Investing in Tech Stocks and Reconsidering Hannah Arendt on Totalitarianism, Revolution, and Adolf Eichmann
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Mark Mahaney QA

Larry Bernstein:

In your acknowledgement section, you mentioned that one of the reasons you wrote the book was so that your son would have a better understanding about how to invest. I've got kids too. Would you recommend this book both for the starting investor as well as for the sophisticated ones? Who's the audience for your book?

Mark Mahaney:

Yeah. It's both. There was this wonderful book, I'm sure you remember it, One Up on Wall Street by Peter Lynch. And I thought that was a Bible for a generation of retail investors and institutional investors. There's a lot of wisdom that came from somebody who had worked the market so hard for so many years and he had some wonderful examples. And if you can remember one thing from that book is it may well be like the coffee buy the stock, that was his approach to Dunkin' Donuts.

I'm trying to provide a framework that you can use for the next Facebook, the next Amazon, and I'm sure there will be some over the next 10 years.

Larry Bernstein:

I want to ask a question about diversification and investing in tech stocks. You mentioned that there was this battle between eBay and Amazon. And eBay ended up with lower revenue growth and a mediocre stock performance, while Amazon ended up being one of the best performing stocks of all time. Is the moral of the story, you're supposed to buy both stocks, and one stock will be a dud and the other will be a fabulous performer and you don't need to be right predicting in advance which firm will end up dominating the other? I mean, when you get investment returns like Amazon's, who will even remember that eBay is in your portfolio. And when I look at my own portfolio, there's some duds. There's some that are average market performers and then there's just a couple that just do spectacularly well. Isn't that true of every portfolio, whether it be tech or any other industry. The key is that you got to make sure you've own some high performing assets more than anything else. Seriously, who cares about eBay?

Mark Mahaney:

Well, that's a good point. It's good to have diversification obviously in the portfolio, but the book is really geared on trying to find those Amazons and try to avoid the eBays. eBay was a phenomenal stock, by the way, for the first five years as a public company. Why was it so phenomenal? And then it became a true dud. From 2005 to 2015, 10-year period, eBay stock went nowhere.

And the mistake was this was a company that had a beautiful business model, high gross margins and high operating margins, but a value proposition that was pretty checked. Amazon,

started to gain and its value proposition to the customers, you can buy something and then we'll get it to you in a week, week and a half. That wasn't nearly as compelling as a company like Amazon that invested an enormous amount of money in building out a logistics network that would get your product within three days, then two, then one, and now same day. What you want to find are the companies that are the most consumer-centric. You're looking for that winner. The false read was to stick with the high margin business rather than go after the low margin business.

One of the most prominent portfolio managers on Wall Street stopped me in the elevator in 2000, pointed his finger at me and said, "You know Amazon's never going to make any money.". And now Amazon is on track to be the largest generator of free cash flow in the world. So, with scale, scale doesn't solve all problems, but darn it certainly solves a lot of problems.

Larry Bernstein:

I want to just drill down a little bit more on that classic Amazon quote because that institutional investor who you met in the elevator was not alone. That was a very common thought that Amazon, one, would not make money. And second, that they were using their free cash flow to invest in CapEx and businesses that investors suspected had little return to it. And now you're saying in retrospect, oh my God, these investments were just out of the park successes. People really questioned the same day or Prime two-day delivery system. Because getting that right, getting that investment decision right was the crux of the matter. And why do you have such confidence that Bezos can do that so consistently?

Mark Mahaney:

And Larry, you're asking a great question. Last thing I want to do is fall into the trap of the narrative fallacy to create the narrative to explain the events that happened in the past. It wasn't preordained that Amazon would be as successful as it was and Bezos would be as successful as he has been. I want to be really clear about that. Anybody who went all-in on Amazon and its IPO, I mean, good to you, but there was an enormous amount of luck. But there was a point in Amazon's history when that went from being a speculative investment to this is a high-quality name that we want to buy when it's dislocated. The question is when was that point in its history? My personal opinion is that that was around that 2006, when the company really showed how innovative it could be. Why? That's when the Kindle came out. Even better, that's when AWS or cloud computing came out.

