Magellan – In The Know: Episode 36

Behind the screens – The evolution of streaming services and the investment case for Netflix

Announcement (00:00):

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Host (00:14):

This is, In The Know, a Monthly Investment Podcast, brought to you by Magellan Asset Management.

Arvid Streimann:

If you've got a fixed content cost and you're getting more revenues in the door, then that extra revenue just goes straight to the bottom line. So the profit outlook for Netflix I think is looking more certain.

Ryan Joyce:

For streaming businesses, it's all about scale and not just scale and users, but scale in revenue. So that's not just that subscriber account but also how much revenue are you generating per subscribers.

Host:

That's Magellan's Arvid Streimann and Ryan Joyce explaining just two of the reasons why Netflix is an attractive medium term investment and why the company is expected to be one of the long-term winners in this dynamic industry.

Welcome to Magellan In the Know.

In this episode, Arvid, a portfolio manager at Magellan is joined by Magellan sector head of finance and technology, Ryan Joyce, to go behind the scenes for a deep exploration of the streaming industry, its history, and its current situation. Stay tuned for a fascinating look at this disruptive sector and why Netflix has emerged as a sound investment.

But first, here's a warm welcome from Arvid.

Arvid Streimann:

Welcome to the latest episode of Magellan's In the Know. My name's Arvid Streimann and today we've got Ryan Joyce who not only is the portfolio manager here and head of financials and technology, but he also covers the streaming services.

So Ryan, how you going?

Ryan Joyce:

I'm very well. Thanks, Arvid.

Arvid Streimann:

Excellent. Now I'm really excited about today's episode because we're going to talk about something which a lot of people do, including me, which is watching TV or I think maybe more accurately watching video entertainment because as we will discuss, TV is not the only way that people can consume video entertainment services.

Now, I think it's also going to be interesting for us and the listeners out there because not only do most of us watch TV or consume video entertainment, some more than others of course, but I think this is an industry where investors can make a lot of money. Now, Ryan, how much TV do you watch?

Ryan Joyce:

I think probably about an hour or two a day, maybe a little bit more if there's a good series that I get hooked on and that's relative to the averages, particularly in the US is quite small. I think in the US they watch about five hours of video content a day that is skewed by older audiences that tend to watch a little bit more, but certainly a big chunk of people's spare time is taken up by watching video.

Arvid Streimann:

Yeah. No, I don't get anywhere near the five hours either, by the way.

But anyway, let's set the scene. I want to talk about a couple of things first. Now I think we're all familiar with TV and video entertainment, but let's break it into two bits.

The first one is how has the way that people watch video changed over time and then the second part is how has the video content that they're watching changed over time. And maybe we can just start with the first bit, which is how do people actually watch video and how has that changed over time?

Ryan Joyce:

Yeah. So I don't think it's a surprise to any of our listeners that the big shift we've seen is this move from linear TV to streaming services. If we focus on the US, streaming is now about 40% of viewership there. Again, that's skewed by older audiences that tend to watch a bit more linear and a little bit behind that 40%. So the percentages amongst younger demographics is quite a bit higher than that 40% and that continues to increase.

Now the other big shift associated with that move from linear to streaming is you're watching on demand. You're selecting what you want to watch from a near unlimited catalogue versus what was being served up to you in the past at whatever particular time slot you turned the TV on it.

Arvid Streimann:

And it's interesting because I recently moved house and when I was putting the TV on the wall as you do, I didn't plug it into the aerial. In fact, I can't actually watch the free to air TV. And there was also a Foxtel, which is a pay TV connection, which I didn't plug into my TV either. I just watched YouTube and the streaming services. So this is very different to what I used to do when I was a kid which was wait until something came on and maybe wait a long time for that to come on.

So we've talked about how people watch TV. What about the content within the TV that people are watching? How's that changed?

Ryan Joyce:

Yeah. So I think it's really bifurcated between those two services that we talked about. Going back in time, linear had a pretty good blend of content. Obviously, you serialised comedies and dramas, some higher budget shows, and then reality, news, sports. And what we saw in the early days of streaming was they went heavy into these high budget dramas and comedy as well as some niche things and films and that left the linear TV much more focused on news and reality and sport.

And one of the reasons for that was they were under pressure financially because of that declining viewership and that shift to reality content which is a lot cheaper to produce than high budget shows with expensive actors or directors. And so that's helped them offset some of the cost pressure on that business.

Arvid Streimann:

Okay. Now let's zero in on streamers. You mentioned earlier before you've got these streamers and maybe you can watch it through an app. Now they've been growing quite fast, you've mentioned some of the numbers and obviously, that makes it an exciting place to be. Can you take us through what their business model is? I want to talk about how they make money.

Ryan Joyce:

Absolutely. So for streaming businesses, it's all about scale and not just scale in users but scale in revenue. So that's not just that subscriber account, but also how much revenue are you generating per subscribers. And if you look at some different services around the world, they might have a lot of subscribers, for example in India as Disney does, but they only generate 60 or 70 cents per month. So it's not the same as generating $12 a month on average that Netflix might generate for example.

