Battle Road Research
An Independent Voice

Wednesday, February 23, 2011

Netflix

Reducing Our Rating from BUY to HOLD

Overview and Investment Opinion

We are reducing our rating on **Netflix (NASDAQ: NFLX - $221.60)** from BUY to HOLD, due in part to valuation, and due in part to the competitive threat posed by Amazon.com as it seeks to gain back lost ground in its core media business, which includes videos. Since adding Netflix to our Buy list on August 4, 2009 at a price of $45.00, the stock has increased more than four-fold, and although we are raising our earnings estimates modestly with the publication of this report, Netflix trades in line with our current price target. The following summarizes our current thinking on Netflix:

- *Dominant provider of online movie subscriptions, and a beneficiary of brick and mortar store closings.* With more than 100,000 titles for rent on more than 70 million DVDs, Netflix boasts a paid subscriber base of over 20 million. Netflix also offers over 20,000 movies and TV show episodes for rent through its video streaming service.

- *Recent changes to subscriber pricing optimizes gross margin yield.* Netflix's subscriber pricing changes announced in November reduced the price of its streaming-only option, and raised prices modestly on DVD-only users. We believe that this structure will stimulate streaming usage and improve gross margins gradually, as it begins to redeploy a portion of its $600 million annual US postage delivery bill on newer content, and save on DVD delivery costs.

- *Amazon.com flexes online rental muscle.* Of all the companies seeking to gain share in online video, the most formidable threat now emanates from Amazon.com, the dominant global consumer product portal, which yesterday announced that it will bundle its streaming service for free to members of its Amazon Prime two day shipping program. Amazon.com is out to gain back lost market share in the video business as the market moves from DVD to online video consumption.

- *Valuation.* At a recent share price of $221.00, Netflix trades at 34 times our calendar 2012 EPS estimate of $6.50, and is about even with our current price target of $225.00 per share. Thus, we are reducing our rating from BUY to HOLD.

Our Investment Thesis

Netflix, based in Los Gatos California and founded 11 years ago by Reed Hastings and Marc Randolph, has emerged as the leading DVD and online film and TV show subscription rental service with over $2.1 billion in sales during 2010. Hastings, the company's CEO, is a Bowdoin College graduate, former Peace Corp volunteer, and founder of Pure Software, a software testing company that was later acquired by IBM. The $40 late fee assessed for Hastings' tardy return of his *Apollo 13* movie rental allegedly became the inspiration for Netflix.

Unlike Blockbuster, Coinstar and others, Netflix does not charge late fees. With more than 100,000 titles available for rent on more than 70 million DVDs, Netflix boasts a paid subscriber base of over 20 million which has grown from 6.8 million less than three years ago. Netflix is unique in that it offers a vast movie selection delivered directly to the home or mobile computing device, commercial-free, for a flat monthly fee.

Netflix offers a video streaming option that allows subscribers to view any one of more than 20,000 TV show and movie titles. This library is increasing each day, and may soon double from the last reported figure. These titles are streamed over the internet, for immediate viewing, via the Microsoft Xbox console, the Sony PlayStation 3 (PS3), Nintendo's Wii, as well as Blu-Ray DVD players. More than 60 percent of Netflix customers stream at least 15 minutes of content per month to their computer of choice.

Netflix continues to benefit from the financial distress of its brick and mortar rivals who must pay monthly rent for video stores, and attempt to guess the tastes and viewing habits of its customers, while at the same time charge prohibitive fees for late movie returns. Blockbuster, which not long ago entered bankruptcy, is only the most recent brick and mortar casualty. We expect Netflix to sign additional deals with Hollywood studios, and redeploy a portion of its $600 million US postage bill to purchase streaming content for its subscribers.

Additionally, we expect Netflix to enter new foreign markets over the next few years, taking advantage of low cost online delivery, thus bypassing the US postal service entirely.
With the publication of this report, our price target remains $225.00 per share, based on a 34 multiple assigned to our 2012 EPS estimate of $6.50. Our rating is HOLD.

