market owing to LYV's technology enabled customer relationship and allocated resources to better content as SFXE a peer that was not in tune to the market declared bankruptcy.

S&P Capital IQ

Company Comparable Analysis > DRI (IQ432600077) > Trading Multiples

Details	
Template:	Capital IQ Default Comps
Currency:	US Dollar
As-Of Date:	May-31-2017

Company Comp Set					
Company Name	TEV/Total Revenues LTM -	TEV/EBITDA LTM - Latest	TEV/EBIT LTM - Latest	P/Diluted EPS Before Extra LTM -	P/TangBV LTM - Latest
Sony Corporation (TSE:6758)	0.7x	6.7x	11.1x	70.9x	3.7x
Sirius XM Holdings Inc. (NasdaqGS:SIRI)	5.9x	16.7x	19.8x	32.6x	NM
General Mills, Inc. (NYSE:GIS)	2.7x	12.2x	14.5x	21.0x	NM
Time Inc. (NYSE:TIME)	0.7x	5.9x	8.6x	NM	NM
Porsche Automobil Holding SE (DB:PAH3)	NM	-	10.4x	11.6x	0.6x
Under Armour, Inc. (NYSE:UAA)	1.8x	16.5x	23.0x	49.4x	6.2x
Gannett Co., Inc. (NYSE:GCI)	0.4x	3.7x	6.6x	86.4x	NM

Summary Statistics	TEV/Total Revenues	TEV/EBITDA LTM -	TEV/EBIT LTM -	P/Diluted EPS Before	P/TangBV LTM -
High	5.9x	16.7x	23.0x	86.4x	6.2x
Low	0.4x	3.7x	6.6x	11.6x	0.6x
Mean	2.0x	10.3x	13.4x	45.3x	3.5x
Median	1.3x	9.5x	11.1x	41.0x	3.7x
S&P 500 (^SPX)	2.4x	12.2x	17.8x	24.2x	8.6x

Displaying 7 Companies.

Excel Comp Set ID: IQ432600077

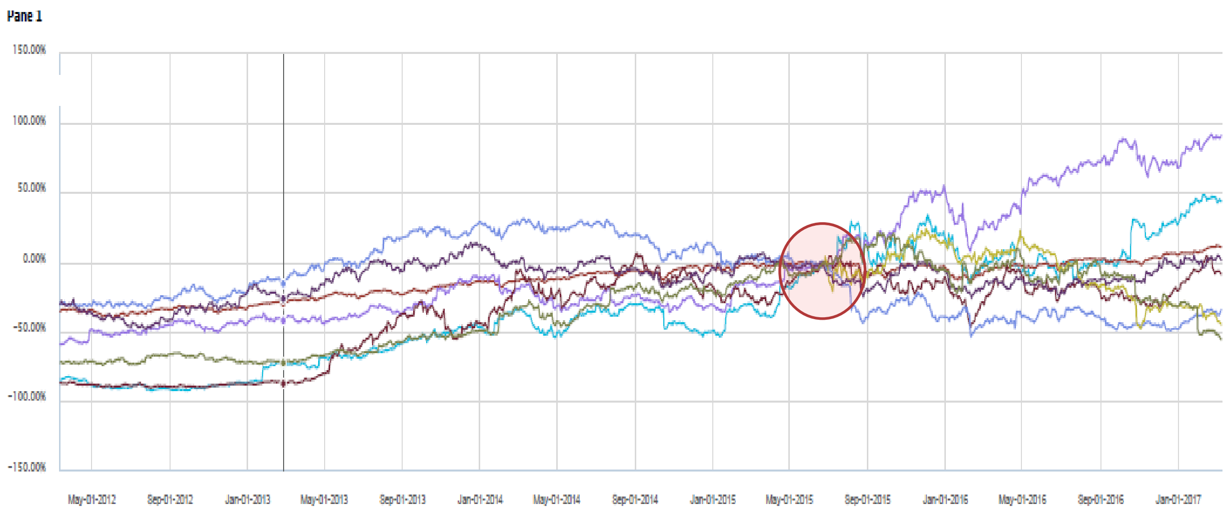
Values converted at today's spot rate.

The Bow Tie Chart

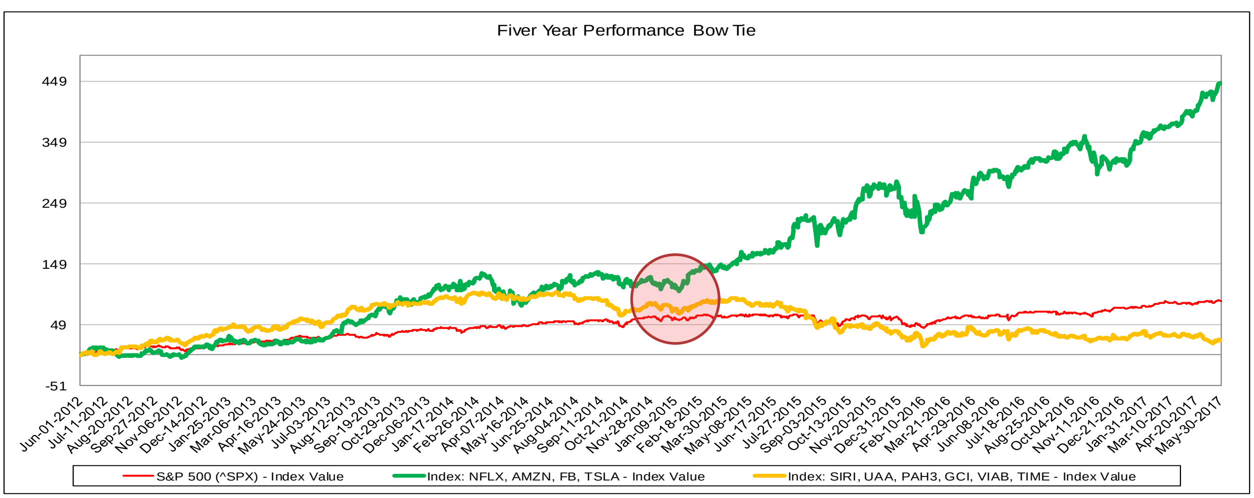
Deconstructing the CRI index and DRI index and plotting the Companies on an individual basis concludes with an unexpected result.

The performance of every company DRI, CRI, and S&P 500 converged at 0% in May 2015 and then the return deltas expanded. I thought chart was wild given the diversity of the DRI and CRI indexes and the fact that the Federal Reserve bank was raising interest rates which should have benefitted companies with better balance sheets.

I think the explanation is in a recovering economy the CRI companies were better positioned to generate revenue from a recovering consumer in a recovering economy just as the Millennial generation was maturing into adulthood ages 20-27.



Without the noise created by individual stocks you can see some of the bow tie in the indexes.



In conclusion, I will let people draw their own conclusions. To be clear there is a secular trend and fundamental observation in this analysis but the value investor in my DNA sees this historical disparity. Perhaps the best way to play this trend is to find the next Live Nation or Dominos. Is it Adidas, or can it be Ford given the new management change? Alternatively, are Pandora, Twitter, and Snapchat more like top down DRI companies than CRI companies? Lastly, is Netflix the most focused company in Silicon Valley deviating from the CRI model?