But having that scale, that revenue scale is critical as what it allows you to do is leverage what are really pretty fixed content costs. Also, the cost of maintaining a tech stack that's a bit more expensive and something that media companies didn't have to invest in and maintain in the past. And also marketing that content so people are aware of it. And all of those things scale across that larger customer base.

And then once you have that scale, you have a choice. You can reinvest that into more content and differentiate yourself from the other services. As I said, you can invest more in marketing to make people aware of your content which will bring you to the service or maybe create that water cooler conversation around that most recent piece of content, reengage people, reduce churn, or you can also invest in price, make sure your service remains price competitive, remains that core service that you have rather than being I guess a lower volume but equally priced service that doesn't have the same value proposition.

And then the last option of course is to let that flow through to your profits or through to the bottom line. Now obviously the management teams are weighing all of these things up when they're figuring out what to do with the revenue they have and so it usually ends up some combination of the above that they think makes the most sense.

Arvid Streimann:

And we've been seeing a lot of these streamers introduce an ad supported tier. What's going on there?

Ryan Joyce:

Yeah, absolutely. So we've certainly seen all the big players roll out and add supported service in the last 12 to 24 months. Apple being a bit of an exception there, although it's not a major player at this point, and there's a few reasons for that.

So I think the first reason is we are seeing a bit of a maturing of the streaming market particularly in developed English-speaking markets like the US or Australia or the U.K. for example. And so the ability to offer a lower subscription price service via an ad tier that also generates revenue through ads is viewed as an important way to unlock another group of subscribers that maybe didn't want to pay 15 or $20 a month but are happy to pay $10 a month to access that content. So I think that's probably the number one reason.

A second important reason is that as you grow the percentage of subscribers that you have with that ad supported tier, it also gives you natural growth in the revenue you're generating from them without having to increase prices. As that shift in streaming continues I mentioned at the start that it's about 40% of viewership today, if that 40% continues to rise, let's say it reaches 80% and you maintain your share of that streaming viewership, the hours are going to go up, a number of ad impressions are going to go up and you're going to be able to generate more and more revenue from that advertising without having to increase the subscription price as much.

So getting on that bandwagon of having that upwards trajectory in your ARPU I think is important for all these services. And a reason that Netflix pivoted from its historical model of not having ads, it was driving growth through just increasing subscription pricing, but having more in this bucket I think provides a nice way to grow that ARPU without necessarily having to increase prices as often as they would otherwise.

I think a related benefit to that is maybe a bit less churn. If the price is a little bit lower, you get your credit card bill at the end of the month, there's two or three or four streaming services on there, it's $20 a month. You might be more likely to say, "Hey, I'll take a breather on that one. There's no new content I've seen recently that's particularly interesting to me." If it's $10 a month, maybe it's a bit of a different decision. And so having that higher retention or lower churn is quite positive.

The final reason I'd say is sports content. If, and it's a big if, streaming service does want to get into streaming live sports, you really need to have capabilities in advertising. A lot of sports, particularly US sports, if you think about basketball or NFL, they're designed for ads. They have these breaks in them for very long three hour broadcast of a live NBA or NFL game, probably an hour of ads in them. And so if you're not able to monetize those breaks through ads, you're at a very big disadvantage and you basically won't be able to competitively licence that content from the leagues. So if you want to do that at some point you need to build those capabilities to have available to you.

Arvid Streimann:

So I just wanted to clarify one thing. When you talk about ARPU, can you just explain to the listeners what that is and maybe spell out what A-R-P-U actually is and how that differs from price?

Ryan Joyce:

Yeah. So that's average revenue per user. And in the context of streaming, this is pretty similar to the price of the subscription. Obviously, if you do have an ad supported service that might generate $10 of subscription revenue plus $10 of advertising revenue per user, then your ARPU is 20. Whereas if it's the subscription service only and it's $20 a month, that's your entire source of revenue.

And just for some context there, Netflix, since bringing out its ad supported service has said in the US that the total revenue it generates from the ad tier is similar to its standard tier. So that discount to that standard tier is being entirely made up through advertising revenue.

Now, that's not the case in all markets. The US is a very advertiser friendly market. The prices for advertising there tend to be higher than most other markets around the world.

Arvid Streimann:

Okay. So you've talked about, say, how do individual streamers make money and I would say there's more of them today than there were five years ago. What do you think is going to happen to the streaming industry? And maybe you can tie that back to how these guys actually make money.

Ryan Joyce:

Absolutely. So if we talk maybe about the past one or two years and what the next one or two years looks like and then what the longer term outlook looks like.

And I think what we've seen recently and still going on is somewhat of a fragmentation, at least if you measure by the number of subscribers. And the reason for that is service stacking of these streamers. So when it first came out, most households would go out, they'd get Netflix, they'd get one service, maybe it's another one, and they'd have that and use that. Particularly during COVID what we saw is households added more services and they're still adding more services. So maybe some still just have one, but some households now, they want everything. So they've got five or six services.

