

July 5, 2011

Netflix, Inc. (Nasdaq/NFLX)

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Sell Rising Costs and Increased Competition

Netflix is the leading internet subscription service for Movies and Television.

Investment Highlights

1) Average monthly revenue per paid subscriber fell 8.7% from \$13.30 in FY2009 to \$12.19 in FY2010. Although the decrease can be partially explained by Netflix's expanded customer base with the new \$7.99/month streaming only plan, subscriber growth in the less expensive one and two DVD/month plans was 69% while there was a 15% decrease in the premium priced three or more DVD/month plans. Additionally, the recent \$1/month increase in the price of many of Netflix's plans only returned prices to their previous 2007 levels.

2) Companies such as Hulu, Amazon (Nasdaq/AMZN/Not Rated), Facebook, and Google (Nasdaq/GOOG/Not Rated) have recognized the potential of the internet subscription movie market and will represent increased competitive threats to Netflix going forward.

3) Acquiring streaming television content will likely continue to become more expensive for Netflix as the popularity of its service increases and further threatens traditional distribution channels such as broadcast and cable television. We anticipate further restrictions on content, such as Liberty Starz's (Nasdaq/LSTZA/Not Rated) recent announcement that new shows would be delayed by 90 days before becoming available on Netflix's streaming service.

4) Inexpensive and unlimited bandwidth are key drivers of success for Netflix's streaming service. Level 3's (Nasdaq/LVLT/Buy) recent announcement of the acquisition of Global Crossing (Nasdaq/GLBC/Not Rated) represents a **possible shift in pricing power towards the content delivery network providers.** Additionally, internet service providers are phasing out unlimited bandwidth for consumers, such as AT&T's (NYSE/T/Not Rated) announcement that its DSL customers will be charged additional fees after exceeding 150 gigabytes/month.

Current Price \$267.99

Price Target \$181.00

Estimates	F2009A	F2010A	F2011E
Revenue(\$Mills)	\$1,670	\$2,163	\$3,249
1Q March	394	494	719 A
2Q June	409	520	790 E
3Q September	423	553	840 E
4Q December	444	596	900 E

EPS	\$1.99	\$2.96	\$4.32
1Q March	0.37	0.60	1.11 A
2Q June	0.54	0.80	1.03 E
3Q September	0.52	0.71	1.03 E
4Q December	0.56	0.87	1.15 E
P/E (x)		90.4	62.1

EBITDA/Share	\$3.29	\$5.22	\$7.44
EV/EBITDA (x)		49.1	34.7

Stock Data	
52-Week Range	\$95.33-\$277.70
Shares Outstanding (Mill)	54.2
Market Capitalization (Mill)	\$14,067
Enterprise Value (mil.)	\$13,924
Debt to Capital (3/11)	42.0%
Book Value/Share (3/11)	\$5.09
Price/Book	52.7 X
Average Trading Volume (Mill)(3-month)	4.7
Insider Ownership	5.8%
Institutional Ownership	85.1%
Short interest (Mill)	10.40
Dividend / Yield	\$0.00/0.0%



Price target and ratings changes over the past 3 years:
Initiated - July 5, 2011 – Target \$181.00

Conclusion

Netflix's growth going forward faces substantial pitfalls including declining average monthly revenue per paid subscriber, increasing competition, increasing costs to obtain content, and many internet service providers placing limit restrictions on consumer bandwidth usage. Although Netflix has a strong history of consistent growth in both revenue and net income, the stock price has appreciated over 500% in the past two years, and has become overvalued by as much as 50-60% compared to its peers. Therefore, we are initiating coverage on NFLX with a SELL rating and a 12-18 month price target of \$181.00 per share, or FY2012E earnings per share of \$5.62 multiplied by a price/earnings ratio of 35 (representing a PEG ratio of 1) and discounted by 8.5% per year (the cost of the Company's most recent financing) for one year, from 2011 to 2012.

Company Business

With 20 million subscribers at the end of FY2010, Netflix is the largest internet subscription service for television shows and movies. The Company distributes content via two channels: instant online streaming and direct to home physical delivery of DVDs and Blu-ray discs. In March 2011, the Company announced that it would begin to acquire first-run content to be available only through its instant streaming service. Netflix was founded in 1997 and began renting DVDs through its website in 1998. The Company has operated under the current monthly subscription model since late 1999 and went public on May 29, 2002. Netflix's internet streaming, mail delivery, and first-run content operations are explained in detail below:

Mail Delivery

Netflix delivers DVDs and Blu-ray discs directly to its customers through the mail (standard red envelope shown at right) using a network of 58 shipping and distribution centers. In 2010, Netflix reached an agreement with several major studios to delay the rental of new movies for 28 days after their release. Price points of Netflix's most common unlimited plans are outlined below:

- 1 DVD – \$9.99/month
- 2 DVDs – \$14.99/month
- 3 DVDs – \$19.99/month
- 4 DVDs – \$27.99/month



Source: Netflix.com

Roughly 90% of Netflix's subscribers have plans for streaming only (detailed below), 1 DVD, or 2 DVDs. All of the plans listed above include unlimited online streaming and can be upgraded to include Blu-ray discs for between \$1 - \$4/month additionally depending on the plan.

