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# THE DEVIL'S ADVOCATE REPORT

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August 13, 2010

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## Netflix, Inc.

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*(SELL)*

<b>Price:</b>	\$134.00	<b>Ticker:</b>	NFLX
<b>52-Week Range:</b>	\$39.27-\$134.37	<b>Dividend:</b>	Zero
<b>Shares Outstanding:</b>	54.3 million	<b>Yield:</b>	Zero
<b>Market Capitalization:</b>	\$7.3 billion		

*Data As of August 13, 2010*



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*Exclusive Marketers of  
The Devil's Advocate Report*

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## Investment Thesis

Netflix is a highly successful company that has managed to grow its business rapidly, to the point at which it now has approximately 14% of all US households as paying subscribers, thereby out-maneuvering competitors such as Blockbuster, Hollywood Video and Movie Gallery. The company is also well established in the Internet streaming business, since more than 60% of its subscribers now stream movies and TV shows to connected devices. In fact, Netflix has been the beneficiary of a confluence of factors: financially strapped consumers have been foregoing expensive entertainment in favor of movies at home; the financial distress of Blockbuster, Hollywood Video and Movie Gallery have forced those companies to close thousands of stores over the past decade, with Netflix and Redbox filling the void; and, finally, high-bandwidth Internet connections have reached a market penetration of more than 70% and Netflix has made deals to stream its service to entertainment devices, including Internet-enabled TVs, DVD players and videogame consoles. Therefore, movie streaming is no longer limited to computers.

Because of these factors, sales and earnings for the company are expected to rise 30% and 42%, respectively, this year. That being said, because the industry is going through some significant changes, Netflix's DVD mail-order business will be obsolete within a few years. To replace that service, the company will have to depend on its digital streaming business. However, many highly resourceful companies will attempt to capitalize on the digital delivery of movies and TV shows. At this point, significant uncertainty exists as to the ultimate survivors in the digital streaming business and, therefore, it appears appropriate to apply a substantial 'uncertainty discount' to the company's valuation. Instead, Netflix's shares are currently trading at 4x the market multiple and at an all-time high.

Digital distribution clearly works in the studios' favor, as they can license the same content to multiple distributors and regain pricing power. Currently, Netflix's selection of streaming titles is rather poor, as the company has not obtained licensing rights for many high-quality movies, most likely because Netflix is unwilling to pay what the studios demand. The reason for this is obvious. When cable companies such as Comcast rent a video-on-demand movie to a subscriber, such a rental generates \$4.00-\$5.00 and the studios receive approximately two-thirds of this amount, or around \$3.00, as opposed to an estimated \$0.54 per Netflix stream. Therefore, it is highly unlikely that the studios will ever make enough recent releases available to Netflix at prices that will allow the company to continue to charge just \$8.99 per month for unlimited streaming while, at the same time, remaining profitable.

Consequently, in the digital market, Netflix will likely have to raise its monthly subscription prices significantly, if it is to be able to offer a wide selection of recent releases. If it does that, however, it may lose many subscribers to pirate sites such as BitTorrent, which would be a highly unfavorable development from the movie studios'

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point of view. More likely, Netflix may decide to focus exclusively on content that is many years old, which is what it is currently doing in its streaming business. Currently, Netflix's subscribers do not appear to be excessively concerned about this, perhaps because the company does offer this content (generally with a 28-day delay from release date) in its mail-order segment. However, once consumers have migrated to the digital streaming model and the DVD by mail segment is wound down towards the end of the decade, Netflix will be hard pressed to compete with burgeoning digital content offerings from Apple, Google, Amazon, Hulu, UltraViolet (an industry consortium) and other forthcoming digital services. Besides, by focusing exclusively on the older, cheaper streaming content, Netflix will become a niche player once the DVD mail order business declines. Thus, its service will likely lack mass-appeal. Because barriers to entry are much lower in digital delivery, more competition will likely limit subscriber growth and pricing power for Netflix. For example, companies exposed to DVD sales and rentals, such as Best Buy, Sears, Walmart, Amazon, and Blockbuster have all entered the digital distribution market as a hedge against declining DVD sales. While Netflix proved able to out-compete Blockbuster, the totality of these digital competitors will likely make the competitive environment considerably more intense.

Furthermore, Netflix does not own the delivery pipes nor the content it distributes. Rather, it is an intermediary in an industry with few barriers to entry, as far as the new business model is concerned. While the company has invested significant amounts into its mail order DVD business and brand name recognition, it is likely that its subscriber numbers will peak over the next 3-4 years and then start to decline as consumers migrate to digital streaming. Currently, Netflix is trying to be all things to all people in order to maximize its subscriber base, but at the end of the day, the streaming service will never have enough attractive titles for the subscribers who prefer new releases, as the addition of such titles would increase costs to the point at which subscription prices would have to be raised significantly, while the service will never be cheap enough for the subscribers who enjoy the older content, given that much of such content is available for free on sites such as Hulu.

Netflix is a well-managed company and the market is awarding it with a premium P/E multiple of 48x the current year's expected earnings. However, such a valuation appears to ignore the substantial risks involved in the transition from its traditional mail-order DVD business to digital streaming. In fact, nobody knows what Netflix's business model will look like 10 years from now, but it is a certainty that it will be much different. Even if Netflix is successful in meeting Wall Street's earnings estimates of \$4.64 per share in 2012, if its growth appears to be slowing at that time, which appears likely given the transition in business models and market saturation in the DVD mail order segment, it is likely that the forward P/E multiple the market is willing to pay for these earnings will contract.

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If Google, another company whose growth rates have declined recently, is a reasonable proxy, then one might expect a forward P/E of around 15x. As such, it is possible that Netflix can continue to grow as projected for the next two years, yet the shares could respond by declining 45% to \$70. In fact, to justify its current stock price five years from now, the market appears to price in a 35% penetration rate of US households for Netflix's services. Given the number of well-funded competitors in the streaming segment, this appears to be unrealistic. Consequently, shares of Netflix are hereby recommended for short-sale.

## Company Overview

### Background

Netflix was founded in 1997 in Scotts Valley, California by Marc Randolph and Reed Hastings, who previously had worked together at Pure Software. The Netflix website was initially launched in April 1998 as an online version of a more traditional pay-per-rental model, which included \$4 per rental, plus \$2 in postage. Also, late fees applied. Netflix introduced the monthly subscription concept in September, 1999. Since that time the company has built its reputation on the business model of flat-fee unlimited rentals without due dates, late fees, shipping or handling fees, or per-title rental fees. Furthermore, Netflix has developed an extensive personalized video-recommendation system based on ratings and reviews by its customers, similar to the system used by Amazon.com. Finally, in 2007, the company began to stream movies digitally to its subscribers over the Internet.

At one point, Netflix played a prominent role in independent film distribution. Through a division called Red Envelope Entertainment, Netflix licensed and distributed independent films such as *Born into Brothels* and *Sherrybaby*. As of late 2006, Red Envelope Entertainment also expanded into producing original content with filmmakers such as John Waters. However, Netflix announced plans to close Red Envelope Entertainment in 2008, in part to avoid competition with its studio partners.