But we will reach this point of a ceiling of how many services do you want to pay for a month? Are you just happy to pay $60 a month or are you willing to pay a hundred dollars a month if you want all five? And we are seeing a bit of a moderation in the growth of the number of services per household.

So when we were seeing that increase from say an average of one per household to three, it naturally lends itself to fragmentation because those smaller services are picking up those additional subscriptions. It's not the established service that's getting them versed.

The other dynamic that was both driving and supporting that but which has changed is that those secondary players that lagged Netflix coming to market were investing aggressively in new content, in marketing their services wherever. I'm sure you saw lots of billboards around the place about their latest show and the service offering, attractive discounts, etc., that also accelerated that service stacking to some point.

But now what we've seen is with the rise in interest rates and a bit of a slowdown in subscriber growth as well, they're having a bit of a reality check. And so they're being a bit more rational in terms of their investments in content, their investments in marketing. This is the future of their business, they need to not just grow subscribers, they also need to make money there.

Arvid Streimann:

Yeah. To monetize the subscribers, it's fine to have loads of people buying your stuff, but if you can charge them a little bit more, they go straight to the bottom line.

Maybe you can talk a little bit about, because you mentioned Netflix, who the biggest players here are in this industry. I think that gives people a bit of context and they probably know a few of them by the way. But just to round out who do you think the biggest ones are. And then as we peer into the future, who do you think are going to be the winners, if you want to call it that? Who do you think are going to be the survivors here because there are more of these players than there used to be?

Ryan Joyce:

I'll start with the US just given it's the biggest media country in the world and a really important exporter of media to other English-speaking countries and that's where all the big players come from effectively.

So we've already talked about Netflix, we've alluded to Disney. They're a little bit different obviously, focused on the content, franchises, and ecosystems that they've developed and the synergies that has with the parks business. But they also need to have the general entertainment. You might've seen here they have the Star content in the Disney+ service and that's really to try and help manage churn. So it's all well and good to have the most recent Marvel movie or the Disney Animation Studios movie but if you want people not to turn it off between those things, you need to have a steady flow of general entertainment content. That's why they acquired the Fox business.

So we think they've both got enough unique content that appeals to families and some other households as well to sustain themselves as I talked about that business model of revenue scale. So we think they're going to make it.

Another one is Warner Brothers Discovery which owns the HBO content and they've now rebranded that into Max. For the Australians here, most of that content makes its way into BINGE, but they have a very big business in the US. They've successfully gone direct to consumer in some international markets which I think is important to getting enough scale to survive. And they've got these pretty strong relationships with the likes of BINGE or Foxtel or some providers in Canada and other markets as well.

And then you've got the tech players that are playing a bit of a different strategy. So here I'm talking about Amazon Prime which is using video much more of a customer acquisition tool for its e-commerce business particularly where it's a bit less established in some international markets.

And then also a retention strategy for that broader prime strategy and to keep people buying goods on their platform basically.

And it's a smart customer acquisition and retention strategy because as I talked about, content's very scalable. So if you're going to offer something as a retention strategy, you want to be able to amortise that across your entire customer base and they can do that with video content which you can't do with music content, for example, where you've got to pay out a big chunk of any usage or revenue you get from that to the songwriters and artists there.

The last one's Apple. I think they're a bit more early in their phase of investing in content. They've taken a more measured approach and we talked a little bit about service stacking before and I think they're trying to occupy this place for higher income households or households that value video content more and they want to have everything and they're happy to be the fourth or fifth service that a household has with some high quality content. You're probably not going to get a lot of content in that service, but for those that want everything, it fits there.

And so they make money I think a little bit differently than the other guys which are trying to have content for everybody and super serve their audience. I think Apple's trying to be a bit more of a niche player there.

They also have secondary benefits. Enhance the brand of Apple overall, strengthen the Apple TV ecosystem where they sell subscriptions to other services.

So those are the five global players that I think we'll still be talking about in 10 years in this space. And then in addition to those, there are some other US players and some other regional and local players particularly those that have first mover advantages or pretty early to move I think will remain relevant.

So if we think of businesses like Stan or BINGE in Australia or Crave in Canada, they went out pretty early relative to these international providers coming into this market. They established a bit of a subscriber base. And so these US companies that produce a lot of content, they need to make a decision. Do I make the most money just by licencing my content to these local distributors if you like? Or do I go out and stop licencing my content to them, take the hit to earnings as very high margin revenue they get and try to build my subscriber base from scratch when the market is getting a little bit more mature?

And I think as part of that more rational behaviour that I talked about earlier by some of these later entrance into streaming, the legacy linear players, they're making much more considered decisions as to will I go aggressively into that market myself or will I actually just partner for the long term with these local distributors. And I think that's increased my confidence that these local and regional players that have a relatively strong position will remain relevant not on the global scale but in their local markets.

Arvid Streimann:

It's very interesting.

And I wanted to expand a little bit on Amazon. You mentioned that as part of... Amazon Prime here I'm talking about. It's part of a broader customer strategy. It comes with a free delivery or expedited delivery. And you always say here that if you want to sell something to someone, to your customer, it's great if you already have that customer and if you can somehow keep them to stay there for longer, then that's even better. So it seems to tick those boxes.

