

Netflix: Navigating deals, AI and growth

Nadine Blaney [00:00:20] Streaming, strategy, and AI collide. So, what's next for Netflix after a blockbuster deal that never was? Magellan Investment Partners Ryan Joyce joins me now to weigh up the investment case for Netflix. Ryan, welcome. Good to have you here. So, let's start there because Netflix obviously spent a lot of time in the headlines probably over the past six months or so in relation to that. That battle that was ongoing between it and Paramount for Warner Brothers, of course. So, Netflix ultimately was outbid by Paramount Skydance. What was your view on the acquisition in the first place?

Ryan Joyce [00:01:01] Certainly. So, it certainly has been an interesting six months and I think mergers and acquisitions in this space never fail to deliver on the drama. This brought it again. There were hostile takeovers, there were lawsuits, there were billionaires involved. So, I do look forward to the movie when it comes out and it's not over yet either. Our view on the deal from Netflix's perspective was that we were positive, particularly on the medium term, assuming they didn't pay too much for the business. There're four reasons we were positive on the deal. The first is the power of bringing together Warner Brothers Discoveries catalogue with Netflix's distribution. Netflix has shown time and time again that when you take some of this older IP, like Friends, like Suits, you put it on that platform, it reinvigorates the IP, you can draw a lot of value and engagement to that content. So, we think that could have unlocked a lot of value. The second reason is the ability to cross-sell HBO. So what we think was going to happen here was they'd take some of that catalogue and just put it on your standard Netflix service, but then they'd have a slimmed-down version of HBO Max, taking it back to its HBO roots, and then they use their big subscriber base to cross sell into their base of customers globally, where they have a much bigger footprint than all the other streamers. The other part, apart from just cross-selling it, is the money they can save. So, a lot of streamers or other services, when they're trying to grow in these emerging markets or different countries that aren't their home market, they have to spend a lot on app store fees, on distribution fees. Netflix hasn't done that. It had the power to do that directly and so it could have just saved a lot on distribution costs from that alone. The third factor is I think it would have brought a good discipline to Netflix in terms of content quality. Netflix isn't necessarily known for the best content, but it's trying to serve a bit of everything to everyone. I think having a theatrical business where you're very accountable for how it does at the box office, having still HBO within the business where they're very well known for the quality of the content, high production value content, would have helped them even if it sat off to the side a little bit. The fourth reason I'd say is the Netflix management team. This is a team that's executed well over a very long period of time. They've acted in the long-term interests of shareholders and been very disciplined. So, there's always risks associated with a deal, but this is a management team that we would have backed to deliver.

Nadine Blaney [00:03:29] So it's really interesting for me to hear you essentially backing what would have been that deal for Netflix, because it seems as if the market was not looking at this deal very positively for Netflix. At least if you judge by the share price.

Ryan Joyce [00:03:45] I think there's a couple things to unpack there. The first is that if we rewind to mid last year, Netflix, I would say the share price was quite elevated. It had this protected status. We had the trade wars at the time. It was kind of isolated from that as a digital media business. And so, it started from a high point. It had a very clean outlook that the market liked. Then as noise of this deal came about, one, that kind of halo came off, but two, the story got a bit messier, particularly in the near term. Markets don't like that. So, it did react quite

negatively, and some of that was fair. In the near-term, there were meaningful risks. So, as I said, we're backing this on a medium-term view. But in the near terms, you had regulatory uncertainty when this would close. The U.S., the EU were probably going to look into it. You had Trump weighing into it always creates some uncertainty. Integration risk with any large deal. This is a people heavy business. You had big talent, big actors, directors weighing in against the deal. These are the people you need to have on your platform to make the great content. You have the Screenwriters Guild, Actors Guild. So, execution risk was real. And then financial risk. It was going cost a lot of money, put pressure on the balance sheet. We think they could have managed that. But if you have some of the events that we've seen transpire, higher energy prices, higher interest rates, you know, it just creates a little bit more pressure and a bit of an ugly nearer term outlook. Interestingly, what we tend to see when share prices do come down is the emergence of new negative narratives. And I think we saw a little of that here where some of that sell down was definitely warranted from an elevated level. But then it started to have this dynamic of this market you that it was lose-lose. So, either they were going to have to pay too much and overpay for this deal, or if they didn't get the deal and they were outbid that they needed these assets and now they didn't have them they are in a less strong competitive position. At that point, we had the opposite view. The share price had come down enough. We thought if they did get the deal at the current price that they were bidding, great. I think you needed to buckle down for a few years and take that medium-term view, which we're happy to do or if they didn't get the deal, that's also fine with us. They can continue to execute on that cleaner story that people used to like. So, at that point, we think there was a window of opportunity to lean in and it was quite attractive. And ultimately, as you mentioned, Paramount upped the bid and Netflix exhibited that management discipline that we like and walked away from the deal.