Netflix's published subscriber count increased from one million in the fourth quarter of 2002 to around 5.6 million at the end of the third quarter of 2006, to around 15 million at the current time. The company's growth has been fueled by the fast adoption of DVD players by US households. In fact, the DVD player is the most successful product in the history measured by the number of units sold and household penetration and the time in which this was accomplished. Specifically, the DVD player had reached a 50% household penetration within five years. It is, therefore, no surprise that Netflix's success has coincided with the proliferation of DVDs, as the DVD format provides advantages over VHS. Most importantly, DVDs are much smaller than VHS tapes, making distribution via the postal service affordable. In fact, Netflix's business model would most likely not have worked with the much larger, heavier VHS format due to significantly higher shipping

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charges. In addition to its cost advantages, the DVD format also provides a superior home viewing experience, leading to increased consumer demand. Netflix has also benefited from the widespread adoption of the Internet, which has allowed its business model to flourish, as consumers can easily review, order, and comment on movie titles from anywhere with an Internet connection.

## Current Operations

Netflix provides an online subscription video rental service for more than 15 million subscribers across all 50 states. Of those subscribers, 61% streamed a TV episode or movie for more than 15 minutes during the second quarter, an increase compared to 37% during the same period last year. Users can view rented video content either on DVDs delivered through the mail or through a PC or streaming-enabled devices such as DVD players, TVs and game consoles. In the expectation that online viewing will dominate the video market in future, Netflix is currently expanding its online catalog, as evidenced by its recent content deal with EPIX. Netflix's pricing plans start at \$8.99 per month, which includes one DVD out at a time and unlimited streaming. For an additional \$2.00 per month, subscribers can get Blu-ray DVDs.

To expand its subscriber base, Netflix focuses on three broad categories: 1) the videogame consoles that have large installed bases and upgradeability over the Internet to include Netflix capabilities, 2) Blu-ray players, which are all Internet connected, as per the Blu-ray security specification and, therefore, relatively easy to upgrade to include Netflix capabilities, and 3) Internet TV, which is just emerging now, with companies such as Sony and VIZIO introducing Internet enabled TVs with applications, including Netflix capabilities. Combined, the number of DVD players, game consoles and Internet-enabled TVs sold every year is currently approaching 50 million units. With 110 million households in the US, Netflix's streaming service is likely already available to the majority of these households because of the adoption rate of these devices.

In addition to technological innovations, Netflix has also benefited from a favorable regulatory environment. The first sale doctrine is what enables rental companies to rent DVDs, and has been crucial to the rental business ever since VHS rentals began in the 1980s (more about that below).

So far, Netflix has been focused on bringing older movies and TV shows online. In fact, in exchange for a 28-day delay in renting new releases, Netflix has been able to license online content relatively inexpensively. However, if the company wishes to license relatively newer content for streaming, studios will likely demand higher payments for these titles, which may force Netflix to pass on cost to customers. Theoretically, Netflix could decide to offer tiered services, including a higher-priced service that includes new releases. That being said, higher prices to the consumer may tempt them to seek alternative, pirated, downloading options through bit torrent services, which would be negative for Netflix as well as the movie studios.

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As mentioned, to save money on licensing fees, Netflix generally focuses on older movies for its streaming service. Even for its mail-order DVD service, though, its subscribers usually have to wait for 28 days from the time a movie is initially released on DVD until it can be ordered on Netflix. This applies to movies from Universal Studios, Twentieth Century Fox and Warner Bros. but not Disney. Competitor Blockbuster is focusing in on this perceived weakness in TV ads by pointing out that its subscription service does offer some of those titles immediately after their release. Likewise, for its TV content, Netflix generally focuses on the prior season, as opposed to the current season.

Postage and fulfillment costs account for approximately 60% of Netflix's costs of service, while streaming bandwidth costs are likely just 2% of physical delivery. Therefore, if customers were to reduce their physical DVD viewing from five per month to three per month as a result of increased streaming, this would clearly help Netflix's profit margins in the short run. However, the offsetting dynamic is that the company pays comparatively very low fees to the Hollywood studios for its DVD service because of the First Sale Doctrine, whereas it will likely have to pay much more to the content owners when delivery takes place over the Internet. The reason it has not paid excessive fees to Hollywood so far is that it struck an agreement with Starz in 2008, which gave Netflix access to approximately 2,500 Disney and Sony movies for a small fraction of what Starz originally paid the studios. The studios most likely did not foresee that Starz could resell its rights in this manner and most likely did not condone it. Consequently, when this contract is inevitably renegotiated between Starz and the studios, it will almost certainly result in much higher content fees for Netflix.

## **Business Model Transition**

Technological progress is rapidly reshaping Netflix's competitive environment. While technological progress enabled it to compete successfully with Blockbuster, the continuation of this trend will result in the obsolescence of Netflix's traditional DVD-by-mail business sometime over the next decade. Once consumers can instantly access digital streaming services on their TVs, through connected DVD players, set-top boxes, game consoles or Internet-enabled TVs, they are unlikely to wait for 1-2 days for a Netflix DVD to arrive by mail. Rather, all of their content needs will be met by digital streaming and downloading.

However, it should be noted that streaming content over the Internet involves the licensing of rights which are separate from and independent of the rights Netflix acquires when obtaining DVD content. Therefore, studios and distributors have to license their content to Netflix specifically for Internet delivery. Unlike DVD rentals, streaming content is not subject to the First Sale Doctrine (which will be discussed later). As such, Netflix is

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completely dependent on the studio, or distributor, providing it licenses in order to access and stream content. Many of the licenses provide for the studios or distributors to withdraw content relatively quickly in they chose to do so. In addition, the studios have great flexibility in licensing content. They may elect to license content exclusively to a particular provider or otherwise limit the types of services that can deliver streaming content.

As a result of this, Netflix can clearly not offer all of its mail order DVDs as Internet streams because to license all of that content for Internet delivery would be cost prohibitive. The company would likely have to double its subscription prices, if not more, to accomplish this. However, if prices are raised markedly, current Netflix subscribers may instead opt to use pirated services, of which there are still plenty. Consequently, one would guess that Hollywood does not want Netflix to increase its prices too much, potentially sending consumers to pirated services. Therefore, it is likely that Netflix's existing pricing model is not transferable to the Internet segment, if the company also wants to please consumers by offering new releases. From the content owner's point of view, why would they allow Netflix to stream new releases to their subscriber-base of 15 million households without being adequately compensated for that? If 15 million households can view a new release through Netflix, which charges \$8.99 per month for unlimited streaming, then the content owner will most likely forgo a DVD sale to that particular household or a \$3.99 DVD rental. Thus, to make up for such a revenue shortfall, the content owner demands a significant license fee from Netflix, which it so far has generally been unwilling to pay. Furthermore, it is likely that content owners want to partner with distributors that have global reach, such as Apple, as compared to Netflix, which up until this point has focused exclusively on the US. Also, while Netflix is currently the only company with a monthly (unlimited) subscription plan, it is possible that several competitors may enter this business as well, in the streaming segment, if it continues to be successful. Furthermore, if the older content is that much cheaper to license than the new releases, it may only be a matter of time until the pricing structure for a-la-carte viewing reflects this, and it is possible for consumers to watch older movies for perhaps \$0.99 each. In that case, the benefit of a monthly subscription may be lost.

