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Large, unbeatable numbers

Evan Lorenz writes:

The cycle's signature big-spending, go-for-growth business model is a co-product of the cycle's signature low interest rates, and while rates remain low, there are non-monetary limits to profitless revenue expansion, too. Uber Technologies, Inc., Tesla, Inc. and Netflix, Inc. (UBER on the New York Stock Exchange, TSLA and NFLX on the Nasdaq) are coming up against the law of large numbers.

Uber's valuation towers over that of the sometimes profitable U.S. airline industry—on the basis of enterprise value to sales, it's 4.1 times vs. 1.1 times—and for that hefty premium, you expect heady top-line growth. The second quarter seemed to deliver it, but the 14% jump in revenue, to $3.2 billion, had little to do with the famous core rideshare segment, which was up by just 2%. The source of the pop was rather food delivery (up 72% year-over-year, to $595 million) and miscellaneous other bets (e.g., freight and scooter rides, up 175%, to $195 million). For comparison, the airline component of the S&P 500 showed year-over-year revenue growth of 10%.

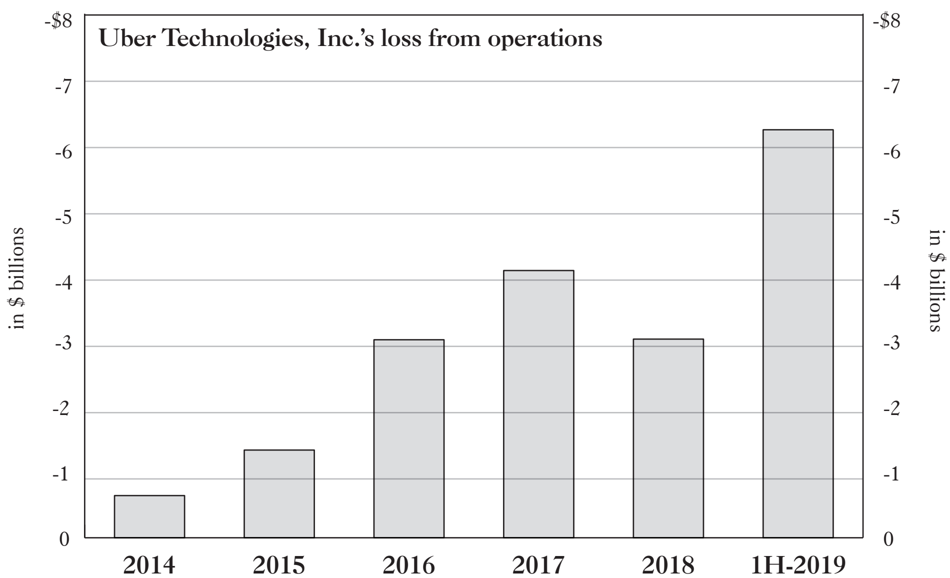
Monday brought word of the launch of a new division of the so-called Amazon of Transportation. Uber Money will offer debit cards, credit cards (the cash-strapped drivers may cheer) and other financial services for contractors/employees and customers alike. Unclear is whether this new effort will reinvigorate rideshare growth or create a path to profitability (see page 1). Uber's third-quarter results are due Monday.

On Oct. 23, Tesla surprised the world—certainly, it surprised the bears—by reporting $1.86 per share in third-quarter adjusted earnings vs. Street estimates of a loss of $0.24. In response, the stock leapt by 17.7%. Recognition of $30 million in deferred revenue attended the September release of a new "smart summon" feature, whereby you can whistle up your Tesla from the parking lot autonomously. A quick perusal of social media will show that the feature has some teething problems, but the $30 million is in the books.

Third-quarter results were notable for the growth they didn't contain. Sales declined by 8% year-over-year to $6.3 billion, matching the magnitude, but not the sign, of the 8% rise in inventories. This likely helped margins in the quarter (higher production rates mean better overhead absorption), but, if sales do not pick up, bulging inventories may prove a drag on future profits. In addition, the quarter was flattered by low levels of capital expenditures, which summed to $385 million vs. $510 million in the year-earlier quarter. At the same time, traditional internal-combustion-engine companies are rolling out new EVs, e.g. the Porsche Taycan, which will raise the level of competition.

Netflix's mixed third-quarter results featured a 65% spike in earnings per share, to $1.47, which beat the Street's guess of $1.05. The more substantive reading, though, was found beneath the headline, as the movie-maker is

Not how Amazon did it



source: company reports

guiding for a 7.6 million fourth-quarter uptick in paid subscribers, measured year-over-year, disappointing expectations of a 9.3 million gain.

More worrying was Netflix's determination to stop breaking out growth in its domestic subscriber base, which increased by 0.5 million to 60.6 million in the third quarter. The streaming giant may be running into a mathematical problem: It's hard to get more than half of Americans to agree on anything, and Netflix captures just under 50% of the 122.7 million households counted by the U.S. Census Bureau. While customers from the 50 states account for only 38% of the worldwide total, Americans made up 62% of Netflix's contribution profit, i.e., segment operating income before corporate overhead.

Then, too, there is an asterisk on the earnings beat. The expense of creating new streaming content ($3.6 billion in the third quarter) has run in excess of what Netflix recognizes on its profit and loss statement ($2.3 billion). It's this difference that explains the discrepancy in the third-quarter report between $665.2 million in net income and negative $501.8 million in cash flow from operations. Between the third quarters of 2018 and 2019, Netflix's amortization of streaming content dropped to 43.5% of sales from 47.8%. Had the company held the amortization levels constant, EPS would have been 33 cents lower.

Streaming competition is hotting up with the launch of Disney+, HBO Max and Apple TV+. "[O]n very competitive shows, there's probably been 30% [cost] escalation from this time last year," Netflix chief content officer Theodore Sarandos said on the Oct. 16 call. Investors had better hope Netflix is able to predict which shows will become hits—and how long consumers will be drawn to its content.

In hoping, you think of screenwriter William Goldman, who described the accuracy of Hollywood box-office forecasts in three words: "Nobody knows anything."

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