October 30, 2019

Dear Partner:

We made continued progress in the third quarter with another good result. The Greenlight Capital funds (the "Partnerships") returned 5.6% for the quarter, bringing the year-to-date return to 24.0%. Most of the gains came in the long portfolio, as the short portfolio had a small loss, which was offset by a small gain in macro. During the quarter, the S&P 500 index returned 1.7%, bringing its year-to-date return to 20.6%.

When we started in this business, there were over 7,000 listed companies in the United States – most of which we didn't know. When we received a stock pitch, we often had to begin by asking, "What do they do?" We wondered who were the people following all these businesses. Even so, while some tickers had little Wall Street research coverage, there always seemed to be somebody paying attention and reacting to news. Today there are about half as many listed companies in the U.S. as when we started, and yet in certain situations we are sometimes left wondering if there is anybody paying attention, let alone reacting.

We raise this because of the curious case of Brighthouse Financial (BHF). Last quarter, we explained how bearish analysts had estimated that BHF had suffered up to a $1 billion loss due to declining interest rates. We disputed that analysis and thought the loss would be much smaller. Coming into the earnings report, BHF traded poorly amid further rate declines, as it appeared that most market participants accepted the bearish analysis.

What happened? When the company reported its second quarter, not only was there no $1 billion loss, BHF actually grew its capital buffer by $400 million. In the early part of the year and again in June, management added to its interest rate hedges and purchased cheap options that protected the balance sheet through the subsequent interest rate declines. Usually, when an advertised bear case doesn't come to fruition, the stock tends to soar. Relative to BHF's $4 billion market cap, the $400 million capital build when the market had expected a large loss ought to have had a large positive impact on the share price. In this case, the market yawned. The glass half-empty crowd concluded that if the hedges generated gains in a falling rate environment, those gains would probably be reversed if rates went back up.

Management made it clear on the conference call in August that the further declines in rates since quarter-end did not erode its capital buffer. While it should be obvious, the greater level of interest rate hedging makes BHF much less exposed to interest rates. Yet subsequent to the announcement, the correlation between BHF stock and interest rates has increased.

As one analyst put it in his summary of the quarter, "we do not expect there to be many buyers for this name despite a seemingly cheap valuation and reasonably good earnings results." But someone has been buying: with the stock in the doldrums, BHF continued its aggressive buyback program, repurchasing nearly 3% of outstanding shares in May and June alone, and management collectively purchased nearly $1 million worth of shares on the open market after the earnings report in August.

During the quarter, the shares advanced from $36.69 to $40.47, making BHF our second largest winner.

Other material contributors included Green Brick Partners (GRBK), whose stock rose from $8.31 to $10.70 based on a strong quarterly result, combined with management commentary that earnings are expected to inflect positively starting in the third quarter, and Altice Europe (Netherlands: ATC), which advanced from €3.16 to €4.80, as the French cellular market is behaving more rationally and the company is deleveraging its balance sheet.

Our Netflix (NFLX) short was another material contributor as the company failed to achieve its subscriber growth targets and the stock fell from $367.32 to $267.62. In 2018, due to the runaway performance of the shares, we converted our position into puts. We have been negative about NFLX for a long time, as the company has yet to demonstrate a profitable business model. While NFLX has grown subscribers and revenues, cash costs have grown even faster. This year the company projects to burn a stunning $3.5 billion on just $20 billion of revenue.[1]

In its early years, NFLX created a niche by licensing cheap content and growing its subscriber base with a low-priced, value offering that aggregated hundreds of popular titles owned by major studios. That arbitrage has gone away as the cost of licensed content has soared, competition has intensified and traditional studios are pulling their libraries from NFLX to launch their own streaming services. It appears to us that the value creation from streaming video on demand has gone to stand-up comics and the owners of perennially popular shows like *Friends*, *The Office* and *South Park*. NFLX has responded by trying to create its own content. To date, NFLX does not appear to have created any similar franchises to rival the longevity of the shows it is losing, as viewership tends to collapse soon after introduction. When was the last time you heard anyone mention watching *House of Cards*?