These examples indicate that nobody knows what Netflix's business model and competitive environment will look like ten years from now. The company's streaming service is currently of limited appeal because of a comparative lack of new content. In fact, the service is mostly made up of older movies and older TV shows, which are relatively inexpensive for Netflix to license, in addition to the approximately 2,500 titles it licensed from cable channel Starz in October 2008 in a deal that is most likely not repeatable (described below). In fact, out of the top 10 movie rentals at Blockbuster as of July 19th, 2010, and the top-10 DVD sales at Walmart.com as of the same date, Netflix had only one movie from each list available for streaming. This highlights Netflix's problem with content availability - the fact that content is much more expensive to license for streaming, and much of the most desired content is not even available to Netflix to license because of studios' pre-existing contracts with premier movie channels such as HBO, Cinemax, Starz,

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and Showtime. For example, Netflix has not been allowed to license any content from Warner Brothers because of a pre-existing contract with HBO (owned by Time Warner). In fact, most of the major studios are locked into multi-year agreements with the pay-TV channels to provide a five-year exclusive window on virtually all movie titles. Even if these contracts come up for renewal (most of the major studios will not be up for renegotiations until 2013 or later), Netflix will have to pay substantially more than they are now to win them. It is likely that HBO pays roughly \$1 billion per year for its contracts with Warner, Fox, Dreamworks and CBS Films. Netflix, with only \$2 billion in overall revenues, can obviously only spend a fraction of that amount on all of its content, DVD and digital.

Consequently, as a stand-alone product, Netflix's streaming segment is unimpressive, considering that it leaves out most popular titles in at least the first year of their release, and because of its strong concentration of TV shows, it is highly susceptible to competition from Hulu, or direct digital distribution from the TV networks. Both Hulu as well as networks such as ABC offer substantial content free of charge over the Internet. Moreover, a large percentage of Netflix's subscribers are not using its digital streaming service. This service is included in all of the unlimited plans, starting with the \$8.99-a-month offering that includes one DVD out at a time. Only around 60% of Netflix users took advantage of the streaming service during second quarter of this year, and those users watched "at least 15 minutes of streaming video", according to the company (no average was provided). While the percentage of subscribers using the streaming feature continues to inch higher with every passing quarter, it also shows that more than six million Netflix users either do not see the value in this feature, or just are not technologically able to get it working.

Furthermore, in its DVD mail order segment, Netflix has decided, in an effort to keep costs down, to offer new releases to its subscriber base 28 days after those movies are initially released on DVD. Even so, its subscriber base does not appear to be too discouraged by that, as it is only a 28-day delay, but in the streaming segment, movies can be delayed for years, to the extent that they ever become available. Thus, it will be difficult for Netflix to successfully make the transition to streaming only while retaining the same subscription model. It appears obvious that there is ample room for a better content aggregator to fill the void by offering new releases over the Internet at competitive prices, as well as access to older movies. Over time, a "cloud-based" business model will likely emerge successfully, such as the recently announced UltraViolet service, which will be described below. If physical media (DVDs and VHS tapes) are truly to be displaced by digital content, consumers would like to have access to their rightfully acquired digital movies and TV shows at all times and from all of their various devices such as TVs in each room of the house, PCs, iPads and cell phones. The technology for this exists today. For example, if one owns a Kindle, Amazon's book reader, one can read any books purchased on the Kindle on a variety of additional devices, such as iPad, smartphones or PCs. This is enabled through the Whispersync technology. Similarly, when one buys a digital movie in

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the future, that movie will be stored in the cloud as well and can be accessed anytime from any device. This is how the UltraViolet service will work.

## Starz Deal

Netflix was not particularly successful in acquiring online licensing rights until it discovered a loophole. Instead of negotiating directly with the movie studios, in order to license digital content, it contracted with movie channel Starz to buy the right to stream its movies. Starz had the pay-TV rights to newer titles, which Netflix lacked. In October 2008, the two companies announced a deal that added 2,500 titles to Netflix's online service offering. These movies were generally available to Netflix subscribers at the same time they were available on Starz. The movie studios were not happy as this resulted in more content being made available to millions of users for no incremental revenue to them and, in response, removed some of the content previously available to Netflix. As a result, it is possible that unhappy movie studios or cable companies will renegotiate their contracts with Starz to discourage it from working with Netflix. In either case, a deal of this magnitude does not appear to be repeatable by the company.

## EPIX deal

Netflix recently announced a deal with premium movie channel EPIX to stream some of the movies licensed to that channel. Movies from this deal will begin streaming from Netflix on September 1, 2010 and include movies from Paramount, Lionsgate and MGM. While financial terms were not disclosed, it is believed by media reports that Netflix will pay EPIX close to \$1 billion over the life of a 5-year deal. While this arrangement may make Netflix slightly more competitive with cable companies Video-on-Demand service (as well as similar online offerings), it is not designed to compete with Hollywood's DVD business. Netflix will still not be able to make these movies available to streaming subscribers until 90 days after they have reached EPIX's distribution window.

The so-called windowing system, the complicated schedule that governs which distributors can show which films and in which format, works as follows: first, national and international theatrical distributors pay to show a film in their theaters. Next, there are the DVD and pay-per-view windows, followed by the release on premium movie channels such as HBO, Starz, Showtime and EPIX. Each studio typically licenses its content to just one pay channel. For example, all Warner Bros. movies appear only on HBO, while Sony's are available on Starz. After a few months, the pay-TV networks hand off their rights to broadcasters and ad-supported cable stations. A few years later, the premium channels get the films back, giving them exclusive rights to air them. Consequently, the windowing system can keep films locked up for years. For example, Disney's *National Treasure: Book of Secrets* came out in 2007 and is tied up in this schedule until 2016. Unless Netflix can find a way around the windowing system, it will be a challenge to show any major movies that had been released in the recent past. A graph of the typical movie distribution windows is depicted below:

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	Year 1				Year 2				Year 3				Year 4				Year 5				Year 6				Year 7			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Domestic Theatrical	█	█																										
International Theatrical	█	█	█	█																								
Non Theatrical (Airlines, etc.)	█	█	█	█																								
Domestic Pay per view		█	█	█	█	█	█	█																				
Domestic Home Video		█	█	█																								
International Home Video		█	█	█																								
International Pay TV									█	█	█	█	█	█	█	█	█	█	█	█	█	█	█	█				
Domestic Network Cable													█	█	█	█	█	█	█	█	█	█	█	█				
International Free TV																	█	█	█	█	█	█	█	█				
Domestic Syndicated TV																									█	█	█	█

As EPIX is owned by three big studios — Viacom’s Paramount, Lionsgate and MGM — all of them are interested in maximizing their profit by retaining this windowing schedule. Consequently, from the time a movie is initially released on DVD for sale or rent, it could take six months to a year before that movie becomes available on premium movie channels such as EPIX, and Netflix’s subscribers will have to wait an additional 90 days from that time. Consequently, these movies will be rather old by the time they are available for streaming on Netflix and, as such, do not add to the appeal for subscribers interested in current releases. Furthermore, Netflix pays an estimated \$30 million per year for its Starz deal whereas it will pay an estimated \$200 million per year for the EPIX deal.

## Rapidly Emerging Competitors

Until this point, Netflix’s main competitor has been Blockbuster. Because of its superior business model, which does not require the capital intensity associated with thousands of DVD rental stores, Netflix has unquestionably emerged victorious in that battle. Perhaps one contributing reason for its success was that the company could offer its subscribers a better selection than Blockbuster, with over 100,000 available titles, as well as all new releases. In the digital world, the competitive situation is much different, as Netflix needs to acquire licensing rights for each movie or TV show it intends to make available for streaming to its subscribers. The average Netflix subscriber watches five movies per month, under the current DVD mail order model. Assuming these viewing habits will hold for the online segment as well, and assuming further that cable companies such as Comcast and digital distribution companies such as Apple (with its iTunes offering) rent these movies to its customers for \$4.99 each, which appears to be the current price point, the average Netflix subscriber would then get around \$25 worth of movie rentals per month. However, Netflix’s current price for unlimited streaming of just \$8.99 per month would,

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theoretically, result in significant savings for the Netflix subscriber and significant amounts of lost revenues for the movie studios.