Recent Developments

Amazon.com Flexes its On demand Muscle

Yesterday Amazon.com announced that it would bundle access to over 5,000 movies and TV shows at no charge to members of its $79 per year Amazon Prime program, which provides free two-day shipping for any item purchased on Amazon.com. AMZN already claims that "millions of customers" access the service, and, candidly, we believe this new program could inspire millions more to purchase the program.

Amazon.com's revenue growth has slowed to 12 percent in its core media business, even as the Kindle comes into its own. Amazon derives a significant percentage of its media sales from DVD movies and games, and has seen its revenue growth slow as the market begins to embrace digital media.

Amazon has therefore begun to flex its video on demand muscle recently through its streaming service, through which it rents over 90,000 movies and television shows on a pay-per-view basis. Most movies can be rented for $2.99 per movie, and TV shows can be accessed for $1.99 per episode. Of course, a few movies and television shows can easily add up to a price that exceeds Netflix's $8.00 per month fee for unlimited streaming.

Amazon's announcement comes less than one month after it acquired the 58 percent that it did not already own of LoveFilm International, a European DVD-by-mail and video streaming subscription service for films and video games. We suspect that LoveFilm may have had as many as 1.5 million subscribers in the UK, Germany, Norway, Sweden, and Denmark. LoveFilm supports the Sony Playstation 3 as a video streaming device, and, according to the *Wall Street Journal*, the streaming consumption of its customers has risen from five percent to 20 percent in the last 12 months.

LoveFilm is evidently a roll up of something like ten separate DVD companies. The company's sales rose by 32 percent from $117 million in 2008 to $155 million in 2009, according to the *Financial Times*, although curiously we have not seen any revenue estimates for 2010. Terms of the deal are not public, but we have seen estimates that range from $300 million to $320 million, which leads us to believe that LoveFilm may have had a relatively soft, that is to say weak 2010, or that it may have lost the confidence to compete against the burgeoning field of video streaming companies. If the estimates are true, Amazon.com may have paid as much as $200 per current subscriber.

Amazon has reportedly entered into discussions with Hollywood studios to license current movies and TV shows in an effort to augment its content, though it is too early to tell whether Amazon has the will or budget to invest in newer content.

It is unclear whether Amazon's video streaming rental business is profitable. And it may not matter, since Amazon.com seeks to maximize total gross margin dollars, rather than gross margin by product line. Ultimately, therefore, Amazon is indifferent as to whether it rents a movie, sells a new or used DVD movie, sells a new or used streaming device required for its connection, or sells the new or used color TV or mobile computer on which the movie will be viewed.

Netflix Services and Recent Pricing Changes

All of Netflix's plans, with the exception of its one DVD per month rental plan, feature unlimited access to the company's streaming library and DVD rental library, but the price of each plan increases based on the number of DVDs that are in circulation at any one time. Though Netflix will not charge late fees the way Blockbuster or the local library does, it nevertheless discourages an excessive number of DVD discs rented at any one time.

Until recently Netflix's most popular plan was its $8.99 per month plan, which allowed unlimited DVD rentals each month, provided that only one DVD is rented at a time, as well as unlimited video streaming from a library of over 20,000 TV show and movie titles.

In late November 2010 Netflix enacted a series of price changes designed to encourage more video streaming, as well as discourage DVD-only use. Under the new pricing structure, subscribers access unlimited movie and TV shows on a streaming-only basis for $7.99 per month. Subscribers that wish to retain the option of renting DVDs by mail (with only one out at a time), will now pay $9.99 per month, an increase of $1.00 per month, or about 11 percent annually. Price increases were also announced for subscribers to Netflix's other DVD plans: for subscribers that wish to rent two DVDs at a time, the price has been increased by $1.00 per month, from $13.99 to $14.99. This seven percent increase is the lowest percentage increase announced on any of the company's existing plans. We suspect that this is because the company wishes to retain as many of these subscribers as possible, as the company's churn level is lowest among subscribers that utilize both streaming and DVD rental.

For the rest of Netflix's subscribers prices rose by an average of 17 percent for each plan, beginning the first of the year. Thus, subscribers that wish to rent three DVDs at a time will absorb a $3.00 per month increase; subscribers that wish to rent five DVDs at a time will pay $5.00 more per month, and those that wish to rent eight DVDs concurrently will be asked to pay $8.00 more per month. Significantly, Netflix did not announce any new DVD rental only plans, in order to encourage as much streaming as possible.