Ryan Joyce:

Absolutely.

Arvid Streimann:

So, Ryan, when we're thinking about technology companies and maybe these types of companies fit into that broad categorization, one of the big issues that comes up with technology companies is regulation. What sort of regulation or regulatory risks do streamers face?

Ryan Joyce:

So for streaming companies, I think the main regulatory risk I see is local countries want to make sure they're protecting their own arts industries, they're protecting their own culture and their own advancement and representation that culture in media. So they don't want people just watching content that's produced in the US and has US culture associated with it.

And so we've seen in different countries around the world, various rules or proposed rules around requiring a certain amount of local content to be in streaming services. Now that might be whether you need to spend a certain amount of your subscription revenue that you generate in a local market on local content. So just reinvesting in that local market, whether it's additional restrictions around highlighting local content and making sure you're giving it visibility within these streaming businesses.

And I think this makes sense but I also think it's quite manageable for these streaming companies. We've seen, for example, with Netflix, the ability to take content from international markets where that content is produced locally for France or Mexico or Germany or-

Arvid Streimann:

The Squid Game's in Korea.

Ryan Joyce:

Exactly. So that's an example of them reinvesting in that local content which will make the Korean regulators happy but then also being able to scale that content across the rest of their user base.

Arvid Streimann:

And that regulatory risk and we always think about risk as being a negative, but you actually said, "Well, maybe this is a positive risk as well in terms of this regulation."

Ryan Joyce:

That's right. I think it's very company by company. But if you're looking at those US platforms, how global have they become, it's probably a bit more difficult for somebody like Disney who's much more reliant on these big budget Hollywood movies, very US produced, US centric, they've got a while to go to truly globalise and become more local ahead of them and that may create some challenges for them along the way.

Arvid Streimann:

On that regulatory risk, one last thing, this regulatory risk that you're talking about the local content requirements that's not specific to streamers, I think it also applies to regular TV and radio and that sort of stuff too, right?

Ryan Joyce:

That's right. So in a sense it's a little bit of a catch-up with the rules that the linear players already had and didn't exist when streaming came out.

Arvid Streimann:

Yeah. I think this is an important point that this isn't a new regulation that's come along to control this new industry that's growing. This is actually just an existing thing.

Now during COVID, Ryan, if you remember that, we all do I suspect, this industry, the streaming industry went through a bit of an event. Can you take us through what happened and maybe what the learning from that is for investors?

Ryan Joyce:

Yeah. I think, again, not a huge surprise to the listeners, but we saw a big pull forward in demand. It wasn't just in streaming, it was in other areas like e-commerce. But people were locked up at home. They needed more entertainment. Linear only offers so many hours a day with a limited selection and so people turned to these streaming services. As I mentioned, maybe they had one, they went to two or to three, maybe they had none and they adopted it for the first time. And maybe those people that would've come to it in 10 years instead they signed up in the first month of COVID when they had nothing else to do.

Now, in terms of where that's trended back towards, we've seen e-commerce go right back to the trend line, for example, I think this probably accelerated it and has kept it a little bit ahead of what that trend line would be, but it's gone back towards it. And I think that's where the broader investment implication is where you have these disturbances in trend line, whether that's due to COVID or some other temporary factor, you really need to be cognizant of what's going to happen when that factor's removed.

And also how people interpret that normalisation. Do people interpret it as you've reached full penetration and you're not going to grow it all anymore before reaccelerating? So I think you need to be really mindful of these disturbances and thoughtful about where that long-term trajectory remains.

Arvid Streimann:

Yeah. I think it's a good point because if you think about it, I think what you are talking about is that there was this external shock to the streaming TV industry or the streaming industry. And sure it came and penetration rates went up, but this was an external shock, nothing really happened. So it went back to more or less where it was before.

But if this was an alternative and let's call it an internal shock where maybe the stuff that the streamers were offering the value to consumers went up incredibly, this is an internal shock, maybe that improvement in penetration may have been more permanent.

Ryan Joyce:

That's right. I think it's important to distinguish between those two things and think there's some probably parallels in the current AI tools that are being rolled out and the productivity benefits that they might have as well, which I think is different to that external environment of COVID.

Arvid Streimann:

Yeah. Well said.

Now we're talking about content here, things that are people watching. We're essentially talking about Hollywood, right? Now, as of today and just for everyone who's listening, we're recording this on the 20th of July, there are two strikes that are happening, the industrial action that's happening in Hollywood. Now content writers have been on strike for a couple of months now and actors went on strike about a week ago. Now we're talking about content and the people that make the content are on strike. So what does this mean for the streamers, Ryan?

Ryan Joyce:

Yeah. I think it means different things for different streamers, but I would say that they tend to be better positioned than the linear TV providers and the reason for that is they're less reliant on live content that might be being written today to be released in a couple of weeks, if we think about talk shows and things like that, and they have this bigger backlog of content that they've completed and they have a plan to release that through the year to keep new content of interest to their subscribers.

