CASH FLOW

e*Research Corporation** is pleased to provide an article from ***The Reformed Broker, featuring Josh Brown.

Today's article looks at examples of companies that focused on cash flow and not earnings and became extremely successful.

The Reformed Broker is a blog about financial markets and the economy.

From Josh Brown's website: My blog is about markets, politics, economics, media, culture and finance. I'll use statistics, satire, anecdotes, pop culture references, sarcasm, fact, fantasy, and any other device that I feel necessary to get my points across.

What I don't do on this site is give financial advice or tell anyone what to invest in. The Reformed Broker is a forecast-free blog. What I will do on this site is provide you with a running commentary of my market-related insights and thoughts as events unfold. I'll point you toward other interesting content around the web. I'll challenge your perceptions, call it like I see it and, occasionally, I'll make you laugh.

A link to the blog's website is provided here: http://www.thereformedbroker.com/.

Joshua Brown is with Ritholtz Wealth Management, a New York City-based investment advisor, whose clients are high net worth individuals, charitable foundations, retirement plans, and corporations. He helps people invest and manages portfolios for them. He is the author of the book *Backstage Wall Street*, from publisher McGraw-Hill. He is a regular contributor to: CNBC, Investment News, The Daily Beast, TheStreet.com, Forbes, CNNMoney, Fortune, Christian Science Monitor, The Faster Times, Marketplace Radio, The Wall Street Journal, and The Business Insider.

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Bob Weir, CFA: Director of Research

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By Josh Brown
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Investors attempt to handicap the future, and in doing so, they heavily discount the present and recent past. What is done is done. No one gets paid on what happened last week.

In the eyes of investors in technology, media, medicine, and communications, *potential* earnings power and cash flow generation matters a lot more than cash EPS. Michael Batnick looks at the fact that Disney has earned $41 billion over the last five years while Netflix has earned a cumulative $1.2 billion over the same time frame – and yet both have the same market capitalization now. Disney's stock has done nothing while Netflix has been one of the greatest performers in market history.

Investors believe that Netflix's rapid gains in regularly recurring payments from users are more valuable than Disney's customers – including ESPN subs which are not growing at all. They are willing to forgo profits today because of the monstrous profit potential of tomorrow. This is a strategy the cable giants pursued in amassing huge customer bases and regional system dominance in the 1970s and 1980s, as personified by TCI's John Malone. He had no interest in showing earnings, because to do so meant to pay taxes, the thing he abhorred the most.

Malone realized that programming costs and taxes were his chief enemies. He dealt with the former by spreading out these costs across a large and ever-growing subscriber base. He dealt with the latter by leveraging up and making more acquisitions. He referred to paying taxes on profits as "leakage" and once said he would rather pay interest (on the company's debt) than taxes. He even invented the term EBITDA (Earnings Before Interest, Taxes, Depreciation, Amortization), now in common use, to teach his investors to focus on cash flow over everything else.

Amazon figured this out a decade after John Malone's pioneering strategy became apparent to the cable industry and he applied it to e-commerce. Had Bezos prized profits over scale, it would have been a trap – no one wants the mid-single digit profitability of a regular retailer. There is a meme out there saying that "Amazon makes no money." This is false: Amazon's cash flow is enormous.

Netflix has applied this to entertainment. Get big, grab a plurality of customers, worry about profits later once the lead is unassailable. Rather than buying up cable systems like TCI or selling products at deep discounts like Amazon, they are plowing their cash flow into creating more proprietary content, which in turn fuels subscriber growth.

Onlookers should not look at Netflix and Amazon as though they are freaks of nature. They are just companies that have figured out, as Malone did forty years ago, that earnings can wait, and an investor base can be trained to focus on the right metric, so long as that metric is growing.

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