In reality, movie studios realize that a movie titled licensed to Netflix for streaming will result in fewer DVD sales, DVD rentals and fewer \$4.99 digital rentals by companies such as Comcast and Apple. Since the movie studios generally retain about 65% of the \$4.99 price to the consumer, the revenue impact can be significant. Therefore, it appears to be inevitable that studios will ask for licensing fees that are high enough to compensate them fully for these lost revenue streams. The end result will likely be that either Netflix does not offer any recent releases (or very few) for streaming and keeps prices low, or it will have to charge its subscribers upwards of \$25 per month for unlimited streaming of old and current releases. Alternatively, the company can have both a budget and a premium plan, with only the latter offering new releases. Even so, the company would lose its competitive advantage, since its prices would be commensurate with those of cable companies or iTunes, etc. , which charge users only for the movies they actually rent, as opposed to a fixed amount for movies one may or may not end up renting.

Furthermore, Netflix's distribution advantage will fade as online movie delivery gradually replaces DVDs. Because barriers to entry are much lower in digital delivery, more intense competition should limit subscriber growth and pricing power for Netflix. In fact, the transition from DVDs to digital delivery is likely to disrupt many companies over the next few years.

The current competitors for Netflix are:

## Blockbuster

While Blockbuster's traditional rental business proved inferior to Netflix's business model, it is now offering a very similar DVD-by-mail service to its estimated two million subscribers (the company does not disclose subscriber numbers). Netflix currently offers a subscription base plan for \$8.99 per month with a Blu-ray Disc option for an extra \$2.00 per month, which allows subscribers to have one disc out at a time but unlimited rentals per month. Blockbuster's base plan is also \$8.99 per month for one disc out at time with no additional costs for Blu-ray discs. While both Netflix and Blockbuster allow subscribers to choose from their libraries of titles online, Blockbuster also allows subscribers to pick up those titles, once selected, from local kiosks. Netflix, on the other hand, is a "virtual" store with no retail stores or kiosks. Both options have quick delivery time (1-2 days) and close to 100,000 titles (some in Blu-ray).

As far as digital delivery, both Netflix and Blockbuster offer titles on demand to Blu-ray players and HDTVs over the Internet. However, Blockbuster also offers video-on-demand, including all the latest releases, for \$3.99 per rental, whereas Netflix's allows unlimited streaming at no extra charge, albeit with generally much older movies and TV shows. An advantage with Blockbuster's DVD-by-mail model is that it offers current releases without

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delay, whereas Netflix delays new releases by 28 days in most cases before offering them to its subscriber base. Finally, Blockbuster on the Internet is the only online service that offers video game rentals in addition to movies. Clearly, Blockbuster is now more competitive than it has been.

## Amazon.com

Amazon.com has a streaming offering with over 75,000 digital movies and TV shows on demand. Consumers can access the services either over the Internet or by using a device connected to their TVs, such as the Roku set-top box, which also enables consumers to access Netflix's streaming services. In addition, TVs and auxiliary devices from Panasonic, Sony, TiVo, Samsung and Vizio also enable consumers to access the Amazon service. New digital movie releases are generally available to rent for \$3.99, or for purchase for \$14.99

## Google – YouTube

Google has at least two different services that can be considered Netflix competitors. First, its YouTube segment continues to dominate the web. While the site is dominated by short amateur videos, almost fifteen billion videos were watched on YouTube in May, 2010, which is approximately equivalent of 43% of all videos watched online at all US websites. With the infrastructure in place, it is possible that YouTube could become a dominant force in online premium video as well if it can get people to cross the divide from consumer-created video to premium content. In fact, there is already some premium content on YouTube, such as its IPL (Indian Premier League) cricket streams, which approached 50 million views earlier this year with viewers from 200 countries. In addition, there are some streaming movies available such as *Casino Royale*, *Precious*, *Reservoir Dogs*, and *Cliffhanger*. With a well-known brand name, Google could turn YouTube into a Netflix competitor in the near future.

However, perhaps the most significant new entry into the TV content aggregation business is Google TV. Google recently introduced its Android 2.1-based Smart TV platform, known as Google TV, claiming that the platform will combine the best of the web with the best of TV. The product is expected to be available to consumers in the fall of 2010. Google TV features a search box similar to the one on Android-based smartphones. For example, one could enter the name of the TV show "House" and in response receive search results including Hulu, Fox.com and Amazon. Hulu and Fox.com will provide the show (or entire seasons of the show) at no charge, albeit with plenty of commercials inserted, though fewer than in regular TV broadcasts. Clicking on the Amazon search result leads to the website of Amazon's VOD service, which is commercial-free but will cost consumers \$1.99 per episode. Thus, consumers have a choice of either watching the show for free with commercials, or paying a small fee to avoid the commercials.

Google's primary partner for the initiative will be Sony, which will produce a full line of connected television sets (equipped with Android code) that integrate Google TV, as well

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as a Blu-ray player with the platform available in the fall. Also, Logitech will be producing a companion set-top box that will enable users with ordinary TVs to access the platform. While GoogleTV could be considered the mainstay platform for third party apps such as Blockbuster, Vudu and the upcoming Best Buy outlet, CinemaNow, it could negatively affect Netflix by making a-la-carte movie offerings from its competitors more widely available.

## Redbox

Redbox has about 24,000 rental kiosks nationwide, renting DVDs to consumers for \$1.00 per day, and is currently dominating that market. Shoppers rent discs by swiping a credit or debit card and users like the convenient location of these kiosks, which are generally located inside and outside of grocery and convenience stores. Technicians in Redbox's offices monitor the machines, which hold multiple copies of films and up to 630 DVDs, for jams and other troubles. Redbox is not, however, streaming movies to consumers' TVs or game consoles yet, but has a large customer base that prefers to pay \$1 per day to rent a movie rather than paying monthly membership fees for services they might not use.

It is possible that Redbox is considering a technology company known as Sonic Solutions Inc. to offer its digital services, as such an agreement would spare Redbox the time and cost of negotiating Web rights with studios. Sonic's technology is already installed in DVD players and TVs, and it has digital distribution rights to thousands of movies. Sonic currently provides technology and a library of about 20,000 movie titles to clients including Blockbuster, Best Buy and Sears. This is just one example of how low the barriers to entry are in the digital movie streaming business. However, the common factor is that the studios generally receive much higher compensation relative to the DVD-by-mail or Netflix's streaming business.

## HBO and Premium Channel Competition

During the established schedule for movie releases, after the movie has been available for rent or for sale for a certain time period, premium movie channels such as HBO generally pay movie studios significant amounts for the right to air these movies early, sometimes exclusively. For this reason, Warner Brothers (which owns HBO) cannot license its digital content to Netflix, since it already has an agreement with HBO. As the industry transitions to digital distribution, HBO is adapting by offering HBO Go, a video-streaming service available to its approximately 38 million cable subscribers (who pay for HBO or its sister service Cinemax). HBO Go provides subscribers Web access to the same movies and TV shows that HBO shows on cable TV at no extra charge. The intent of this service appears to be to build a Netflix Web-streaming competitor. Considering that HBO Go will be able to offer access to newer titles than Netflix, which, at least for now offers only older catalog films on its streaming service, HBO Go could become a significant competitor to Netflix.

