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Insigneo Weekly Dispatch

A Tale of Love and Hate: Nvidia and Disney

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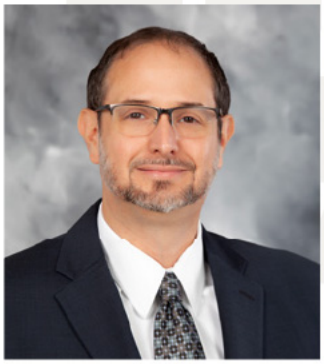

By Mauricio Viaud
PM and Senior Investment Strategist
Insigneo

A Tale of Love and Hate: Nvidia and Disney

Sometimes stocks are loved, sometimes they are hated. Love and hate have no place in investing; objective conviction does. I have always believed that you treat a stock opposite the way you would treat your partner, keep a healthy degree of skepticism towards a stock and never fall in love with one. This is not to say that you should never feel strongly about a stock. In fact, conviction is key to any investment decision. But this conviction must be based on research and data, not feelings. Sometimes investors fall blindly in love with a stock, to the point where they will only pay attention to data that supports their case and disregard any data that makes a different point. This is so common in our industry that it has even been given a name in behavioral finance: confirmation bias. Confirmation bias cuts both ways too. Sometimes investors hate a stock so much that they will only focus on the negatives and completely disregard the potential for a turnaround. We're not advocating for anyone to sell stocks that are well liked and purchase stocks that are disliked solely on this premise. What we are saying is that investors should have an objective conviction as to why they like or dislike a stock, as well as a healthy degree of skepticism. Something that has proven invaluable to me over the years analyzing equities is always looking for "the holes in my story", in other words, where could my investment thesis be wrong. No one is a perfect investor, being aware of potential pitfalls is paramount.

Let's look at two stocks, one that is loved and one that investors love to hate: Nvidia (NVDA) and Disney (DIS).

Nvidia (NVDA) has been a leader in this year's artificial intelligence-fueled Large Cap Tech rally, loved by most investors, and rightly so. The stock has risen nearly 240% since the beginning of the year, compared to the S&P 500 rising close to 20% over the same period. As a leading manufacturer of computer graphic processing units, Nvidia has been a strong player in the semiconductor industry for decades. Its products, initially used to power high-end video game graphics, expanded to supply data centers used to power anything from company websites to bitcoin. This dynamic has changed even more with the advent of AI. In fact, its Graphics business line now constitutes only 45% of the company's revenues, with the remaining 55% stemming from the Computing and Networking division, which includes end markets such as data centers, the cloud, autonomous driving vehicles, and robotics. This is where Nvidia's presence in artificial intelligence comes in. The company has become a full-scale solution provider for generative AI, providing hardware and cloud-based software used to develop AI systems across multiple industries.

After a blowout first quarter this year, Wall Street's expectations going into the second quarter earnings report were high. Still, Nvidia managed to beat this high bar when it reported second quarter results in late August. The company saw revenues jump nearly 90% over the previous quarter, with data center revenues jumping 141% over the same period. Networking, where Nvidia faces stiffer competition, saw revenues jump 85% for the quarter. Demand for the company's artificial intelligence products and solutions was broad-based, and management stated that it foresees demand growth well into next year. There is little doubt that Nvidia is now the 800-pound gorilla in the room when it comes to providing hardware for the artificial intelligence revolution, and revenues are likely to continue growing in the future as demand for AI continues to grow. However, we believe that a good portion of revenue growth may have been pulled forward, as Nvidia has successfully capitalized on its first-mover advantage in the industry. What this means is that a large part of the revenue growth that may have been spread out over the next few years, has instead occurred over a few quarters.

As we all know, every investment needs to be viewed through the lens of valuation. NVDA currently trades at a forward P/E near 36X compared to its industry peers at 25X. There is no question that Nvidia is the leader in its peer group and should trade at a relative premium. However, a nearly 45% valuation premium to the group average appears high. This high valuation could potentially leave the stock vulnerable if we experience a general market pullback or if the company fails to meet lofty expectations. We are not saying that Nvidia is a bad company. In fact, it is a great company and will likely continue to prove to be a good investment over time. However, given the large run-up in this stock, we would exercise prudence when investing in Nvidia. An investor with large gains could consider protecting some of these gains, and an investor considering investing in the company could do it through a dollar cost averaging strategy.

