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When Revenue Growth Collapses

Dear fellow investors,

When we are on the road, we like to tell the story of our imaginary bottled water company. The first year we manufacture one million bottles of water at a cost of $1. To attract customers, we sell them for 90 cents per bottle. In our second year we make two million bottles for $1 per bottle. Again, we sell them for 90 cents per bottle.

In the revenue growth world of the last five years, this make-believe company would be a huge success story. They would tout a 100% growth in sales the second year and ask investors to ignore the doubling of the loss from $100,000 to $200,000 for the sake of growth. Lastly, they would remind everyone that there are over seven billion people in the world who drink water and that is a total addressable market (TAM). Imagine the opportunity in front of them.

At this pace, in five years Wall Street could help us go public at a five-billion-dollar market capitalization. We'd offer 10% of the company at $20 per share and force a six-month lock up on existing shareholders. The stock would soar to $30 per share the first day and regularly get mentioned and followed on the financial news channels.

We wish our farcical water company was just an outlandish caricature of reality. There are gigantic multibillion-dollar market cap companies selling things at a loss all around us. Uber and Lyft sell rides in an automobile at a loss. Amazon sold 13 billion dollars more in the recent quarter and spent 14 billion more doing it than the year before. They aren't happy losing that much, so they announced on October 29, 2019 that they are dropping the $14.99 per month for Prime members to get groceries delivered to their door, so they could do more revenue and lose more money.

Netflix is running $500 million dollars of negative free cash flow each quarter and is claiming an accounting profit. GrubHub and others are dashing to your door to lose money on each transaction. We could go on, but you get the idea.

All of this is happening under two theories. First, that if you get a massive share of a TAM that the profits will come at some point. Second, if you have the mentality of a monopolist and capital markets are willing to fund your effort, you can dump products at the door at a loss and crush any competition, especially when investors reward you with outstanding stock market performance.

This all begs the question, what determines the value of a company? In theory, the net present value of a company is all future free cash flows discounted back to today at an acceptable discount interest rate. How do you value these businesses which have negative free cash flow or are selling their main product at a loss? The answer for Smead Capital Management is we don't try to value these companies and we don't envy those who make money from these financial euphoric adventures. We agree with Charlie Munger who we heard say, "Envy is a lousy sin, because it is no fun!"

While the stock market is chasing these companies emulating our make-believe water company, we are very excited about companies with massive free cash flow and profits which the stock market thinks won't last. Discovery Inc. (DISCA) has massive free cash flow which equates to 15% of its stock market capitalization. The market fears that they won't do as well in the streaming world dominated by Netflix, as they have in the cable-TV world. In six-plus years you will have all the money back in free cash flow coming from the most successful creator of unscripted television. Think HGTV, Food Network, Travel Channel, TLC, etc.

JPMorgan (JPM), Bank of America (BAC) and Wells Fargo (WFC) are heavily over-capitalized to defend the nation against a future financial meltdown. Since they have all the capital needed, even in a financial distress situation, all the profits each year can be returned to shareholders in dividends and stock buybacks. Is it any wonder that Warren Buffett is asking the government to let him own more than 10% of BAC? We don't have to wonder about the TAM in the banking business, those three companies already have their fair share.

We are not going to abandon our portfolio of wonderful companies which already produce massive profits and free cash flow to buy into our imaginary water business. We believe when interest rates rise in the future there will be a total collapse in the financial euphoria which got us here and a collapse in the revenue growth stories which created the euphoria.

Warm regards,

William Smead