Financial Analysis and Projections

During its most recent quarter (ended December 31, 2011), Netflix recorded revenue of $596 million, an increase of 34 percent over the prior year. This marked the fifth consecutive quarter of accelerated year-over-year sales growth, as well as the fifth consecutive quarter that Netflix added more than one million net new subscribers. The company's gross margin was 34.4 percent, compared to the prior year's 38 percent. Operating margin for the quarter increased to 14.5 percent from 12.7 percent in the prior year. Our model, which appears at the conclusion of this report, taxes all quarters at 39.5 percent. We also exclude stock-based compensation expense.

During the quarter Netflix added over three million new subscribers, almost tripling the 1.16 new subscribers that it added in the same period of 2009. Total subscribers now exceed 20 million. Subscriber acquisition costs, a closely watched metric, were $11.13, a dramatic decline from the $25.23 per subscriber that its recorded in the same quarter a year ago.

EPS, by our calculation, was $0.92, versus $0.60 in the prior year. At the end of the quarter, Netflix held $351 million in cash and investments, and shoulders the interest expense of roughly $5 million per quarter on $200 million in long-term debt. Netflix's current ratio at the end of the quarter was 1.6 and its return on average shareholder equity over the last 12 months is 70 percent.

New Estimates and New Price Target

Our new 2011 estimates call for revenue of $2.9 billion and EPS of $4.80, which imply increases of 35 percent and 46 percent over 2010. Our model assumes modest margin expansion, a modest contraction in the company's share count, and a tax rate of 39.5 percent. *Importantly, our model excludes stock-based compensation expense.* Our model for 2011 and 2012 assumes net interest expense of $16 million, a result of the company's $200 million in convertible debt. Our previous 2012 estimates called for revenue of $3.6 billion and EPS of $6.40. Our new estimates are $3.9 billion in revenue, and EPS of $6.50. Our new price target is $225 per share, based on a 35 multiple assigned to our calendar 2012 EPS estimate. We believe that this earnings multiple is on line with the company's three year earnings growth potential. For additional details, please see our model at the conclusion of this report.

Conclusion

We are reducing our rating on **Netflix (NASDAQ: NFLX - $221.60)** from BUY to HOLD, due in part to valuation, and due in part to the competitive threat posed by Amazon.com as it seeks to gain back lost ground in its core media business, which includes videos. Since adding Netflix to our Buy list on August 4, 2009 at a price of $47.00, the stock has increased more than five-fold, and although we are raising our earnings estimates modestly with the publication of this report, Netflix trades in line with our current price target.

Notes:

1) We assume a tax rate of 39.5%

2) We exclude stock-based comp., and one-time charges.

Netflix

($ millions, except EPS and %)

