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Holland Views: Meta ($495) Netflix ($625) Amazon ($165) TSMC (ADR $160)

Was summer tech sell off a Fat Pitch…?

We entered the 2020's with a clear sight of what we wanted to find in an investment. A powerful customer-centric business model, great returns on capital and aligned owner managers being the short summary. In the last couple of years, we have spent more time reflecting on further drivers of corporate profit directions, and in turn, investment returns, doing so via a few mental models.

1. '***Who are you? vs Where are you?'*** We considered where a company is in its own investment cycle or its sectors capital cycle. Markets hate the route into such cycles, but they love the winners that emerge on the way out.
2. **PUMTMM (Put up more To Make More)** is our acronym to think about companies that retain large amounts of their profits, then redeploy them at great rates of future ROI. This in turn lead on to our thinking on Supernatural Compounders. These being a small subset of companies that can consistently perform this PUMTMM trick, re-investing almost all their profits at high returns for long periods. (NB: The law of compounding means a 30% ROE business with 100% retention can do 14x in ten years).

Each of these reflections has led us to a better understanding of how each of the businesses we are studying finds itself positioned for future profits growth. Both short-term gradients of growth and the long-term runways. Two things we think are crucial when assessing companies in this way:

1. A good understanding of each company's true business model before any overlay of future re-investment or cycles
2. A good understanding of what other investors rate as important and what they don't over differing time frames

> *"At Berkshire, we particularly favor the rare enterprise that can deploy additional capital at high returns in the future. Owning only one of these companies – and simply sitting tight – can deliver wealth almost beyond measure. Even heirs to such a holding can – urg! – sometimes live of lifestyle of leisure."*
> **Warren Buffett, Berkshire Hathaway 2023 annual shareholder letter, published 25th February 2024**

Jam today vs uncertainty tomorrow

The more we have reflected on the above ideas the more we see them replayed time and again (examples follow). **A super short conclusion of this work would simply be that the *"Where are you*?" analysis drives near term share price performance (1-3 years). However, the re-investment potential drives longer-term returns (3-10 years).**

We look for discrepancies between other investors' understanding of founder-lead businesses vs such a company's true compounding capability. In the same way we now are also seeing more discrepancy between these 'near-term' and 'long term' compounding drivers.

Mr Market is today obsessed with guessing the path of interest rates, the state of the consumer and other macro market drivers. None of which this report will offer any opinion on. He is also fearful that tech valuations are stretched, and that AI spending is out of control and will dampen individual company investment prospects.

Elephants still run

We think we have a good grasp on the business models of the companies commented on below. All are network economies with already huge scale advantages. Interestingly enough, most are still growing at a very high rates (20-35%). Whilst that is not surprising for newer companies (Nubank) it is a remarkable achievement considering the age and scale of others (Netflix revenue +17%, Meta revenue +22%, AWS revenue + 19 % and TSMC +40 %).

> *"…the fact that a firm is quite large already does not necessarily tell you that its growth rate is set to slow.* **Nick Sleep, Nomad Partnership letters**

When describing our thinking on companies and where in their investment cycle they are, we previously contrasted them with the simplicity of a farming cycle. I.e. it is obvious to farmers and even passers-by when sowing and harvesting takes place. In investing the cycles are more complex and subtle. A winning business emerging from an investment cycle can see powerful profit drivers (see Nubank quote and Netflix's EBIT margin chart below). Once this becomes obvious, Mr Market jumps aboard. Our opportunity comes from predicting when this will happen ahead of time. (Hopefully Holland Views: SCA & Netflix – The Discovery Channel, April 2023 at $340p is an example of such work).

> *Simply put Nubank is at a point in time when its operating leverage is becoming more apparent and thus revealing its underlying earnings power. That is only interesting if an investor thinks such a profit reveal will be better than markets currently discount. We do. The reason for investors to own the shares longer term will be due to Nubank's defendable, scalable, high return on capital business model. However, the now underway, revealing of its earning power could be a powerful reason to own the shares right now.* **Source Holland Views: Nubank – Our take on Buffett's Latam flywheel, Jan24**