More generally, NFLX structures its site to emphasize new releases and popular licensed content while library content requires an effort to watch. And yet, NFLX amortizes its content over up to 10 years, inflating GAAP margins by deferring expense recognition. Even as its portfolio shifts from legacy titles with steady long-term viewership trends to binge-and-forget Netflix Originals, amortization as a percentage of cash spending has plummeted. At least we have heard of *House of Cards*; NFLX's balance sheet likely contains capitalized values for unpopular shows like *The Get Down*, *Lilyhammer*, *Atelier*, *Longmire*, the aptly-named *Disjointed*, and the even more aptly-named *Everything Sucks*. While we enjoyed Aziz Ansari's *Right Now*, we suspect 80% or more of its lifetime viewing has already happened.[2] How and why does something like that deserve a multiple-year accounting life? We believe that management's approach to expense recognition renders NFLX's GAAP financials nearly meaningless.

The point is that NFLX needs to maintain a constant stream of popular new content in order to sustain, let alone grow, its subscriber base. Thus, the cash burn of over $3 billion (which NFLX promises will improve "slowly" and "gradually") better reflects the business economics than do its GAAP financials.

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[1] Through the first nine months of the year, cash burn has tracked roughly in line with the comparable period in 2018, when the company ultimately burned $3 billion. As such, there is a good chance that the $3.5 billion projection is overly conservative. The CEO ended its most recent earnings call by saying, "I look forward to blowing away the numbers."
[2] Our data indicates that by September, just two months after the show's debut, U.S. viewership had already fallen by 95%.

When NFLX subscribers were growing at an accelerating pace, the market did not care about these pesky financial issues. However, NFLX's domestic subscriber growth has slowed sharply in 2019. Unsurprisingly, NFLX – as is its custom[3] – announced that it will no longer guide to the number of U.S. subscribers. International subscriber growth also appears to have peaked. At the same time, NFLX has begun offering heavily discounted "mobile-only" plans in some emerging markets. Bulls forecast ever-higher international prices (from roughly $9.50 per month currently to $14-15 per month or higher over the next decade), but that math breaks down as NFLX increasingly relies on $3-4 monthly subscriptions in low-income countries like India and Malaysia to maintain the global subscriber growth narrative.

Of further note, in its most recent 10-Q, NFLX adjusted its description of its pricing plans by changing one rather important word. The filing now says, "We expect that from time to time the prices of our membership plans in each country may **~~increase~~** **change** and we may occasionally test other plan and price variations." With a disclosure like that, the NFLX story of unmitigated pricing power for years to come has to be called into question. We're surprised no one has noticed. Then again, we were surprised in April when no one noticed another disclosure change that clarified that operating cash flow (as well as free cash flow) would be negative "for many years."

All told, NFLX has a suspect content library carried on the balance sheet at $23 billion, supporting $8 billion of net debt, over $3 billion annual cash burn and a $117 billion market capitalization. At a time when the market appears to be re-evaluating companies that have demonstrated poor economics and rely on sustained access to the capital markets,[4] we think NFLX, like many of its shows, is in the process of being de-rated.

Finally, we had a surprising winner this quarter as subordinated debt we held, marked at zero over ten years ago and long since forgotten, turned out to be worth par. It was a bank failure and not an error, but nevertheless it felt like this:


[3] NFLX stopped disclosing global churn in 2011 and domestic churn, gross subscriber additions and subscriber acquisition costs in 2012. NFLX began reporting and emphasizing domestic contribution margin in 2011, but will stop disclosing it in 2020. The company used to tout rising engagement metrics (hours viewed per user), but stopped disclosing hours viewed in 2016 and stopped citing viewership growth rates in 2018. Finally, in 2019, NFLX switched guidance and emphasis from Total subscribers (which includes free trials) to Paid subscribers. Year to date, the change has inflated "headline" net adds by 3.6 million and helped obscure the underlying subscriber growth weakness: Total net adds are down roughly 21% versus last year (and down 11% in the International segment) amid a sharp slowdown in sign-ups, while Paid net adds are down only 4% (and up 8% in the International segment) due to the lagged effect of a record late-2018 surge in free trials.

[4] WeWork reportedly cited NFLX's example of relying on high yield borrowings "as recurring cash" in an internal discussion of the viability of its financing strategy.

In 2008, we bought subordinated debt in Guaranty Bank. Shortly afterward, the bank invested in AAA-rated tranches of Alt-A mortgage pools. That turned out to be fatal, and the bank was seized by the FDIC in 2009. Over the last decade, the FDIC liquidated the bank's troubled assets and pursued claims against the Wall Street banks that dumped the toxic bonds on Guaranty Bank. The FDIC achieved sizable recoveries, which it is now passing back to stakeholders. In September, the FDIC contacted us and more or less asked where to send the money. It was so odd that the running joke in the office was that it was a scam. But ultimately we received the funds… and so far there have been no follow-up requests from a "foreign dignitary" with further instructions.