And so they will have less content as a result of these strikes. We'll have to see how long they go on for. I think the longest strikes have been around six months. We've had other ones resolved quite quickly. My base case is let's call it three months but they can spread out that release of new content over that period. Maybe it's not a show every one week, maybe it's a show every two weeks, but they still have this flow of new content coming on.

And I think the other important difference for streamers is they've released a lot of new content over the past few years and they have a big back catalogue of licenced content that they can serve up through their algorithms and through their recommendations to people that they haven't seen that content. I think I get the feeling that you can't keep up with the content that's coming out.

Arvid Streimann:

Me neither.

Ryan Joyce:

Yeah. I'm sure there's some things that have come out in the past 12 or 24, 36 months that would be very interesting. And so they have this opportunity to resurface that content and I think fill that gap that might come from these strikes.

Arvid Streimann:

And I think you've touched on a really important point for investors which is they know what you've been watching, okay? So they know that you may have missed this series that they released six months ago and they can just direct you to that. And if we take a broader lens here, all types of companies which are collecting usage data from their customers, whether it's a fast food restaurant or maybe it's some other type of business, they'll also know if you haven't visited the store recently. And this I think is a very powerful sales productivity initiative. And you're seeing just another example of it here with Netflix.

And the other thing I would say here, Ryan, or thinks it's more of a question than a statement, you've talked about the stream as pointing you to stuff which is already on their menu which you haven't watched before or you haven't consumed before. But you're also saying this flow of new shows onto that catalogue has slowed. How long do you think... Well, how big do you think that inventory of shows which they have in their back pocket but they haven't quite put onto the menu is at the moment? Do you have some sense of that?

Ryan Joyce:

Yeah. They were pretty coy about it when asked about it on their recent earnings call. And I think part of the reason for that is they don't want to downplay the magnitude and seriousness of these strikes and talk about that their business will be perhaps more protected than other video companies during this period.

But I would think that they should be able to absorb a multi-month strike without too much visible impact on the flow of new content to the viewer. I think if you went out and you actually measured it, you would see it. But I don't think if you're just hitting the Netflix button on your TV remote, you're necessarily going to notice the difference.

Now if the strike extended materially beyond six months, I think we maybe get into a bit of a different scenario. Again, and not to underplay the impacts of these strikes, but it's hard to see strikes going on for significantly longer than that because of the impact on people's incomes that are involved in these strikes. They simply can't extend indefinitely when people need that money.

And I think it's easy to think that Hollywood actors, why are they striking? Do they need more money? But there's the vast majority of them that aren't the top five, 10% that make a lot of money do receive quite low incomes from their work.

Arvid Streimann:

Yeah. Important point. And I like what you mentioned there about that there is some argument that these people actually want to come to a deal.

When I'm thinking about investment risk or we're thinking about investment risk and something happens and there's some friction, there's some negotiation which needs to take place. The worst scenario is if one of those parties can actually walk.

In this case, I would say that both of them actually want to do a deal because Netflix and the other streamers are actually reliant on new content coming through and of course, the actors and the writers would like to earn some income as well.

So when we are thinking about event risk and investment risk, this goes into the easier to solve bucket and at least that gives us some confidence that a resolution will occur. How that resolution occurs and who gets the biggest slice of the pie, so to speak, I think comes down to bargaining power and that's where I think your economic moat is important.

Ryan Joyce:

Yeah. And in the case of the impact on these video companies, we saw a similar negotiation with the Directors Guild and we've seen the outcome of that negotiation which was around similar issues. So we can also size the likely impact as well.

Arvid Streimann:

Okay. So let's hope that it's small because there are people that want to watch TV and I think there's investors who want to make money out of the streaming businesses as well. I don't think there's really a winner out of all of this if this continues for a long time.

Now, Ryan, I wanted to move on to Netflix. You mentioned that they're one of the leading players at the moment and you also mentioned that they're probably one of the players that's going to survive into the longer term. They're the biggest in the world at the moment, around 240 million subscribers. Now I'm going to say subscribers being paid subscribers as opposed to users.

Now I want you to talk to us about the business fundamentals before we talk about an investment in Netflix. So how are they different to their competitors? What are they good at? What are they not so good at?

Ryan Joyce:

So I think we talked about the importance of scale, and that's really where they are differentiated versus their competitors. You talked about them having 240 million paid subscribers and then there's about a hundred million households that have access to the service through somebody else's paid subscription. So they're very broadly distributed and importantly, I talked about earlier, it's not just subscriber scale, it's revenue scale.

So they generate $12 a month on average from those subscribers. So they have this huge revenue base and they've already shown an ability to generate significant profits. So they're targeting 18 to 20% EBIT margins this year generating multi-billion dollars in profits which really does separate them from their competitors, particularly those legacy players that are trying to make the shift from linear that are monetizing the content they produce through different avenues of which streaming is just one but not withstanding generating revenue from multi-source and not just streaming. A lot of these are losing several billion a year at the moment, companies like Disney and-

Arvid Streimann:

Yeah, that's no good.

Ryan Joyce:

No. That's not helpful.