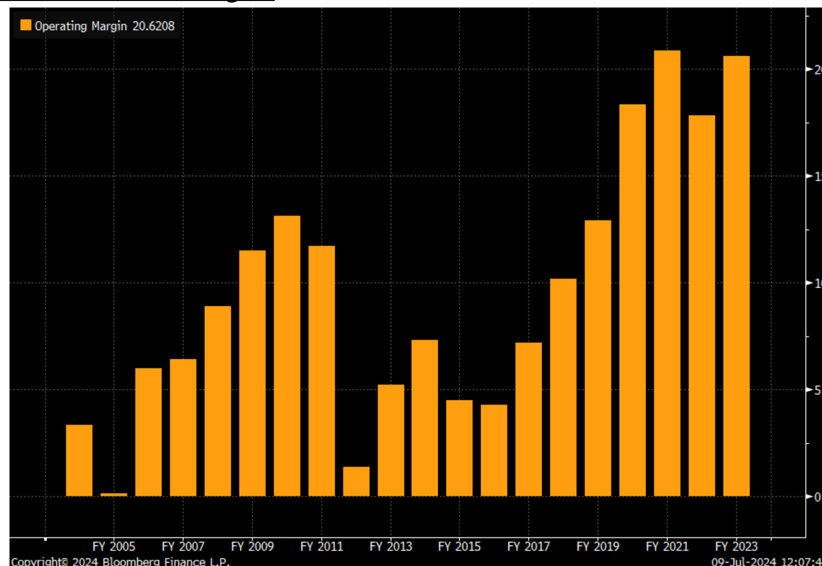
We must also overlay such expected operational gearing onto the underlying company business model to help decide how long such a company might grow for and at what rate. Thus, decide how long to stay invested for.

Companies with powerful re-investment opportunities might never (or rarely) display this near term operational gearing. However, they can still be wonderful investments on longer time horizons. This is what we suspect Mr Market might be missing in a few companies today. His blind spots remain; 1) deferred gratification; and 2) understanding the effect high rates of reinvested capital at high ROI's can make to investors longer term returns.

Netflix: Jam… everywhere!

Near term operational gearing was what Netflix showed investors recently. Higher EBIT margins (28% and rising) were music to Mr Market's ears. That this came alongside dividends and share buybacks that equated to a c.80-100% payout ratio. i.e. just what the 'show me the money' groupies are after. Jam today.

Fig.1: Neflix historic EBIT margins



Source: Bloomberg

All of this does not make Netflix a share we feel in rush to sell, but it does a) make its earnings power far less of a secret than its once was. Also, b) shows Netflix now has more profit than it can seemingly re-invest… meaning it might no longer make it on to any super-compounder list. With the company's now strong position as the global leader in content production/distribution it looks set to win far more market share. It also seems likely that yet more operational gearing will result.

Maybe a 15% global entertainment share (vs 6% today) of a c.$90bn market and c.35-40% margins are a Netflix endgame we could consider. Working through such a prospect gives the company's equity valuation upside of c.100% we guestimate. That this upside is not more shows Mr Market is working hard to discount a far rosier future for the company than it assessed c.2-3 years ago.

Meta – Pantomime villain becomes superhero

This summer Meta also showed investors powerful operational gearing. Employee numbers rose only 2%, whilst general and administrative costs fell 12%. When this occurs as revenues rise 22% powerful things happen to profits. A 38% EBIT margin being reported after a c.$20bn pa drag from Realty Labs division losses was rightly something markets were impressed by.

We were impressed too, but for different reasons

1. Considering Meta's already vast reach, for its ad impressions to grow 10% and pricing a further 10% we thought impressive. It speaks to the ongoing power of the social networks it controls
2. WhatsApp is rapidly (and finally) becoming the go to messaging service in the US. Additionally young Americans are using Facebook Marketplace and Groups in greater and greater numbers. Who'd have thought it!

We often highlight our Owner Manager Inc piece on Meta. Its wider observations about Owner Manager types and Mr Market's misunderstanding of them we thought powerful. Arguably the full rehabilitation of Zuckerberg in investors eyes suggests this piece has served its purpose as it relates to Meta. On reading Meta's Q2 results we were minded however to revisit our first Meta (Facebook) piece. Holland Views: Facebook Inc – G.A.R P Fishing. Below is an extract:

Our approach to this complex business

In researching FB the amount of articles and books on the company and its Silicon Valley peers is vast. Most of the recent "analysis" focuses on the gossip of how some college kids turned into billionaires, how they are secretly surveying the world or how the regulators are going to kill the business. In addition, how the platform today is out of fashion, no longer used by younger Americans and perhaps therefore set up for decline. In short, most of it focused on the trees, not the forest.