Tesla (TSLA) and Chemours (CC) were material losers during the quarter. TSLA shares recovered from $223.46 to $240.87. Unit sales in the June quarter improved more than we expected compared to the March quarter.

Even so, TSLA appears to continue to spin positive PR ahead of the safety and fair treatment of its customers. For example, in August Walmart sued TSLA because its solar panels were catching on fire. Rather than warn its solar customers when TSLA became aware of the fire risk, TSLA allegedly created Project Titan – a covert program to replace the defective components while staying out of the news. Similarly, in response to a series of car battery fires, instead of recalling the batteries, TSLA appears to have quietly issued a "software update" to the battery management system that has a side effect of reducing battery range. TSLA has chosen not to warn or compensate its customers for the decreased performance.

Finally, to the surprise of nobody, documents in TSLA's SolarCity litigation unsealed in September showed that Elon Musk knowingly orchestrated a significant fraud by arranging the $2.6 billion acquisition at a time when SolarCity was insolvent. Musk and his family had a huge conflict of interest, but rather than properly recusing himself, Musk initiated the transaction and drove the process. SolarCity was so cash-strapped, it was trying to delay payments to vendors after parts were delivered and the vendors had recognized the revenue; SolarCity could not raise any funds at reasonable rates from third parties; and Musk engineered the unveiling of the Solar Roof tile to convince TSLA's shareholders to approve the deal, even though the product did not exist at the time. As was the case with Musk's extraordinary "funding secured" tweet last year, we believe this level of trampling of standard processes of corporate governance, ignoring methods to deal with related party transactions and self-dealing should lead to substantial consequences. For now, the accepted reality appears to be that Elon Musk is above the law.

CC's stock price fell from $24.00 to $14.94. The quarterly result was disappointing, as the company's $TiO_2$ segment continued to cede market share due to its efforts to maintain pricing discipline in a weak market, and the fluoroproducts segment was impacted by illegal importation of refrigerants into Europe. Management indicated that both headwinds will take time to resolve. Further, the noise about CC's environmental liabilities (which we believe is unjustified) grew louder. As a result of the weaker operating performance we have reduced our 2021 earnings estimate from $10 to $8.50. Even so, we believe the price drop is an overreaction and the stock is extremely cheap. So does management, as insiders made substantial purchases after announcing the quarterly results.

We had only a few portfolio changes this quarter. We added a small new long position in Siltronic (Germany: WAF), which makes wafers used in semiconductors, after the shares fell in response to oversupply and falling prices. We believe that the oversupply will be short-lived and the shares were inexpensive at our average entry price of €63.59, or 8x our estimate for 2020 earnings net of its cash on the balance sheet. Notably, WAF's Asian competitors Sumco and Globalwafers trade at substantial premiums to WAF. WAF ended the quarter at €69.70.

We exited our long-held short position in Caterpillar at a loss. The company did a better job of improving its long-term cost structure during the downturn than we expected, which will mean higher peak and trough earnings going forward. We closed out a medium-sized short position in Nvidia with a solid profit, as demand for graphics cards fell in response to the collapse of the cryptocurrency mining bubble last year. We exited our long position in Dialog Semiconductor with an excellent return. The shares soared after the company sold part of its business to Apple and investors appreciated the strength of the remaining business.

We had two investment analyst departures during the quarter. After eight years at Greenlight, Gabe Marshank relocated from London to the West Coast and will be pursuing new opportunities. In September, Ethan Auerbach left to join a distressed credit hedge fund as a portfolio manager. We thank them both for their contributions and wish them well.

Please save the date for our 24th annual partner dinner, which will be held on January 21, 2020 at the American Museum of Natural History in New York.

At quarter-end, the largest disclosed long positions in the Partnerships were AerCap Holdings, Altice USA, Brighthouse Financial, General Motors and Green Brick Partners. The Partnerships had an average exposure of 116% long and 72% short.

*"Great is the power of steady misrepresentation."*

– Charles Darwin

Best Regards,

Greenlight Capital

Greenlight Capital, Inc.

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