And when you had a management team that could successfully innovate in a dramatically different business that should have been the tell that there was something truly special there. And I know the stock had already run up there, but that's all right. It had plenty of room to go after 2006.I think Prime was described by Amazon management, as the best customer loyalty program in history. Market first was negative on it because of the losses associated with it.

But a year or two later, it was clear that Amazon Prime was growing and at an accelerated rate. And that led to more satisfied customers, more spend per customer. Then when you realized that the company had also not only had great product innovation, but had great customer loyalty programs, i.e., was really focused on customer satisfaction, that was probably another

really good tell for a company that should have gone from being one of your potentially a speculative investment to being a core, high quality growth/tech investment and part of your portfolio.

Larry Bernstein:

I want to apply the lessons from your book to a sample stock, and let's use Spotify. I know from our previous conversation that this is one of your favorite stock picks and that you currently have a buy recommendation on it. Could you discuss Spotify as it applies to lesson number four: revenue matters. Lesson five: does Spotify have that product swing? And Lesson six, how do you think about Spotify's TAM or its total addressable market defined as its industry's annual total sales for its product segment. And finally, does Spotify's revenue growth and its industry market size justify Spotify's market valuation?

Mark Mahaney:

This is a company, is it a high quality? It's certainly dislocated. This stock is traded off well over 30% from the highs. And what was that product innovation on the part of Spotify? They brought in podcasting and included that in the mix, which therefore made the service more compelling to consumers.

They really showed great industry vision. They did it right when podcasting started hitting critical mass. So, to me, they kind of check the box when it comes to product innovation.

When it comes to management, this is a founder-led company, and I've done enough work around the management team to know that this is a company that really thinks long term, has had great industry vision. The TAM, the way we looked at the TAM is we thought it was excess of a hundred billion. Now it's not a T TAM; it's not a trillion-dollar TAM but it's one that's an excess of a hundred billion. And one, therefore, which the company only has a single digit percentage share of. So that's one of those relatively large TAM, small penetration. I like the, the setup there.

And in terms of the customer value proposition, that kind of the fourth screen I look at, I think that value proposition is pricing power. When companies raise prices and customers stick, churn doesn't get elevated, that means that customer value proposition is super strong. Amazon's done that. They've raised the price of Prime three times over 18 years that Prime's been out. Netflix has done this numerous times over the years; shows you how strong that value proposition is. And Spotify has now done it for the first time. First time ever, they started raising fees at the end of last year, coming into this year, and churn continued to come down. Also, when you just step back and think about it, that those things that we all carry around, they're not phones; they're music devices, they are social media devices, and you can pretty much be certain that just about every smartphone in the world has some sort of music app on its home screen. This is something that is just widely, broadly endorsed, engaged, adopted by consumers globally. So that's how we came up with a over a hundred-billion-dollar market.

Now, then what about the 20% revenue growth? The company has been pretty consistently printing revenue growth around that level. And we think given the low penetration and a large

TAM, that they can continue to do that for several more years. You got a stock that's dislocated. That's the pitch on Spotify.

Larry Bernstein:

Spotify's revenues have been growing at 20% since 2018. But is it profitable? No, it's EBIT has consistently been negative in 2018 the Company's EBIT was negative $43 million. 2019 EBIT was minus 73, 2020 negative 293. And the forecast for 2021 is minus 90. Spotify is currently valued at 4.7x current sales.

Here is a company with negative earnings, trading for almost 5 times sales, how do we think about this as a value proposition? And when you have a valuation of around $40 billion, and you're thinking about the TAM, the total size of the addressable market of around $100 billion, so Spotify's market cap that's 40% of its TAM using 100 billion as your number. How do you think about market cap as a percentage of its Total Addressable Market?