We saw a very different company when we looked at the big picture. We focus on three areas:

1. *Digital Ads: a proper growth market. But investors seem wary?*
2. *Facebook as the global digital Town Square*
    a. *Asian ARPU catch up*
    b. *The importance of Groups*
3. *The next leg: Pivot to e-commerce*

Source: Holland Views: Facebook Inc. G.A R P Fishing, April 2021 ($313)

What we think notable in the US's increasing use of WhatsApp or returning young users to the Facebook platform is its utility usage, not its fad attraction. This was what we saw in our early work. I.e. how Facebook as a digital town square could be used by all for many different utility functions, messaging, eCommerce and to tailor your feeds to match your interests (groups). April 2021 is only three years ago, so in the real world it is no surprise that these traits still exist and continue to drive the company and its users. The outlier during this time was the investment world's assessment of this company. Specifically, how extreme and reactive markets became as to whether parts of the platform were 'unfashionable' for a while. Also, wholly pessimistic assessments of new-leg investments.

Today's profit and EBIT margins are notable as they are reported after massive, but we say affordable, Reality Labs losses (c.-$20bn annualised). We remain sanguine about such investment as we are on the scale of capital that will be deployed on AI areas. To us Zuckerberg and team have proved clearly that:

- They powerfully understand the need for investments to make good ROI's
- That the strength of the core business means such investment can be afforded
- That Meta has always been a business with long investment cycles

We thought this quote an interesting reminder of this fact:

Mark Zuckerberg on Threads and Meta's deferred gratification investment cycle

"And it's a good reminder that even when you have that start, the path from there to 1 billion people using an app is still multiple years. And that's our product cycle. And I think that that's something that is a little bit different about Meta in the way we build consumer products and then business around them than a lot of other companies that ship something and start selling it and making revenue from it immediately"

"So I think that's something that our investors and folks thinking about analyzing the business, have needed to always grapple with all these new products. We ship them and then there's a multiyear time horizon between scaling them and then scaling them into not just consumer experiences but very large businesses." **Meta Investor Call, July 2024 (emphasis ours)**

We have long held Zuckerberg in far far higher regard than most other investors. His innovation, cloning and using of scale on long time frames we think have often been underrated. With profit margins now recovered other investors might be quick to agree… whilst quietly choosing to forget that they sold a great many shares at $200 or $150!

Meta today roughly trades at 20x pre-Reality Labs annualised earnings. It also trades on c.23x Mr Market's EPS for 12/23 which include those losses. Considering the power of this network and that it can still report 22% revenue growth these are not egregious valuations.

Spend, spend, spend

More interesting we think is the company's language toward the scale of profitable re-investment opportunities that exist in front of it. Some might be in areas hard to assess (Metaverse/Generative AI). But a large part of future capital deployment looks set to use AI for practical improvements in the network and products that users and advertisers clearly already love.

Meta to us looks an interesting example of a business that has powerfully proved to Mr Market how profitable its core business can be, how fast it can still grow and how it is tackling and winning at a hard problem (e.g. building threads, US WhatsApp growth and recovering Facebook young US users).

That such a company is also telling us how much opportunity it sees to invest (at likely high ROI's) many years out is music to our ears.

Amazon – No Jam

Amazon's summer Q2 reporting and investor's reactions we thought interesting. Like other companies its comments centred on some slowdown among US consumers, and this was the focus. Unlike others there was no dividend, no share buybacks and no new operational gearing. US 6% margins and AWS 30% margins were visible earlier in the year. In short there was no jam today!

As the daddy of deferred gratification and without the operational gearing upswings that Meta and Netflix demonstrated it had no margin recovery rabbit to pull out of its hat. However, like Meta it talked extensively again about the scale of investment it planned to make not just in deploying AI, but as it strives to produce its own AI chips. Mr Market just saw a large investment bill as another reason to worry.