And so I think that is a key difference is that scale. And I think part of that is related to their first mover advantage, let's say, or a distribution advantage. So they saw the game here early, this big shift to streaming. They were scaling their margins quite nicely around 2015, 2016 in the US as they built subscriber scale there and they said, "This is a global game. We need to go globally and we need to go fast."

And so they expanded to basically globally X China by the end of 2016 which is well ahead of their peers, many of which are still, I talked about making that decision, do we go direct into this market or do we keep that partnership. And maybe the boat sailed when it comes to going direct now. But Netflix made that early aggressive decision, did take a hit to profitability for a while, but I think it was really important in building that first mover or distribution advantage which reinforces that scale advantage.

I think another advantage they have is the lack of a legacy linear business. Early. I think it made the business a bit more tenuous because you didn't have this profit pool from which you could invest into streaming. You had to at least break even and generate some cash flow or rely on debt as they did to try and fund some of their content investments and that international expansion. So it made it harder initially. It also probably meant the legacy players took them a bit less seriously which didn't really work out so well for them.

But today I think it's a real advantage because it means they can focus on what is a pretty simple business model when it comes to streaming, growing that subscriber base, monetizing those subscribers and those that aren't paying versus these legacy players, they're having to make all these trade-offs and decisions of do I put my content just on the streaming, do I stop licencing content elsewhere, what is my windowing arrangements around stuff. And so I think it just slows the decision making for those businesses and makes for a lot of internal compromise that makes it quite difficult.

Another advantage I think they have, and it's related to that, is the execution and culture of the organisation. So I think Reed Hastings at Netflix, he's no longer the CEO, he recently stepped down from that role, but he built a very performance orientated, very tech first company and that culture and focus has remained in place over a long period.

And as I said earlier, that tech stack has become ever more important to these media companies. And so while these other companies are trying to get up the curve on that, they're ahead of the curve and they're continuing to invest and improve there.

And I think we've seen that execution historically whether it was in the DVD wars with Blockbuster, whether it was shifting from their DVD model to streaming or more recently, whether it was turning around and standing up this ad supported tier much faster than what most people thought and rolling out some of these restrictions on paid sharing. So I think it's a very impressive organisation in terms of their ability to move quickly and get things done in a impressive fashion.

Arvid Streimann:

And what about the weaknesses? What do you think that they can work on here or maybe is the thing which a competitor might be able to go after them on?

Ryan Joyce:

Yeah. I think one element is, I did talk about that aggressive international expansion and I think they're ahead of those big US centric peers that are going globally, but there's still learnings in local markets.

This isn't something like Facebook or Instagram where the content naturally becomes local because it's the local people putting it up, it's user generated content or something like YouTube. This is more scripted content.

You need to learn the nuances of those local markets. And so where you do have a pretty well positioned local competitor, they might have a better understanding of that. What is the right content? What are we trying to tap into with the content that we're producing that engages people in that? So I think there's probably some learnings that they need to do in specific markets over time to improve that.

And the other questionable one I think is sports. We talked about... There's a bit of a debate whether streaming companies need sports to attract subscribers and become a must-have platform.

I think Netflix has shown you don't need to have sports to be a must-have platform at least to date in most markets but they don't have experience producing live sports. As I said, they're building that advertising infrastructure so that if they needed to in the future, they should be able to monetize sports and I think they should be able to come up the curve on production. But versus some of the legacy players, if you think of a company like Disney that also owns ESPN, it has huge capabilities when it comes to sports.

Now, interesting in Netflix's most recent result, they were asked about sports and are you interested in going into that part of content and they basically said, "No, we're happy with our existing strategy," which is really to focus on sports adjacent content.

So there's been some great content out that I've enjoyed recently, the Tour de France Unchained, for example. They've done some around golf and tennis, the Formula 1: Drive to Survive.

And those leagues, instead of bidding their content out to the highest bidder, which occurs with live content often those media companies might lose money on a sports contract, they want Netflix to produce content for them because it grows the sport, it expands them to a new audience. And we saw that with Formula 1 in particular which led to more Grand Prix in the US and big growth in the US

So it's a very different dynamic when Netflix is coming with this huge audience base to the sports and the sports want access to that, then the live sports negotiations where they're coming and they're saying, "Hey, we need to have subscribers, so we need your sports content." And they're saying, "Well, how much money can you offer me?" So it's a very different dynamic there as well.

Arvid Streimann:

Yeah, I was fascinated when all of these, what you call adjacent sports programmes came out when you're not actually showing the sport live. But in the examples of the sports which Netflix made docuseries about the cycling and the golf, the people who I know who are really into cycling and are really into golf, they rave about them and they're watching them just as much as they're watching the live sports. So I think it's a real interesting way to piggyback onto the success of a broad league with the blessing of the sport as you point out.

Ryan Joyce:

Yeah. Well, I think the reason people like it is it brings out the stories about people-

Arvid Streimann:

Yeah. Which you don't see normally.

Ryan Joyce:

That's right. You can't do that in the live broadcast.

Arvid Streimann:

Yeah. Okay. So you've talked about Netflix and the fundamentals and what they do well and what they don't do well. Let's switch over to an investment in Netflix. Okay?