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## Hulu

Hulu, owned by News Corp, Disney and General Electric's NBC Universal division, is an online video service that streams primarily TV shows and a handful of movies. Hulu is currently advertising-supported and is generally provided free of charge to the consumers. That being said, the company recently announced a new subscription-based service, Hulu Plus, priced at \$9.99 a month. For this fee, Hulu Plus subscribers will have access to all seasons of TV shows from NBC, ABC and FOX, whereas Hulu's free version only offers a limited number of episodes from each show. Hence, the subscription service would greatly increase content availability. Since Hulu is owned by three large media companies that can be expected to invest heavily to expand the subscription service if it performs well, it is likely to acquire more content and expand distribution services to more devices and platforms.

In addition to Hulu, networks can also approach consumers directly. For example one can download the ABC Player app for iPad and watch full streaming episodes of all ABC shows (with ads) without registration, fees, or any other commitment. While most networks have apps, not all of them offer as much content yet, but it may just be a matter of time until one can also watch new and old content from CBS, NBC, Fox, HBO, Comedy Central by using their respective apps. The barriers to entry seem to be falling fast, and as Netflix's streaming service is highly dependent on older TV shows, it is clearly vulnerable to such a development.

## CinemaNow

This service has 20,000 digital titles available for rent or purchase. Originally marketed by Sonic Solutions (makers of Roxio software), CinemaNow is currently used by Best Buy as its main entry into digital movie sales and rentals, as well as by Blockbuster. The company generally charges \$3.99 per rental and \$19.95 to buy new releases. CinemaNow is expected to be embedded on 30 million devices, including Blu-ray Disc players, by June 2011. Finally, Sears announced in June that it also plans to sell and rent movies online through an agreement with Sonic.

## UltraViolet

Approximately 60 entertainment and technology companies from around the world are working together to create a new approach to digital entertainment using cloud-based technology. Under the "UltraViolet" brand name, consumers will be able to rent and purchase movies at their choice of participating retailers – including stores with whom they already have relationships. Their accounts with those retailers will then be linked to an UltraViolet Account so that when consumers make a purchase, a right is automatically added to their UltraViolet Account. For instance a consumer with an Ultraviolet account can buy a copy of a film, store it in a "digital locker" and then view it in various ways from a cable company's video-on-demand service, Internet enabled TVs and DVD players as well as game consoles and iPads or smartphones. Additionally, for families, individuals' own retail shopping accounts will all be linked to the family's shared UltraViolet Account.

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While most large technology and media companies are included in the UltraViolet initiative, there are two notable exceptions - Walt Disney and Apple Inc. Disney is developing a competing system called KeyChest, while Apple sells songs and videos in proprietary formats through its iTunes Store. While the service is not available yet, it clearly has the potential to become a formidable competitor to Netflix.

## Vudu

Wal-Mart recently acquired Vudu in an attempt to offset declining in-store DVD sales with digital sales and rentals. Vudu provides 16,000 movies for rent or purchase in HD quality, with Dolby Digital Plus 5.1 surround sound, unlike Netflix, which still lacks 5.1 surround sound. Older movies can be rented for \$1.00 while new releases can cost as much as \$4.99. Vudu is supported by LG, Mitsubishi, Samsung, Sanyo, Sharp, Toshiba and Vizio, which integrate the Vudu player in their DVD and TV offerings.

## mSpot

mSpot primarily offers movies to mobile devices such as iPads and smartphones. For example, the new iPad-optimized version of the mSpot movie streaming app as well as iPhone and Android apps allow users to rent streaming movies that are generally considerably newer than the selection available at Netflix's streaming service. For between \$2.99 and \$3.99 users can rent and watch a movie streaming over either 3G or WiFi. Users can also rent movies on their home computer, pause them there, and then resume playback on an iPad, iPhone or Android device right where it was left off. The mSpot service currently offers about 1,200 titles. mSpot has had a movie service for almost four years on smartphones, and in its experience, the majority of its mobile movie rentals are new releases. As such, the company has reached the conclusion that it can always back-fill the library, but its primary focus will be in the new-release window. mSpot has announced that it is considering an unlimited streaming subscription plan that is similar to Netflix's, but that it needs to get more movie studios on board with its rental streaming service first.

## Apple

Over the past five years, Apple has sold its products (iPod, iPhone, iTouch, iPad, Macs) to millions of consumers. Along with the hardware devices, consumers have also grown accustomed to iTunes, which allows consumers to seamlessly download audio and video content. Accordingly, Apple's installed base of devices provides content owners a huge platform to reach consumers. However, the company has been less successful with Apple TV, the company's standalone set top box geared toward viewing content on the television screen. That being said, considering the popularity and familiarity of iTunes, Apple would likely have an advantage over these companies if it decided to focus more on this segment. It appears as if Apple is negotiating with television studios to allow it to offer TV rentals for just \$0.99 each on Apple TV. Currently, Apple offers consumers television shows on its Apple TV set-top box for \$1.99 for standard-definition episodes, and \$2.99 for high-definition episodes. With its ability to reach a wide audience worldwide, one can easily imagine that Apple would make a desirable distribution partner for Hollywood studios as

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well as TV networks. While there is little evidence of this yet, it appears unlikely that Apple would not attempt to become more established in this industry.

## Cable Companies

As media companies attempt to maximize the profits generated by their content, the current business environment, with Netflix and Redbox partly responsible for the decline of Blockbuster and, in turn, a significant decline in rental revenues, has been less than ideal. In addition, declining DVD sales and piracy are making the situation worse for content owners. Partly in response to this, several studios recently introduced a 28-day delay in making programming available for rental on Netflix and Redbox. Compared to rental distributors like Netflix, content owners can generally generate higher profits from cable providers, because of their bulk carriage capacity and higher on-demand pricing. Comcast and other cable providers have been distributing video content over their networks for decades and have established strong ties with studios. They can use these relationships to acquire on-demand rights to more content. Since cable companies are likely willing to pay more for the video-on-demand content that they acquire, they might influence content owners to provide exclusive distribution rights, albeit for a short period of time. The reason cable companies have well-established relationships with the film studios' parent companies is that five of the six major film studios (Sony being the only exception) are owned by companies that also own media and cable networks. Additionally, according to the National Cable & Telecommunications Association, more than 42 million households subscribe to digital cable. Having these hardware devices installed in millions of homes is a great advantage in the digital movie distribution business. Not only does this guarantee that cable customers will have access to their content, but it also gives them the best opportunity to help the studios control piracy.

## First Sale Doctrine

From the content industry's point of view, the fact that the number of Blockbuster DVD rentals has declined, as consumers instead use the \$1 per day rentals offered by Redbox and the \$8.99 per month unlimited rentals from Netflix, has resulted in significantly lower revenues. In fact, depending on how retailers, kiosk competitors and consumers respond in the coming months, industry revenue losses caused by this displacement could be as low as \$200 million or as high as \$2.2 billion, according to a report from the Los Angeles Economic Development Corp. Overall, DVD sales in the United States have also slowed significantly over the past few years. For example, in 2009, they declined 13% to \$8.73 billion, compared to \$10.06 billion in 2008. Partly responsible for this was the success of Redbox.