Our assessment of Amazon positioning in the AI world we have discussed in past pieces. What we have heard from recent Amazon calls was something different from other investors it seems. All we heard was of the enormous opportunity for AWS to scale for decades to come. Unlike the past scaling of Amazon's ecommerce arm, AWS can do so while generating great margins and returns on capital. AI, in whatever manifestation, is just a turbo drive to AWS growth rates, in gradient and duration. Possibly both.

> *"AI is going to get big fast, and all of it is going to happen online...i.e. in cloud not on in-house servers"* **Andy Jassy, Amazon Q2 analyst call**

Hype, hope and trust

The AI period that has unfolded in the last 12 months has created the near-term excitement that new technologies often do. It has no doubt produced hype in some areas also. It does now seem very likely to soon herald changes helping corporates be more efficient in many businesses' areas. What happens further down the line with gen AI type services we have no idea.

Improved functionality in the next 3-5 years could have real benefits to many businesses. Businesses like Amazon and Meta with existing powerful networks look set to be benefit. We feel no need to second guess each and every new product they might release. Instead, we think we can (selectively) be led by these managers that we know and trust. It is their job to assess what investments are speculative vs what they see as high probability, good ROI spending.

That a company like Amazon sees such a great opportunity to redeploy a huge amount of capital in an accelerated way over the next 5-10 years rather than distribute it to shareholders should be something long-term focused investors find compelling. In essence what this business manager is saying to investors is… '*whatever you/we thought the fade rate of this business was 2-3 years ago, it is way better than that now*'.

As a vast capital re-deployer (0% payout ratio and ROIC of c.30%) this retention (at likely good ROI's) is the biggest driver of the company's future growth in intrinsic value. That Amazon (and Meta/TSMC) are more confident than ever on the ability to profitably deploy such capital is highly instructive. That is what we learnt from recent company communications.

That Mr Market distrusts this spending, like it distrusted Zuckerberg Metaverse spending suggests opportunities are being presented to long term investors.

TSMC – The pickaxe seller in a gold rush

The final company we comment on using this jam today vs huge potential of longer term capital compounding tomorrow is TSMC. Like Amazon, TSMC's summer results and the falling price only a few weeks later were notable.

We hope our earlier work on TSMC showed our admiration for the company's unmatched processing power, with the company dominating year in year out in the most demanding of global industries. Also evident to us was both TSMC's intense customer focus and leading edge innovation. This all shows the company as easily clearing our **'Operate'** hurdle. What also interested us was how equally impressive TSMC was when assessed on our '**Generate**' and **'Allocate'** functions too. I.e. what return on capital does the company consistently make and how is that capital then allocated. We will not repeat what was in those past pieces only to say that this is a company consistently making c.25-30% unlevered returns on equity (i.e. with a net cash balance sheet). Crucially however it flexes what amount of that capital is retained and re-invested for future growth according to how it assesses the outlook for its products and the wider industry. The result is a company whose dividend payout ranges between 30-80% with the implied capital growth being the inverse of that. Zero goodwill on the balance sheet and stable, over time unlevered ROE's show that the company has been highly successful in generating great returns with the capital it re-invests. **This combined capital discipline and successful redeployment is both highly unusual and very attractive.**

Against this backdrop the company's recent results commentary was intriguing. Clearly TSMC are the beneficiary of others scaling up their demand for new AI and related chips. We make a few observations:

- The true scale of AI potential is hard to know at this stage, thus excitement or hype are interchangeable depending on investor mood. Companies like Amazon and Meta are useful guides as to how they see AI affecting their networks and customers in the near term. Both companies suggest they see substantial changes and benefit coming soon

- TSMC is not a company built on hope or hype. It is one built on wonderful engineering and excellent planning and execution. As such it was interesting to hear the company state that it was testing AI out on itself:

  > *"…the whole company is now examining to study what AI will be used for, and by a lot of people or not. So first we test it on ourselves. Inside TSMC we are using AI, we are using machine learning skills to improve our productivity, and we find it is very useful"*

- Despite this clear belief in the potential benefits AI can yield, the company explained numerous times that its capacity planning process would be very 'disciplined'. They even called out the over expansion TSMC made in the 2021-2022 period and how they did not want to repeat that mistake

As a super disciplined past re-investor of capital at very attractive returns it is interesting to read TSMC's prognosis of what is coming. With its dividend payout ratio at long term lows and capital re-investment high it is poised for 20-30% pa growth, certainty for the next few years. The effects of this can be seen on the company's valuation. Its Dec 2025 PE falls to c.15x and c.13x in Dec 2026. These are inexpensive prices to pay for this quality of business. Especially one with such proven past (and seemingly near-certain future) compounding. We are proud of our past work on TSMC (at c.$80 😉). You can find the pieces here and here.