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	FY08(A)	FY09(A)	FY'10(A)					FY'11 (E)					FY'12 (E)				
	Year	Year	Mar-10	Jun-10	Sep-10	Dec-10	Year	Mar-11	Jun-11	Sep-11	Dec-11	Year	Mar-12	Jun-12	Sep-12	Dec-12	Year
NET REVENUES	1364.66	1670.27	493.67	519.82	553.22	595.92	2162.63	676.32	706.95	741.31	792.58	2917.16	899.51	940.25	978.53	1038.27	3856.56
Cost of revenues (total)	909.77	1078.99	306.99	314.63	344.15	390.49	1356.25	412.56	432.66	455.91	495.36	1796.48	555.00	570.73	592.01	653.07	2370.81
Cost of subscription	761.13	904.85	259.56	265.39	292.41	336.76	1154.11	351.69	367.62	385.48	424.03	1528.81	476.74	479.53	499.05	560.67	2015.99
Fulfillment expense	148.64	174.14	47.43	49.24	51.74	53.73	202.14	60.87	65.04	70.42	71.33	267.67	78.26	91.20	92.96	92.41	354.83
GROSS PROFIT	454.89	591.28	186.68	205.19	209.07	205.43	806.38	263.77	274.30	285.41	297.22	1120.69	344.51	369.52	386.52	385.20	1485.75
Technology and development	86.23	110.09	35.53	35.49	39.41	42.71	153.14	45.99	49.49	51.89	56.27	203.64	61.17	65.82	68.50	73.72	269.20
Marketing	197.87	235.96	74.58	73.78	80.46	61.98	290.80	94.68	84.83	103.78	116.51	399.81	130.43	112.83	136.99	144.32	524.57
General and administrative	43.72	45.06	14.38	13.63	13.63	15.30	56.94	17.58	18.38	19.27	17.44	72.68	23.39	24.45	25.44	22.84	96.12
Gains on disposal of DVDs	-6.33	-4.56	-1.65	-1.97	-1.23	-1.24	-6.09	-1.60	-1.60	-1.60	-1.60	-6.40	-1.60	-1.60	-1.60	-1.60	-6.40
Total Operating Expense	321.49	391.11	122.83	120.92	132.28	118.75	500.87	158.26	152.70	174.95	190.22	676.13	214.98	203.09	230.93	240.88	889.89
OPERATING INCOME	133.40	200.17	63.85	84.27	76.80	86.68	305.50	105.51	121.60	110.46	107.00	444.56	129.53	166.42	155.59	144.32	595.86
Int./other inc. (expense)	10.42	0.25	-3.99	-3.97	-4.13	-3.89	-15.99	-4.00	-4.00	-4.00	-4.00	-16.00	-4.00	-4.00	-4.00	-4.00	-16.00
Income before taxes	143.82	204.98	59.86	80.30	72.67	82.79	295.61	101.51	117.60	106.46	103.00	428.56	125.53	162.42	151.59	140.32	579.86
Income taxes (benefit)	56.81	80.97	23.64	31.72	28.70	32.70	116.77	40.09	46.45	42.05	40.68	169.28	49.58	64.16	59.88	55.43	229.04
NET INCOME	87.01	124.01	36.22	48.58	43.96	50.09	178.84	61.41	71.15	64.41	62.31	259.28	75.95	98.27	91.71	84.89	350.82
Avg. shares outstanding	62.82	58.45	54.78	54.32	53.93	54.19	54.31	54.00	54.00	54.00	54.00	54.00	54.00	54.00	54.00	54.00	54.00
EPS (Fully taxed)	1.39	2.12	0.66	0.89	0.82	0.92	3.29	1.14	1.32	1.19	1.15	4.80	1.41	1.82	1.70	1.57	6.50
Yr-to-Yr % Change																	
Revenues	13.2%	22.4%	25.3%	27.2%	30.7%	34.1%	29.5%	37.0%	36.0%	34.0%	33.0%	34.9%	33.0%	33.0%	32.0%	31.0%	32.2%
Operating Expense	-0.6%	21.7%	28.8%	45.2%	38.7%	5.5%	28.1%	28.8%	26.3%	32.3%	60.2%	35.0%	35.8%	33.0%	32.0%	26.6%	31.6%
Cost of subscription	14.6%	18.9%	20.6%	18.0%	25.4%	45.4%	27.5%	35.5%	38.5%	31.8%	25.9%	32.5%	35.6%	30.4%	29.5%	32.2%	31.9%
Fulfillment expense	22.5%	17.2%	8.2%	11.2%	22.7%	22.6%	16.1%	28.3%	32.1%	36.1%	32.7%	32.4%	28.6%	40.2%	32.0%	29.5%	32.6%
Earnings per share	32.7%	53.2%	63.6%	56.8%	45.6%	55.3%	55.2%	72.0%	47.3%	46.3%	24.9%	45.8%	23.7%	38.1%	42.4%	36.2%	35.3%
Sequential Sales Growth			11.1%	5.3%	6.4%	7.7%		13.5%	4.5%	4.9%	6.9%		13.5%	4.5%	4.1%	6.1%	
As a % of Sales																	
Cost of subscription	55.8%	54.2%	52.6%	51.1%	52.9%	56.5%	53.4%	52.0%	52.0%	52.0%	53.5%	52.4%	53.0%	51.0%	51.0%	54.0%	52.3%
Fulfillment expense	10.9%	10.4%	9.6%	9.5%	9.4%	9.0%	9.3%	9.0%	9.2%	9.5%	9.0%	9.2%	8.7%	9.7%	9.5%	8.9%	9.2%
Gross profit	33.3%	35.4%	37.8%	39.5%	37.8%	34.5%	37.3%	39.0%	38.8%	38.5%	37.5%	38.4%	38.3%	39.3%	39.5%	37.1%	38.5%
Technology and development	6.3%	6.6%	7.2%	6.8%	7.1%	7.2%	7.1%	6.8%	7.0%	7.0%	7.1%	7.0%	6.8%	7.0%	7.0%	7.1%	7.0%
Marketing	14.5%	14.1%	15.1%	14.2%	14.5%	10.4%	13.4%	14.0%	12.0%	14.0%	14.7%	13.7%	14.5%	12.0%	14.0%	13.9%	13.6%
General and administrative	3.2%	2.7%	2.9%	2.6%	2.5%	2.6%	2.6%	2.6%	2.6%	2.6%	2.2%	2.5%	2.6%	2.6%	2.6%	2.2%	2.5%
Gains on disposal of DVDs	-0.5%	-0.3%	-0.3%	-0.4%	-0.2%	-0.2%	-0.3%	-0.5%	-0.5%	-0.5%	-0.5%	-0.2%	-0.5%	-0.5%	-0.5%	-0.5%	-0.2%
Operating margin	9.8%	12.0%	12.9%	16.2%	13.9%	14.5%	14.1%	15.6%	17.2%	14.9%	13.5%	15.2%	14.4%	17.7%	15.9%	13.9%	15.5%
Income before taxes	10.5%	12.3%	12.1%	15.4%	13.1%	13.9%	13.7%	15.0%	16.6%	14.4%	13.0%	14.7%	14.0%	17.3%	15.5%	13.5%	15.0%
Net income	6.4%	7.4%	7.3%	9.3%	7.9%	8.4%	8.3%	9.1%	10.1%	8.7%	7.9%	8.9%	8.4%	10.5%	9.4%	8.2%	9.1%
Tax rate	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%	39.5%