Mark Mahaney:

You're asking some really great probing questions. Another way I think about it is I look at the market cap of say, a Netflix. Netflix now is doing almost $300 billion market cap. Spotify is a sixth of that,. And I think, well, what's the end use case here? It's people having entertainment options on their phone, whether it's watching video or listening to music, the subscription fee prices, by the way, aren't dramatically different. The real difference between these isn't so much the TAM or the consumer use case, it's the gross margin setups because the suppliers are much more concentrated with music with the big powerful labels, than they are with video, with produced film and series. That's really the big difference. But it's not enough, I don't think, to warrant that kind of market cap difference between the two. The company isn't profitable.

Then I get to those four logic questions. Well, is there any particular reason why scale over time doesn't help drive them to profitability? And I think the answer is no; there's nothing in particular that structurally stops from doing that. And by the way, sort of like Netflix... I mean, we lived through this. Netflix had no leverage with the studios, much smaller studios or with artists, when they first got into original content seven years ago. But now Netflix it's become a must shop destination for content creators. That's what allowed it to gain leverage in terms of its streaming costs. And I think the same actually can happen with Spotify over time.

Also, as you become bigger, you become a platform you can layer in more revenue streams. Advertising. One of the advantages of podcasting, by the way, this is very specific to Spotify, is that podcasting, the ad revenue associated with podcasting isn't shared with the label. So as podcasting grows, as ad revenue around podcasting grows, that's going to help the gross margins at a name like Spotify. So that those are kind of a couple points I'd give you on Spotify.

Yeah. It's hard to be exact when you look at these names about what the right valuation is, especially when they're pre-profits or they're very slim in the profits. And I think the point I try to get across here is, you want to avoid precision traps. What you're looking to try to figure out is, is the valuation ballpark reasonable? Don't let the perfect be the enemy of the good, because valuation is always based on future forecast and we're all as good as each other in terms of predicting the future. IE. It's not predictable.

Larry Bernstein:

Lesson 7 is the customer proposition. And using Amazon, as an example, the customer proposition is unbelievable. I mean, Amazon offers customers an incredible product selection, anything they want at a reasonable price delivered in a day or 2. I mean amazing. But when I think about the customer proposition for Spotify, I'm baffled.

We are having this conversation on my podcast. I publish this podcast on Spotify, but I own it, and I choose to give it to Spotify for free, which obviously is a great deal for them. But what is it that Spotify offers its customers? It's offering a platform to listen to music and podcasts. Sure, it owns some of its podcasts. But it doesn't own most of the podcasts or the music, as you pointed out; the music recording industry does. What is Spotify's customer proposition that is so compelling to you?

Mark Mahaney:

The world's music library personalized on your device whenever you want it. Now that's also offered by other companies. In the past, Pandora. Although Spotify's global; Pandora's had very limited success outside of the US. Apple music, although that's not available on the majority of the world's phones, because Apple devices are a minority of the world's phones. It's an Android world, not an Apple world.. But that's Spotify's advantage, that the basic value proposition of music streaming...

Larry Bernstein:

Let's move on to Uber. Pre-Covid, Uber had an incredible product, for a relatively cheap price, they will pick you up using your smartphone's GPS and Uber will take you wherever you want to go. Amazing. Currently, labor markets are incredibly tight. Uber prices are much higher because it is very difficult for Uber to find you a driver. How do you think about tight labor markets as a risk to Uber's business?

Mark Mahaney:

Well, so Uber's a marketplace. And it has had an enormous number of challenges. And you got to manage that marketplace. We've had dramatic demand and supply fluctuations caused by COVID. Although, it had one huge hedge in terms of its delivery business, that was positively boosted by COVID. But its mobility business, which was prior to COVID, what most investors associated with Uber, that got hit as almost as hard as the travel companies did. And then there was this surprise that they were going to need to incentivize drivers. They were going to have to lean much more heavily than expected on driver subsidies in order to rebalance the marketplace. It's very easy for all of us on the demand side to start back up with Uber. All we do is open up the phone and click the app again. But for drivers, there were some frictions.