Now what do you think are the two to three things which are really going to determine whether Netflix's stock price is much higher than it is now or maybe it's about the same as it is now or maybe it's a little bit lower than it is now in the future. What do you think are the two to three things that people really need to be aware of and watch and maybe have a view on?

Ryan Joyce:

I think about it probably in two different timeframes because I think the factors are different in those two timeframes.

So I think over the next two to three years, let's call it, a lot of the debate or drivers of that performance will be about its ability to monetize its existing users and how well that monetization translates into higher profit margins given we have visibility into how much they've been spending on content in the last two years from a cash perspective, how much they're going to spend this year and next year as well, given they've given some guidance around that.

Longer term's a little bit different. And I will dig into just those short term debates a little bit more. But I'd say that it's a big shift from where we were two years ago. I think two years ago it was all about subscriber growth. Could they add 30 million a year, 20 million a year to 10 million a year per annum for the next X number of years? So the debate has really shifted more to this monetization front.

And so on that monetization front, there's two big drivers. One, we've already alluded to is that password sharing. So you said 240 million subscribers, about another a hundred million households that access through someone else's account. And Netflix, I think in late '22 said, "Hey, we're going to come out and we're going to restrict password sharing and we're going to try to generate some revenue from those a hundred million users."

And then in late May, they trialled that in some Latin American countries, they trialled that in Canada and taking the learnings from that, they rolled that out to countries that represent about 80% of their revenue in late May. And then I think as of today, this recording, they're rolling that out to most of the remaining countries so it'll be in place across all of those.

And they've offered people a few choices. You can become a sub account. So if it's a family and you've got a children at uni and they need an account there, perhaps that's what you do-

Arvid Streimann:

It's just an add-on account, essentially.

Ryan Joyce:

It's an add-on account, you pay an extra $8 a month or something like that.

And then the other option is you shift to your own account. You can port your profile over, bring your viewership data of course.

And the timing here is quite interesting with the release of that ad supported tier because when you go over to that full account, maybe you don't use it enough to justify that $20 a month or $15 a month subscription, but now they've got this ad tier available at, call it $10 a month. And so I think that was an important option to have available to people that were being locked out of the service to transition into that service.

Now exactly how accretive this is going to be is somewhat difficult to forecast. You've got a hundred million households, but how engaged are all of those households? The most engaged are very likely to go and get their own account or subscribe to a sub account but maybe some of those a hundred million only watch Netflix occasionally and that's why they were happy sharing someone else's account.

But if we do the math on different assumptions around how many we do think will eventually subscribe or start paying in some way and then we make another assumption as to what percentage do so via a sub account and which do so via having their own account, we can size the potential increase to revenue and we think that could add, call it, 10 to 15% to its overall revenue and there's not going to be a lot of extra cost associated with that.

Now a nuance on that is that they're not increasing prices this year. So whilst it is very incremental to profitability, so is any price increases. They're not doing one this year but they are doing this paid password sharing.

It's also a bit unclear how quickly that will occur. So as those very engaged users are more likely to subscribe straightaway and want to maintain that access, but some other households might wait for the next season of Stranger Things or Bridgerton or whatever content they like or might be a completely new bit of content that gets blown up in the news becomes very popular and that's the catalyst for them doing that. So we're watching that very closely to refine our forecasts and expectations around how much accretion they would get from that password sharing.

The second part of monetizing, not those password shares, but the existing base is they've had this basic tier. It hasn't been promoted very well for quite a while. It was initially a very entry level service to get people on the service and they kept the price of that in the US, for example, very low for very long. They increased the price of the standard tier and the premium tier but kept that low to make sure some people could get accessibility.

But again, with the rollout of that ad tier which is priced about the same as the basic tier which doesn't have ads but has only SD content or standard definition content, for example, they've decided to discontinue that in Canada. That was a month or so ago and now they're discontinuing that in the US and the U.K., two of their biggest markets

If you go to sign up here in Australia or you go to change plans, you can still access it, but it's hidden. You got to... They only show the ad, the standard and the premium. You've got to click a little button to reveal the basic plan-

Arvid Streimann:

Got to be sneaky.

Ryan Joyce:

You got to be a bit sneaky.

And so as they grandfather out this plan and transition people to the standard plan or the ad supported plan, they also get a revenue per user uplift from that. That won't happen immediately because if you are already on that plan, you're not getting kicked off it. This is just if you churn off and you come back on for the most recent content you want to see, you'll have to pay either a little bit more or you go into the ad supported tier and they generate money that way. So you've got these two drivers that are going to increase the average revenue per viewer or household if you like meaningfully over the next 18 months or so.

And as I talked about, the main cost for this business is content and it's been pretty stable for the past few years. They're investing around $17 billion per annum in content and then that takes a while to come into the cost base but you can model those things out. And if the revenue comes through as we expect and the costs come through as we expect, we should see a lot of margin expansion and profit improvement in the business going forward.