Nadine Blaney [00:06:22] And so, you know, you've got the dynamics of the bid itself, you had, you know, Paramount kind of lifting its bid. So, all of those were, were reasons why you do now endorse the company's decision to walk away. Is that how I can read it?

Ryan Joyce [00:06:37] The price was going up, so who knows where it would have ended at the end of the day, but there has to be a line where it's no longer adding value to the business and you've got to weigh some of those risks, particularly the regulatory risks if Trump is involving themselves. So, look, if they could have got it done over the line at a roundabout where they exited, I think that could have still been positive, but don't mind them walking away either if they think the risk reward is not as attractive as when they first reached a deal.

Nadine Blaney [00:07:05] And lots of ego involved, lots of money.

Ryan Joyce [00:07:07] A lot of ego, a lot of billionaires and for Paramount it was existential. They needed this deal and so that was always the risk that they continued to go, and they ran a smart campaign and they did lift their bid meaningfully.

Nadine Blaney [00:07:19] Okay, so we've got Netflix still as Netflix and an investment opportunity, but there are still so many debates around AI and how AI, I guess, could significantly impact a range of companies. How do you think about the impact of AI on Netflix?

Ryan Joyce [00:07:36] So, there's two impacts that we're thinking about for Netflix. The first impact is what is it doing for engagement? It's quite interesting because about 12 months ago Netflix stopped disclosing subscribers, which the market didn't really like, we didn't really like and they said let's focus on engagement. This is the value we're delivering to our customers. We're introducing ad tiers so revenue will end up over time being more linked to engagement. This is what you should measure us on. Fast forward 12 months. And unfortunately, that engagement started to slip a little bit, which isn't helpful. Our view is AI is a factor here. And how it's a factor



is that it's really lifted the engagement of short video. So, think Reels, TikTok, where now you've got this blend of human content, AI content, the combination of the two, then the algorithm serving you that content. So, it's driving increases in the amount of time people are spending on short video that's coming a little bit from long form video. Importantly, we think this is a temporary dynamic. So that's gotten a bit more entertaining. You've got a little bit of a shift towards one, but we think that kind of plays out and then stops it's not something that keeps happening over time. And then the other thing is I don't think it changes the value people put on a streaming service. If you watch one less episode of TV a week, does that make you less willing to pay for your Netflix subscription? In our view, it doesn't really go to the pricing power of the business.

Nadine Blaney [00:09:01] So that's the main view when it comes to AI and its impact on Netflix. Is there anything else we need to be aware of or any other sort of secondary reverberations that you might see play out?

Ryan Joyce [00:09:10] Yeah, the other big one in the content and media space is, what does it mean for production costs? Does AI meaningfully bring down these costs? Does that impact the pricing power of these streaming services? Does it mean you need less ads, you don't need to monetise as much? Our view is that AI will create efficiencies in creating good content. But there's a couple reasons we don't expect that to have a meaningful impact on Netflix. The first is that it's pretty hard. So, we think it's quite different to maybe some music in the background that you might listen to and you're not paying too much attention to, versus a two hour movie or a 10 hour TV series where you're trying to create this coherent storyline. Video is incredibly informational dense. There's a lot of context there. It's often about what's not in a scene, about what is not said, about a look, about an unexpected moment. That's not to say AI can't do parts, but we think that human involvement is still going to be in there, which just restricts a little bit how much efficiency you can get. The other element is we think that gets reinvested. We've seen it time and time again. The special effects get better, they get cheaper, yet the budgets for the top movies are getting higher and higher. It gets reinvested in the actors, the top directors, that can bring people in to actually watch the content. It gets invested in the marketing budget to, again, introduce people to it. There's a lot of content out there. And then the other element is that there's the scripted content, but there's also a lot of live content. There's sports, there's comedy and so to the extent that becomes more of a differentiator, we would expect to see more investment in that part as well.

Nadine Blaney [00:10:48] So back to the share price, though, and we have seen a bit of a recovery in Netflix's share price over the past couple of months, even though we're in very challenging and uncertain markets. So how are you thinking about Netflix now?

Ryan Joyce [00:11:00] Yeah, I think the way I describe it is a quality business, what we always thought, executing at a fair to attractive price. So, we still see a long runway for subscriber growth. They're at around 330 million, which sounds like a very big number, but the world's a big place, and they've been doing a fantastic job of investing in local content and localising their offering for some of these bigger markets. The ad tier is relatively early, and I would say under-monetised. They introduced that at a low price, a low subscription rate, the ad tech is still pretty nascent, so there's an opportunity to drive revenue through that. We also see significant opportunity for operating leverage as they grow into that TAM. They've taken margins from 20% to a bit above 30%. We think that could nudge over 40% overtime. And then as part of walking away from the deal, they also got paid a \$3 billion break fee, plus a strong balance sheet and strong free cash flow so we think they can reinvest in buyback shares as well. Altogether we see a business that can compound earnings in the high teens for the medium term and deliver strong returns to shareholders.

Nadine Blaney [00:12:07] Ryan Joyce, Magellan Investment Partners, thank you.



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