In fact, in 2009, Redbox's \$1 a day rentals accounted for nearly 20% of all money spent on DVDs. The movie studios responded to this declining profitability by strong-arming

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wholesalers to not sell DVDs to Redbox. Redbox responded by sending employees to Target and Wal-mart to buy DVDs in bulk. While somewhat absurd, this is completely legal under US copyright law. It is important to note that both Netflix and Redbox benefit from a section of the US copyright law known as the First Sale Doctrine, which allows them to purchase DVDs and rent them out without having to pay the content owner for more than just the initial purchase of the disc.

The first sale doctrine allows anyone who buys a DVD to sell, exchange, rent, or lend it to others, without paying the content owner. Therefore, rental companies like Netflix, Blockbuster, and Redbox can buy DVDs from the cheapest source and rent them as they please. Although these companies usually work directly with the studios, they still have the option to acquire content through a middleman (distributor, wholesaler, retailer) if necessary. As a result, the rental companies have had the upper hand in negotiations up to this point. It has been estimated by Morningstar that Netflix pays the studios on average \$0.54 per DVD shipped, which should be compared to the \$2.50 - \$3.50 studios receive from a digital a-la-carte rental, such as through iTunes or a cable company's video-on-demand service. The reason for the wide discrepancy in pricing is that first sale doctrine only applies to physical products (DVDs, books, etc.), and does not apply to electronic (digital) copies. Therefore, to an extent, the movie studios were held hostage to a business model that clearly favored Netflix and disfavored the studios. Now, however, a company wishing to rent out digital movies cannot simply buy digital copies at the lowest possible price and rent them to a large subscriber base.

Consequently, with online streaming, Netflix has no longer the same advantage it has enjoyed for years in the DVD mail order business. Rather, Netflix needs to craft more-complicated licensing deals. These negotiations are likely difficult as, if Netflix pushes too hard or offers the wrong incentives, the studios could potentially block Netflix from getting attractive content. Contradistinctively, if Netflix is not aggressive enough, Hollywood could impose intolerable rules regulating when a movie could be shown, on which platform, and for what price. As a result, it appears that the studios will inevitably regain some pricing power as the movie rental business moves to digital distribution, leading to higher content costs for Netflix.

## **Canadian Expansion**

An interesting development that should be monitored closely is Netflix's imminent plan to commence a streaming-only service in Canada. Since the company will not offer its successful DVD-by-mail service in Canada, this will provide an indication of the attractiveness of its digital library of generally older movies and TV shows. Netflix has not yet set a price for this service. As, over time, the company's traditional DVD-by-mail business will likely be wound down in the US, in favor of digital delivery options, the Canadian business will, in a way, provide an indication of how the future subscription

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plans will be priced and how valuable consumers consider the streaming content to be. The company does not offer a “streaming only” plan in the US yet, but it most likely will at some point in the not too distant future.

After the expansion to Canada, some speculators believe that Netflix's next expansion will be to enter the UK market, as the service is best suited for English-speaking countries. However, that market is already dominated by a company known as LOVEFiLM, Europe's leading online DVD rental subscription service, with over one million members in the UK, Sweden, Norway, Denmark and Germany. LOVEFiLM UK carries over 65,000 unique titles, including video games. We note that one of LOVEFiLM's major investors is Amazon.com.

## **Growth May Not Last Much Longer Due to Saturation**

Netflix has grown rapidly in the past 10 years, to the point at which the company now has 14% of US households as paying subscribers. With approximately 114 million households in the US, it is unlikely that Netflix will ever penetrate much more than half of the market, as some of these households do not watch much television at all, while others prefer cable TV or lack the required technology or know-how to use Netflix services. Assuming that the company's services will never appeal to more than 50% of households, it will never have more than 57 million subscribers (as there is no reason to assume that there is more than one unique subscriber per household). Consequently, continued growth will be increasingly difficult to obtain. In fact, in order to achieve its 15 million subscribersbase , Netflix had to acquire over 28 million subscribers (some have since left). Therefore, it appears that most potential subscribers are already active subscribers, or have tried the service and decided against continuing as subscribers.

Even so, assuming that Netflix's installed base of subscribers will double to 30 million over the next two years (in other words, its recent 42% annual subscriber growth continues for two more years), it would likely have churned through approximately 50 million households to reach that number, or more than two-thirds of its entire addressable market. At that point its potential household base will be almost completely saturated and growth rates will most likely slow considerably, or even turn negative. Consequently, it is likely that Netflix will be challenged to grow at its current pace for more than two additional years and, in response, its premium valuation should soon collapse.

In addition, there is evidence that a great number of subscribers are choosing the cheapest plan available, the \$8.99 per month plan. This is evident since Netflix's subscriber count expanded by 35% over the past year while its revenue growth was only 25% in the same time frame. With the cheaper plan, it appears that subscribers are getting by with just one disc out at a time as long as they have access to the streaming content.

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## Share Buybacks

It is noteworthy that Netflix has been an active repurchaser of its shares. In fact, since January 1, 2007, the company has reduced its share count by approximately 15 million shares, or 22%. Naturally, these repurchases have boosted earnings per share growth over the past three years. While share repurchases, in general, could be considered an indication of financial health and optimism about the future, we note that Netflix has spent \$777 million on these share repurchases since January 1, 2007, despite generating just \$311 million in free cash flow over that time period. In fact, last November, the company issued its first long-term debt of \$200 million and used part of the proceeds to repurchase stock. The share buybacks and free cash flows have been as follows:

	<u>Share Buybacks</u>	<u>Free Cash Flow**</u>
2007	\$99.9	\$46.1
2008	\$199.9	\$95.7
2009	\$324.3	\$97.2
2010	\$152.9*	\$72.1*

(In millions. \*first half of 2010. \*\* defined as cash flow from operations minus capital expenditures and acquisition of content library, plus sale of DVDs)

## Sensitivity to Postage Rates

Given its current business model, which is dominated by DVD rentals by mail, it should be no surprise that approximately 60% of Netflix's cost of revenues is made up of postage fees, with the remainder being licensing fees for content and DVD purchases. Consequently, since the US Postal Service has proposed a \$0.02 increase in postage, effective January 2, 2011, this will actually have a meaningful impact on Netflix's earnings. Two cents on 15 million subscribers, receiving five DVDs per month through the mail, amounts to \$36 million per year, given that Netflix pays for the postage both ways. Given that the company is only expected to earn approximately \$200 million next year, the postage increase will, ceteris paribus, result in an after-tax earnings decline of 11% next year. Yet, Wall Street's earnings estimates for Netflix have not been revised lower since this rate increase was announced; rather they have been revised higher. Furthermore, since Netflix's subscriber count should continue to increase in 2011, perhaps the cost increase will be substantially higher.

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## Valuation

### Relative Valuation

While there is clearly significant uncertainty about what Netflix's business model will look like ten years from now, the market is willing to pay valuation multiples that exceed those of well-established Internet companies that have significantly less uncertainty associated with the longevity of their business models:

Company	Symbol	Price	2010 P/E	2011 P/E	EV/ Sales	Price/ Book	EV/ FCF	Market Cap.
Amazon	AMZN	\$126.00	48.3x	35.5x	1.58x	9.78x	26.2x	\$57.3B
Apple	AAPL	\$260.00	16.6x	13.7x	2.79x	5.59x	13.7x	\$241.0B
eBay	EBAY	\$21.00	13.0x	11.8x	2.73x	1.92x	12.7x	\$27.3B
Google	GOOG	\$500.00	18.3x	16.0x	6.13x	3.92x	14.4x	\$159.0B
Priceline.com	PCLN	\$295.00	24.4x	20.1x	4.60x	10.83x	24.6x	\$15.0B
Yahoo	YHOO	\$14.30	20.7x	19.1x	3.57x	1.60x	23.5x	\$19.9B
			23.5x	19.3x	3.6x	5.6x	19.2x	
Netflix	NFLX	\$134.00	47.7x	35.4x	3.3x	41.1x	26.0x	\$7.3B

As this table indicates, Netflix generally trades at multiples that exceed the averages of this peer group of established Internet companies. The logical conclusion of this is that Wall Street has placed great expectations upon Netflix, which the company may be able to meet over the next year or two. Thereafter, however, growth will likely moderate, or even turn negative. This will partly be a result of market saturation and partly a result of the company's transition to streaming and the intense competition in that business.