Note: Fiscal Year Ends December 31.

02/14/11

Netflix
Balance Sheet
($ in millions, except Key Ratios)

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	(A) Mar-10	(A) Jun-10	(A) Sep-10	(A) Dec-10
Assets:				
Cash and cash equivalents	79.86	107.33	113.11	194.50
Short-term investments	186.47	171.76	143.71	155.89
Prepaid content	31.70	33.84	59.32	62.22
Current content library, net	55.57	93.12	138.39	181.01
Deferred tax assets	0.00	0.00	0.00	0.00
Other current assets	25.94	35.17	37.72	47.36
Total Current Assets	379.54	441.22	492.25	640.97
Content library, net	109.43	94.67	120.05	180.97
Property and equipment, net	127.17	123.29	125.06	128.57
Deferred tax assets	18.79	21.95	19.22	17.47
Other assets	13.37	12.85	13.71	14.09
Total Assets	648.29	693.97	770.28	982.07
Liabilities:				
Accounts payable	102.70	120.03	170.12	222.82
Accrued expenses	38.72	34.75	36.97	36.49
Current portion lease finance obligations	1.92	1.97	2.03	2.08
Deferred revenue	100.11	101.42	102.99	127.18
Total Current Liabilities	243.45	258.17	312.11	388.58
Long-term debt	200.00	200.00	200.00	200.00
Lease financing obligations, exlcuding current portion	35.70	35.19	34.66	34.12
Other liabilities	22.41	23.98	31.54	69.20
Total Liabilities	501.56	517.33	578.31	691.90
Shareholders' Equity	146.74	176.64	191.98	290.16
Total Liabilities & Equity	648.29	693.97	770.28	982.07
Key Assumptions and Ratios:				
Current Ratio	1.6	1.7	1.6	1.6
Cash & ST investments % of Tangible Assets	43.2%	42.3%	34.8%	36.9%
Cash and Securities/Share	$4.86	$5.14	$4.76	$6.47
Tangible Book Value Per Share	$11.25	$12.13	$13.67	$17.54
Return On Equity (TTM)	55.0%	60.0%	76.3%	71.8%

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