BANYAN CAPITAL MANAGEMENT

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The second quarter of 2020 was better for markets than the first. Banyan's equity composite gained 16.1% in the second quarter compared to the S&P 500's total return of 20.5%. Year-to-date, our equity composite returned –10.6% through June compared to the S&P 500's total return of –3.1% (review attached reports for your portfolio's performance).

While sluggish, we've long advised not to put much weight in quarterly results, good or bad. Stock prices eventually reflect business fundamentals, but market sentiment drives daily price action. For fundamentalists like us, therefore, short-term results are as likely to mislead as enlighten.

That isn't to say some wounds weren't self-inflicted. In 2019, we bought more Wells Fargo near $50. It trades near $25 today. While extreme, the price is more or less justified by poor operating results. We bragged of low turnover in 2019; you'd be better off had turnover been closer to zero.

Mistakes aside, short-term results can be especially misleading at present. The world is hardly five months into a pandemic and recession. All sorts of economic activity remain outlawed, and a huge sum of money has been injected into the system. The long-term effects are largely unknown.

Hence the extreme volatility in markets. Lacking an analogous experience or contrary evidence, almost any position can be argued to a stalemate. Anecdotes are used to bridge the gap between the pre- and post-pandemic world. It will take months for reality to separate fact from fantasy.

In the meantime, imaginations are running wild, and firms with bright prospects are the prime beneficiaries. Take, for instance, our most recent purchase, Discovery (DISCK), and its arch-nemesis, Netflix (NFLX). Some relevant details on the two firms are set forth below.

($ in Millions)	Discovery	Netflix
2019 Revenue	$ 11,144	$ 20,156
YoY Revenue Growth	5.6%	27.6%
Cash Operating Margin	38.9%	-9.9%
2019 Free Cash Flow	$ 3,110	$ (2,634)
Net Debt	$ 14,421	$ 9,518
Diluted Market Cap (06/30)	$ 13,482	$ 206,104
Year-to-Date Return (06/30)	-36.8%	40.6%
Free Cash Flow Yield	**23.1%**	**-1.3%**

This is a common juxtaposition in the stock market today. Great foresight isn't needed to see that Netflix, the leader in "streaming-video-on-demand," has a bright future, and Discovery, a "Pay-Tv" media company, faces challenges. But does that alone mean Netflix is a safer *investment*?

Clearly not. Price must be taken into account. At risk of oversimplifying, let's assume (1) investors must earn 8% on equity to be satisfied and (2) "free cash flow," or the no-strings-attached cash a firm generates, fairly represents earnings. With these assumptions, what is implied by stock prices?

1. **Discovery** | Investors will be satisfied *even if* the firm's earnings abruptly fall and stabilize near $1 billion, or roughly 65% *below* Discovery's 2019 free cash flow levels.

2. **Netflix** | For Netflix, on the other hand, investors won't be satisfied *unless* the firm soon earns $16.5 billion, which equates to more than 80% of Netflix's 2019 *revenues*.

In reverse order, Netflix will struggle to clear the 8% hurdle within a reasonable timeframe. While Netflix added 56.45 million subscribers in the two years of 2018 and 2019 (8.59 million in North America),[1] the cost was stunning. It spent $27 billion on content in the process, and it is expected to spend another $15 billion in 2020 alone. For context, that is enough money to build Atlanta's Mercedes-Benz Stadium 26 times over in three years. It is also equal to the market cap of FedEx.

That level of spending is a luxury no one else has, but good story telling is limited by the number of good writers. More money can't drum up a hit like HBO's *Game of Thrones*, for example. The result is diminishing marginal returns on content spend. In addition, the economics of a release on Netflix differs from a linear release. A season of *Game of Thrones* retained attention for months on Pay-Tv. On Netflix, a season can be consumed over a weekend, which depletes the value of content quickly. Thus, Netflix's insatiable appetite for cash won't change. It can only be outrun with subscriber growth. With competition heating up, that is a precarious position indeed.

Turning to Discovery, it must merely avoid disaster to clear the 8% hurdle mentioned above. We believe it is up to the task. Discovery focuses on the less glamorous niche of "unscripted" content, which is popular but less costly to produce. In fact, Discovery's channels account for only 5% of Pay-Tv's cost but deliver 20% of the total audience. Discovery also owns its content and has been reluctant to license to others. As a result, it controls a library twice the size of Netflix in terms of content hours. These attributes will prove valuable as Discovery adapts to a new environment.

In light of this, we believe Discovery is a safer investment. The truth won't be known for years, but, at least for now, the less speculative bond market agrees with us. Both firms have bonds maturing on May, 15, 2029. Netflix's 2029 bonds yield 3.6%; Discovery's 2029 bonds yield 2.2%. In fact, Discovery's bonds maturing in 2050, a full 20 years later, yield a mere 3.5%. At even odds, therefore, the bond market views Discovery as a safer bet even with 20 more years of risk.

We, too, prefer a growing business, but we won't pay too dear a price for it. Neither will we ignore a strong but challenged business the market has left for dead. As Warren Buffett wrote in 1979, "You pay a very high price in the stock market for a cheery consensus." Stated differently, what

[1] Through 2018, Netflix reported subscribers in two segments: "US" and "International." Beginning in 2019, Netflix reported subscribers in four segments, one of which is "UCAN," or United States and Canada. Therefore, it is not possible to know exactly how many subscriber additions were in North America between 2018 and 2019. We simply added US additions in 2018 and UCAN additions in 2019 to arrive at a North America estimate of 8.59 million.

is comfortable isn’t always safe, and vice versa. It won’t show every period, but keeping this firmly in mind is key to ***building permanent wealth***.

Sincerely,

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