As such, it is not difficult to imagine that Netflix's 2012 earnings will not grow significantly from the \$3.78 per share expected in 2011. However, even if the company meets Wall Street's earnings expectations of \$4.64 per share in 2012, the market will likely be hesitant to place a multiple upon those future earnings that is materially higher than the multiple currently placed upon eBay, or roughly 12x forward earnings. This would result in a stock price of only \$56 for Netflix, a decline of 55% from the current level. eBay is still expected to grow around its revenues and earnings at approximately 10% per year whereas Netflix may be hard pressed to grow even at this rate in 2012 and beyond. It is noteworthy that Google had a P/E of approximately 100x 5-6 years ago, but earlier this year traded at close to 10x forward earnings, even though its growth continued throughout the period and it is expected to grow revenues and earnings at 15-20% in each of the next two years. Consequently, at 45x the current year's expected earnings, Netflix's shares appear to be priced for perfection, such that a slowdown in its growth rates could easily cut its P/E ratio in half.

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Alternatively, the market is effectively paying almost \$460 per subscriber for Netflix's 15 million subscriber base, which could be compared to around \$5,000 per subscriber for Cablevision and \$885 per subscriber for satellite TV company Dish Network. Given Netflix's vastly lower average cash flow collected per subscriber (around \$150 per year), compared to \$2,000 per year for Cablevision and \$877 per year for Dish Network, the valuation appears to be even less justified in Netflix's case, given that the two latter companies own their distribution networks in addition to some of the content they distribute, whereas Netflix is strictly an intermediary. Alternatively, Netflix trades at an enterprise value to sales ratio of 3.1x compared to 2.5x for Cablevision (a recent subject of this report) and 1.0x for Dish Network.

## Profit Margin Contraction

According to Adams Media Research, studios generally retain approximately 65% of cable video-on-demand revenues. Assuming an average price point of \$5 for the rental of one digital movie, the studios would then receive \$3.25 per movie. Morningstar estimates that Netflix pays the studios just \$0.54 per movie. The primary difference is that video-on-demand titles viewed on cable are primarily new releases, whereas about two thirds of Netflix's rentals are inexpensive, catalog titles. However, since Netflix will soon become more reliant on its streaming business, the company will likely have to pay significantly higher content fees to the studios to license attractive content (i.e. more recent releases). However, if Netflix pays studios \$1.50-\$2.00 per movie streamed, its profitability would decline dramatically to the point at which the company will start to lose money if the average subscriber watches around 5-6 digital movies per month (at a cost of \$9.00) while only paying \$8.99 in subscription fees. While this is unlikely to happen in the near-term, as DVD shipments are still increasing, albeit at a rate that is slower than management originally expected, it is likely that DVD shipments will peak around 2012-2013.

At that time Netflix's subscriber growth will begin to deteriorate, since competition in the online segment is much more intense because barriers to entry are almost non-existent, compared to the DVD mail order business. This will lead to higher churn rates, lower revenues per customer, lower or non-existent revenue growth and, therefore, lower earnings and potentially negative earnings trends, which will disappoint Wall Street. There are already signs of this trend as, in the most recently reported quarter, compared to the prior quarter, Netflix reported higher average subscriber acquisition cost, higher number of cancellations, lower new gross subscribers, lower net new subscribers, and lower average subscription revenue per user. Alternatively, one could say that it is becoming increasingly difficult and more expensive for Netflix to acquire new customers, who are paying less on an average, and are more likely to cancel their service. In fact, the average monthly subscription fee per subscriber has decreased from \$17 in 2005 to \$13 in 2009 and \$12 in the most recent quarter.

## Scenario Analysis

Even using very optimistic assumptions, Netflix's shares do not appear to be inexpensive. For example, HBO and Cinemax have a combined 38 million subscribers. An assumption

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that Netflix will also reach 38 million subscribers by 2015 must, therefore, be considered quite aggressive. Furthermore, we assume that the average revenue per subscriber will decline from around \$12.00 now to \$9.50 per month, over the next five years, since there has been a strong shift in subscriber preferences to choose the cheapest \$8.99/month plan and pricing pressure should intensify over the next few years. Also, we assume that the EBITDA margin will not decline significantly, even as the company must invest substantial amounts in digital licensing rights as well as technology to accommodate increasing subscriber numbers and increased data storage/network capacity to stream its movies to an increasing number of streaming subscribers. Using these assumptions, the following table can be constructed:

	2008	2009	2010	2011	2012	2013	2014	2015
<b>Average Paid Subscribers</b>	8.27	10.58	14.7	19.8	25.8	31.0	35.6	38.0
<b>ARPU</b>	\$13.75	\$13.15	\$12.50	\$11.00	\$10.50	\$10.00	\$9.75	\$9.50
<b>Revenue</b>	\$1,364	\$1,670	\$2,205	\$2,620	\$3,251	\$3,715	\$4,165	\$4,332
<b>Revenue Growth</b>	13%	22%	32%	19%	24%	14%	12%	4%
<b>EBITDA Margin</b>	27%	27%	27%	25%	25%	25%	24%	24%
<b>EBITDA</b>	\$368	\$458	\$595	\$655	\$813	\$929	\$1,000	\$1,040
<b>Cash Taxes on EBITDA (40%)</b>	\$147	\$183	\$238	\$262	\$325	\$371	\$400	\$416
<b>Tax shield of D&amp;A</b>	\$97	\$103	\$119	\$122	\$133	\$144	\$150	\$155
<b>Less: CapEx per Subscriber</b>	\$5.30	\$4.34	\$2.65	\$2.60	\$2.50	\$2.25	\$2.20	\$2.00
<b>Total CapEx</b>	\$44	\$46	\$39	\$52	\$65	\$70	\$78	\$76
<b>Acquisition of DVD library:</b>								
<b>DVD spend /average sub.</b>	\$22.67	\$18.24	\$13.00	\$11.50	\$10.50	\$9.50	\$9.00	\$8.75
<b>Total DVD acquisition cost</b>	\$187	\$193	\$191	\$228	\$271	\$294	\$320	\$332
<b>Plus: DVD sales</b>	\$18	\$11	\$20	\$25	\$30	\$35	\$40	\$43
<b>Free Cash Flow</b>	\$105	\$150	\$266	\$260	\$315	\$372	\$391	\$413

(in millions, except for per subscriber data)

As the table above indicates, even using fairly aggressive assumptions for the next five years only results in free cash flow of just over \$400 million for 2015. Given Netflix's current enterprise value of around \$6.8 billion, the company is trading at almost 17x this number. By comparison, eBay currently trades at approximately 10x the free cash flow it generated in 2009 and Yahoo trades at 18x its 2009 free cash flow. Consequently, assuming the growth projections outlined in the table above will materialize, if Netflix in 2016 trades at the average of Yahoo's and eBay's trailing multiples, at 14x free cash flow, its shares will decline slightly to \$106 over the next six years, even though the company will continue to grow rapidly, in spite of intensifying competition. To justify this stock price, Netflix would need to attain a market share of approximately 35% of US households by 2015. If Netflix fails to meet these aggressive growth estimates, its P/E multiple may contract significantly when Wall Street's focus shifts from near-term momentum to the longer-term concerns, such as increasing competition, content cost inflation, declining

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average revenue per subscriber, and rising subscriber acquisition costs. Besides, since Netflix's streaming service focuses on older content, it will likely become a niche service that lacks mass-appeal. Therefore, with intense digital competition offering new releases and many new business models likely to emerge, a 35% household penetration rate for Netflix appears to be unrealistic.