So I think that's what's really going to drive things over the next two years. I think beyond that, when you get this benefit, it goes back to a more balanced debate around subscribers, around the ability to increase prices, or grow the revenue per user without advertising, as I spoke about earlier over time. And also the long-term debate around how much content's enough, do they need to continue to invest or as they have over the past four years, can they keep that spend more constant.

And obviously, the further you go out in time, it becomes a bit harder to have conviction in these debates. But if we think about subscribers and we include those password sharing households, they're about 330 million today. We think... Today's TAM is probably around 500 million. They're adding 10 to 15 million a year at the moment excluding the password sharing. They've got that lower priced ad tier. I don't think that's necessarily going to accelerate, but if that 500 million is about right, they should be able to continue to add that similar number for quite a long period of time.

I think pricing's trickier. Have they priced up the headline... Is $20 a bit of a ceiling for streaming services or maybe not a ceiling, but when $10, it was a no-brainer.

Arvid Streimann:

Yeah, that was dirt cheap.

Ryan Joyce:

The value was very clear. Exactly. Two coffees for a month's supply of content and new content all the time. I think it's still really good value at $20 a month. But how do consumers think about it? Is there some increased elasticity above a certain point or at least for a while above a certain point and then you break through that? I think it was the $10 paid lunch and then you're very resistant to going above it and then now we no longer really have a choice, unfortunately.

Okay. Arvid, you've been asking me a lot of questions. I thought I might ask you a question as a portfolio manager on the Magellan Global Fund. It was just disclosed in the investor letter that Netflix is in the portfolio again. Could you talk us through the reasoning for that?

Arvid Streimann:

Yeah, sure thing.

I think the best place to start here is in the first half of last year, so the first half of 2022. I think there were a couple of key considerations that were occurring at that time. Netflix at that time revealed that password sharing was a lot bigger than what most people had thought.

And I think that really shocked people because they translated that new news to say, "Well, if a lot of people are using this, not necessarily paying, but if a lot of people are using this service, then your potential sales trajectory, the amount of people you can sell this to, it's probably smaller than what we thought because a lot of people are getting this for free."

Now, when they reacted to that, obviously, they said, "Well, we're going to try to monetize those people and start to get paid for the content they're watching." And that's exactly what you talked about.

But at the end of the day, that was an additional level of complexity. Okay? This was a new source of execution risk.

The other thing they did, which you mentioned, was introducing an ad supported tier which is something that they said that they would never do. Again, an additional source of uncertainty.

So I would say from a fundamental perspective, and this is my first point, from a fundamental perspective, the degree of difficulty or the complexity or the level of conviction you could have around their future growth profile took a little bit of a hit.

Now the second thing that was going on was, if you recall back at that time of the year in 2022, we had a high conviction view that interest rates were going up. And Netflix on our estimates, its stock price sensitivity to higher interest rates is about twice as much as the market overall. So twice as much as the average stock in the market. Now, we were trying to manage our interest rate exposure, so that was another reason that was in the column against holding Netflix.

Now, if you fast forward to today, I would say that on the first point which is around the execution risk around converting people who don't pay to paying and also the success of the ad supporter tier I think that they're doing a decent job there. And so that's being de-risked a little bit. There's still always some execution risk, but I'd say that the management team's done a fairly good job.

And I think, Ryan, you did a pretty good job too of explaining that if you've got a fixed content cost and you're getting more revenues in the door, then that extra revenue just goes straight to the bottom line. So the profit outlook for Netflix I think is looking more certain.

Now, at the same time, I would say that the US dollar, which isn't rising like it was this time last year, the US dollar has become less for headwind. What I mean by that is that Netflix collects its fees or how much you pay to watch Netflix from around the world in local currencies. Okay? So the US dollar matters, and when the US dollar weakens, that helps them. Now, the US dollar was rising last year so that was hurting them, but it's weakening now or at least flat lined. It's down off its peaks, the US dollar.

And the reason why that's important is because most of the content comes out of America and that's paid for in US dollars.

So there is a currency angle here as well. So there's less of a currency headwind right now.

But in terms of interest rates, and I mentioned interest rates before and Netflix's sensitivity to interest rates, we would have less conviction about interest rates going up right now. Okay? I think we're getting towards the end of the fed hiking cycle which means that when we're thinking about the interest rate which matters for valuation, which is the 10 or the 30-year bond yield in America, I would say that the outlook there is more flat than opposed to up where it was last year. So that consideration of Netflix's interest rate sensitivity is less relevant to the investment decision in our minds than it was this time last year.

So those issues I would say have changed. And Netflix's, I would say, durable competitive advantages and above average profit growth, the clouds around that have parted a little bit and it's become a more certain view around that. So that's why it's back in the portfolio.

Ryan Joyce:

Thanks, Arvid.

Arvid Streimann:

All right. So I think we'll wrap up there. Thanks very much, Ryan. We enjoyed our chat and I hope the listeners have as well.

Ryan Joyce:

Thanks, Arvid.

Host:

That was Magellan head of macro and portfolio manager, Arvid Streimann, in discussion with Magellan's sector head of finance and technology, Ryan Joyce.

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