But the value proposition here, I think has also been proven. You've seen pretty material rise in pricing. And you have not seen driver demand fall off as strongly as the pricing, in some cases has shot up, i.e. there's a real value proposition because people still need to get from point A to point B. And what are your alternatives? Car ownership, taxis, public transportation. That's why the value proposition we think is extremely compelling here.

But yes, there's a huge amount of execution risk associated with Uber. It's a very large TAM. They have a tiny share of it. I think the management team, I think at Uber, based on that has a lot of credibility with me personally, but I think increasingly will in the market. And I think there's a chance for a real material re-rating opportunity here at Uber, and the chance for the company to be able to generate given a small penetration of a very large TAM, the ability of the company to sustain premium revenue growth for years and years, i.e. 20% revenue growth for three, four, five years. And I don't think that's priced into the stock at all.

Larry Bernstein:

I would like to ask a question about changing business strategy, and I want to focus on Zillow. The company's original business plan was to offer a real estate listing platform. Zillow was successful, and in your book, you referred to Zillow as real estate porn. And then Zillow changed its business plan. Zillow got into the business of buying, refurbishing, and flipping homes. Zillow announced this week that it was getting out of that business. I am not particularly interested in whether it was a good decision or a bad one, but I am fascinated by management teams radically changing their business model. How do you think about Zillow as an example of how to radically altering their business strategy?

Mark Mahaney:

Well, I used the Zillow pivot in the book as an example. And to me, this is an example of the advantage of having a founder-led company. This was a very risky pivot that they've made. But I'm going to take you back a few years. When they first announced, they were going to get into this, the stock tanked. I think it traded off as much as 30% over the following several quarters because it was perceived to be a lot more expensive than originally thought. It's a different area of competence. Prior to iBuying, Zillow was an advertising tool for professional real estate agents. A few other things, but that was principally it.

Then with iBuying, they actually go into the business of trying to price, purchase, fix, sell homes. That's a very different set of challenges and competencies required. And it could be damn expensive, too. And you could be sitting out there with a lot of housing inventory. Imagine what happens if there's a dramatic decline in home prices. Are you going to be able to react quickly enough to get that inventory off your books? I think it was the right strategic call.

But I don't think they could have done that if the company hadn't been founder-led, because that was something that you're telling investors, we're going into a major new adjacency, major TAM, but dramatically different set of competencies. "It's going to be extremely expensive." I don't think most professional managers would've had the guts to do something like that. And it required founders. This is like Jeff Bezos announcing Amazon Prime, which hurt the stock, hurt the company's financials for a short period of time now. But back then it was unclear how long it was going to hurt. It was certainly going to be costly.

Yeah. Founders have the ability, the guts to do that.

Larry Bernstein:

We end each session on a note of optimism. What are you optimistic about your sector?

Mark Mahaney:

I just think that there's still sustained secular growth ahead for these businesses. There are two fascinating challenges I think that need to be worked out in 2022. First is, how do we do targeting and tracking of advertising campaigns in a post-privacy world? There's probably been a big win for consumers in this. They have the ability to opt out of being tracked, but it's a huge negative for marketers and retailers, their ability to track consumers, to know whether their ad campaign really worked or not. That's been diluted and it's a huge negative for names like Facebook. So, somebody needs to do it, i.e. Facebook is one of them. Somebody who can come up with an alternative, effective tracking, targeting technique in advertising and marketing that doesn't undermine privacy, boy, there's a lot of value to be created in that.

The second key issue that I'm focused on for next year, and my guess is will be fixed, stems from what I refer to as shipocalypse.. Somebody who can solve supply chains, there’s a lot of upside to the companies that can figure that out.

Larry Bernstein:

Mark, thank you very much. I really appreciate it.

Mark Mahaney:

Thank you, Larry.