Fat Pitches and Tech sell offs

We don't do quarterly results commentaries. If you think this is what this note is, maybe we have not explained ourselves well. Our search for the very best businesses offering investors wonderful multi-bagger long term compounding has resulted in us narrowing in on businesses with a few common traits:

Extract from Holland Views: In search of Nirvana, March 2024

> *Quite a lot of the companies we look at might have ROIC/ROE's of say 20-25%. The good ones can maybe re-deploy 60% of their profits to grow. If reproducing past returns on capital, then they are growing at 12-13% pa and maybe paying us 2-3% pa in dividends/buybacks. As such we are owning companies that will likely beat market returns by offering +/-15% pa growth in intrinsic value.*
>
> *What we need to be doing however is reacting correctly and thinking harder when we are being offered a raffle ticket with a potentially far greater payout. This likely comes from a business making ROE/ROIC of 20-40%, but importantly one that can redeploy almost all of those profits in future growth capital*
>
> *Is c.20% long term growth actually possible?*
> *Clearly many company and analyst forecasts have growth rates of c.20% built into them. Our job as seasoned investors is to realise:*
>
> - *That, in most cases, the probability of such forecasts being worth the paper they are printed on is very low indeed*
> - *That very few companies in the course of history have ever compounded at such rates*
> - *That those that did, had some powerful driving forces that enabled them to do so:*
>   - *These are likely either secular or structural in nature*

- *Also, with a human backup, i.e. most likely headed by a highly talented Owner Manager and strong company culture.*

Source: Holland Views – In search of Nirvana, March 2024

In Summary

We like the current disconnect we have with Mr Market. His desire for near term profits and dividends sees him impressed when margins rise and dividends and buybacks occur. We agree these are a healthy sign of a thriving businesses today. In this light we are pleased that our past work on companies like Meta and Netflix has borne fruit. Each still has growth ahead, but likely the easy recovery money has been made. What interests us more today is proven high ROIC business investing heavily for tomorrow, even if there is a cost (financial or reputational) of that today.

What we find interesting is how Mr Market is now treating with some suspicion those who are articulating a clear road map of high ROI growth many years into the future. Our work has taught us that this is where the greatest long term investment profits are made. As such we are engaged, maybe even excited!

Is there uncertainty about exactly what returns will be made on this capital and when? Yes. But we need to accept that the outlook is uncertain rather than risky. Distinguishing between the two we can perhaps invest with greater conviction where others fear to tread.

We have no greater knowledge on the ROI that Meta, Amazon or TSMC will make from their expanding capex budgets looking out over the next 5 years. What we do feel comfortable about is the proven ability such businesses have for making excellent returns on committed capital over very long periods of time. As such we need to have a degree of trust in their ability to critically assess when to invest and how much into what exact area. Also, their ability to then curtail such investment if they think it right. It was exactly this assessment, i.e. of the company's ability to invest or not, that saw us find TSMC attractive in the first place. Also our assessment that we thought Zuckerberg as an aligned owner would ultimately be logical with his metaverse capital spending drove our ability to invest in Meta near its lows. It was not any assessment of the products or services it might throw off. Today's wider AI spending by proven compounders has some echoes of this we think.

Deciding what is a fad and what is a compelling investment opportunity and distinguishing between them is what this job is all about. We talk about wanting companies and managers to be **Proven**, **Profitable** and **Probably** likely to succeed. As such you are not going to find us backing the next AI start up, no matter how promising it looks. We are interested in businesses and managers that are proven. Also, ones that are aligned with a great understanding of shareholder value. If they are then rolling out an expansion of an existing service (TSMC and AWS as examples) we assess these as low risk. Finally, if the price is right vs that melting pot of traits and the future compounding offered then we are keen to invest. We will leave you with Charlie and Lou Simpson. Please take a look at our past pieces.

"Sometimes what you can't measure matters more" **Charlie Munger**

"Pay only a reasonable price, even for excellent businesses" **Lou Simpson**

Andrew

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