Now, let's look at a stock that most people love to hate. Mickey Mouse can bring a smile to most people's faces. Its stock, however, not so much. While Nvidia soared this year and the stock market posted strong returns, Disney's stock floundered, dropping close to 6%. In fact, the stock has been cut in half from its most recent highs in March of 2021, dropping 57% while the S&P 500 rose nearly 16% and Nvidia more than 250% over the same period. While Nvidia's management was successfully positioning the company to become a leader in its industry, it appeared like Disney's management could not get out of its own way. In an effort to grow and diversify its revenue stream, Disney may have grown to become too big for its own good. A strategy of growing for the sake of growth may backfire, if expenses grow faster than revenues and if such a strategy is not carefully implemented. This appears to have been the case with Disney. In order to diversify away from its traditional cable business, the company shifted focus to ESPN, acquired Hulu, and launched Disney+. These are all great business lines, but improperly managed, they saw their revenue and earnings growth potentially limited. For example, subscriptions for Disney + were severely underpriced compared to competitors such as Netflix and Max. On the movie and tv content creation side of its business, Disney appeared to be producing too much content, almost irrespective of profits.

Enter Bob Iger. The board of directors appeared to recognize the company's problem, and in an attempt to shake up management and turn around the business, brought back its legendary CEO, Bob Iger, to lead the company. Mr. Iger already appears to be turning things around, shifting the focus back from revenue growth to profitability. This past quarter, he announced another price increase to Disney+ subscriptions, bringing this number more in line with its competition. He is also implementing a series of cost cuts, including a reduction in budgets for its content division to reduce the creation of less profitable movies and tv programs. Nothing appears to be off the table in an effort to turn the company around. Management will largely lean on its core theme parks business while it attempts to increase profitability of its streaming businesses, but the sale or spinoff of a number of business lines, including its traditional cable business and even ESPN are also possibilities. Bob Iger is in the same line of seasoned leaders such as General Electric's Larry Culp. When GE was floundering a few years ago and its stock was at multi-year year lows, the board of directors brought in Larry Culp to take the helm. Mr. Culp undertook a number of hard decisions, including the refocusing of the company through the divestment of several of its business lines. However, GE's stock has risen almost 150% of its lows. We are not saying that the same is going to happen to Disney. But given the stock's current valuation at 17x earnings on a forward P/E basis, representing a 70% discount to peers like Netflix, there is potentially meaningful upside if Mr. Iger is successful in turning the business around. In fact, looking at its historical valuations, the stock currently sits nearly 30% under its 10-year average P/E of 24x, and over 100% under the high end of its normalized valuation range near 36x. However, much like when GE was undergoing its turnaround, many on Wall Street appear to be focusing solely on Disney's numbers for the next quarter, not on the company's long-term potential. If Mr. Iger is successful with his turnaround plan, the seemingly over-pessimistic sentiment surrounding the stock could create a lucrative opportunity for a long-term investor with a high tolerance for risk.

It is important to keep in mind that valuation is not its own catalyst, to the upside or downside. Just because a stock trades at discounted levels, it does not mean that it must go up, and vice versa. However, we live in a world of probability. If a stock trades at a discounted valuation and we can envision an objective investment scenario for it to rise over the long-term, then probability is on our side. We like both Nvidia and Disney as long-term investment ideas for investors with the appropriate tolerance for risk. Nvidia carries a high level of risk due to its currently extended valuation and lofty Wall Street expectations. Disney carries a high level of risk due to the possibility that its turnaround plan will not be properly executed. The important thing is that we reached our conclusions, leaving our emotions aside. Love and hate have no place in the investment world.

As always, it is also important to consider that the individual equities mentioned here can exhibit high degrees of volatility and are not suitable for every investor. These investments are best considered on a case-by-case basis, based on a particular investor's willingness and ability to tolerate risk. If you need more information or would like to discuss these or other potential ideas in more detail, please do not hesitate to contact the Insigneo Research Team.

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