## **Investment Summary**

Netflix's has grown rapidly over the past 10 years as its business model proved to be superior to that of Blockbuster. Because of this, the latter is now on the verge of bankruptcy and has closed approximately 1,000 stores in the past 18 months. The end result has been a significant shift in customers away from Blockbuster in favor of primarily Netflix and Redbox. However, Netflix does not meet the needs of most Blockbuster customers and does not intend to do so. Blockbuster has traditionally focused on having new releases in stock, whereas Netflix has focused on older, cheaper, content. In fact, Netflix is prevented from offering most DVDs by mail until those movies have been released for at least 28 days, and its online offering only includes a few of the most popular movies released in the past year. Consequently, with Blockbuster reducing the size of its organization, there is an untapped need from consumers to watch recent DVD releases, and this need can be satisfied through a-la-carte digital streaming through a number of companies.

The shift away from physical DVDs to the digital distribution of movies should allow the movie studios and TV networks to regain some pricing power as the First Sale Doctrine does not apply to digital media. As a result, Netflix will likely have to pay more for its digital content, relative to its physical DVD content and, therefore, its profit margin should be negatively affected over the next few years as this transition takes hold. Ultimately, Netflix will be at a disadvantage since it neither owns the delivery mechanism nor the content it distributes. On the other hand, with media networks and cable networks controlling the major movie studios, one cannot expect those companies to offer Netflix the same content with the same terms at a lower price than the \$4-\$5 per viewing charged by the cable companies. Consequently, as far as the digital streaming operations are concerned, Netflix will likely never be able to offer a significant amount of recently released movies but, rather, focus on the 'long-tail' with predominantly older movies. Since this will put Netflix in a niche, particularly given the strong competition, it is unrealistic to assume that the company can reach a household penetration rate of over 35% over the next five years, which appears to be the level anticipated by Wall Street to justify the current stock price.

Instead, Netflix's DVD-by-mail business should be in significant decline five years from now, as digital movie distribution is a superior business model. Consequently, it is highly

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likely that its growth rates will be flat, or even negative at that time, given the limited appeal of its streaming business and the competition that segment is subject to. Therefore, since the Netflix's stock price appears to completely price in all the significant gains over the next five year period, the company's shares are unlikely to increase significantly from current levels even if it manages to grow as rapidly as projected by Wall Street. If, instead, as we propose in this report, its growth rates will slow significantly in 2012 and beyond, its P/E ratio can easily be cut in half the expected growth prospects get called into question. The fact that nobody knows what Netflix's business model will look like ten years from now should result in a discounted valuation. Instead, the shares are trading at an all-time high with a P/E multiple of 48x this year's expected earnings. Furthermore, there is no discount applied for the strong likelihood that Netflix will experience significant content cost inflation as studios exercise more control over digital supply. Consequently, with limited upside and significant downside risk, Netflix's shares are recommended for short-sale.

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**Netflix, Inc.**  
**Condensed Consolidated Balance Sheets**  
**(unaudited)**  
**(in thousands, except share and par value data)**

	As of	
	June 30, 2010	December 31, 2009
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$107,327	\$ 134,224
Short-term investments	171,758	186,018
Current content library, net	93,123	37,329
Prepaid content	33,837	26,741
Other current assets	35,173	26,701
Total current assets	441,218	411,013
Content library, net	94,666	108,810
Property and equipment, net	123,292	131,653
Deferred tax assets	21,951	15,958
Other non-current assets	12,845	12,300
Total assets	<u>\$693,972</u>	<u>\$ 679,734</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$120,031	\$ 91,475
Accrued expenses	34,746	33,387
Current portion of lease financing obligations	1,971	1,410
Deferred revenue	101,419	100,097
Total current liabilities	258,167	226,369
Long-term debt	200,000	200,000
Lease financing obligations, excluding current portion	35,185	36,572
Other non-current liabilities	23,980	17,650
Total liabilities	517,332	480,591
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$0.001 par value; 160,000,000 shares authorized at June 30, 2010 and December 31, 2009; 52,358,171 and 53,440,073 issued and outstanding at June 30, 2010 and December 31, 2009, respectively	52	53
Accumulated other comprehensive income, net	802	273
Retained earnings	175,786	198,817
Total stockholders' equity	176,640	199,143
Total liabilities and stockholders' equity	<u>\$693,972</u>	<u>\$ 679,734</u>

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**Netflix, Inc.**  
**Condensed Consolidated Statements of Operations**  
**(unaudited)**  
**(in thousands, except per share data)**

	Three Months Ended		Six Months Ended	
	June 30, 2010	June 30, 2009	June 30, 2010	June 30, 2009
Revenues	\$519,819	\$408,509	\$1,013,484	\$802,607
Cost of revenues:				
Subscription	265,387	227,316	524,947	444,772
Fulfillment expenses *	49,547	41,927	97,149	83,739
Total cost of revenues	314,934	269,243	622,096	528,511
Gross profit	204,885	139,266	391,388	274,096
Operating expenses:				
Technology and development *	37,863	27,119	75,262	51,319
Marketing *	74,533	46,231	149,752	108,473
General and administrative *	17,119	13,252	34,312	26,266
Gain on disposal of DVDs	(1,972)	(118)	(3,625)	(1,215)
Total operating expenses	127,543	86,484	255,701	184,843
Operating income	77,342	52,782	135,687	89,253
Other income (expense):				
Interest expense	(4,893)	(674)	(9,852)	(1,344)
Interest and other income	921	866	1,893	2,476
Income before income taxes	73,370	52,974	127,728	90,385
Provision for income taxes	29,851	20,531	51,937	35,579
Net income	<u>\$ 43,519</u>	<u>\$ 32,443</u>	<u>\$ 75,791</u>	<u>\$ 54,806</u>
Net income per share:				
Basic	<u>\$ 0.83</u>	<u>\$ 0.56</u>	<u>\$ 1.44</u>	<u>\$ 0.94</u>
Diluted	<u>\$ 0.80</u>	<u>\$ 0.54</u>	<u>\$ 1.39</u>	<u>\$ 0.91</u>
Weighted average common shares outstanding:				
Basic	<u>52,486</u>	<u>57,872</u>	<u>52,697</u>	<u>58,301</u>
Diluted	<u>54,324</u>	<u>59,660</u>	<u>54,548</u>	<u>60,182</u>

**\* Stock-based compensation included in expense line items:**

Fulfillment expenses	\$ 307	\$ 102	\$ 483	\$ 222
Technology and development	2,376	1,190	4,245	2,261
Marketing	756	458	1,399	901
General and administrative	3,489	1,528	6,303	3,026