Source: Netflix.com

Internet Streaming

Netflix offers a growing portion of its content catalog online for instant internet streaming. The Company includes streaming at no charge with most of its mail delivery DVD plans, as well as offering a streaming only service for \$7.99/month. Level 3 Communications serves as the primary content delivery network for Netflix. During 2010, streaming surpassed at-home DVDs for the most hours of viewed programming for the Company. Netflix also offers streaming over various hardware devices including internet-ready televisions (shown at left) and Blu-ray players;



game consoles Wii, Xbox, and Playstation 3; and mobile devices such as Android phones, iPhones, and iPads. Outside of the United States, Netflix currently offers a streaming only plan in Canada, and has plans for continued international expansion in FY2012 into one or two additional countries.

First-Run Content

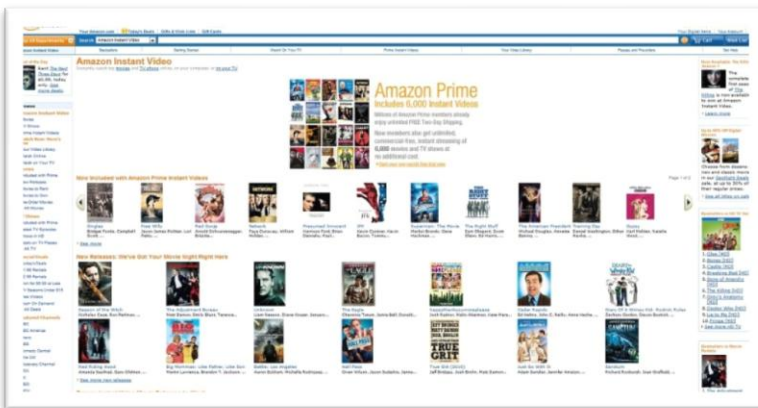
In March 2011, Netflix announced that they had acquired the first-run rights for an upcoming political drama titled “House of Cards” for availability exclusively on its streaming video service. The Company will not be producing the series, but has committed to license two seasons from content producer Media Rights Capital. In their 2011 first quarter letter to shareholders, company management outlined that the acquisition of the rights to “House of Cards” is not a major shift in strategy since if the show is successful it will not be any more expensive than licensing a popular show from a network. Additionally, the Company has plans to acquire the first-run rights to two or three less expensive programs.

Competition

Many companies, including content producers, are entering the internet content distribution market and represent direct competition to Netflix. However, Netflix’s recent net subscription adds have remained robust even while facing increased competition. Current and potential competitors are detailed below:

Hulu, commercially launched in 2008, is a joint venture between content producers Comcast’s NBC (Nasdaq/CMCSA/Not Rated), News Corp.s Fox (Nasdaq/NWSA/Not Rated), and Disney’s ABC (NYSE/DIS/Not Rated) to provide subscription and ad-supported internet streaming of television shows and movies. Hulu’s subscription service, Hulu Plus, retails for \$7.99 per month. Hulu Plus includes access to a wider content catalog, high-definition streaming, and internet ready device support. The homepage for Hulu Plus is shown at right. The Criterion Collection (classic movies) of movies was removed from Netflix’s instant streaming and became available on Hulu’s subscription service in 2011. In June 2011, Hulu retained Morgan Stanley (NYSE/MS/Not Rated) as an advisor for a potential sale. The incorporation of this division into a larger technology conglomerate could provide Hulu with additional resources to pursue content acquisition.

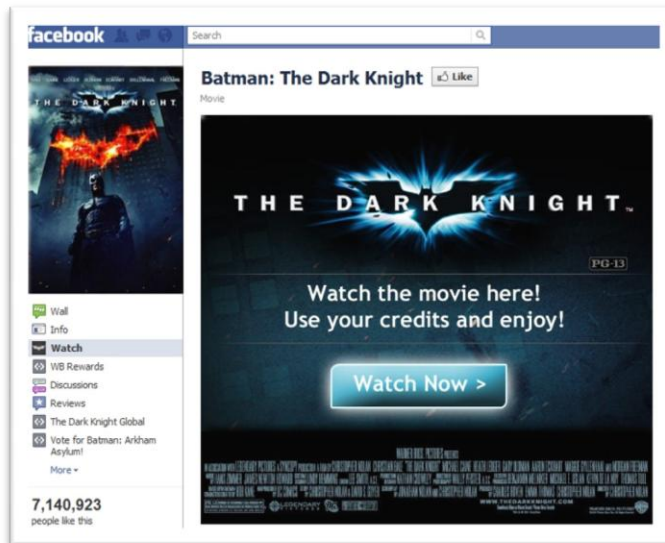
Source: Hulu.com



Source: Amazon.com

In early 2011, **Amazon** (Nasdaq/AMZN/Not Rated) announced that it would begin offering unlimited streaming of 5,000 television and movie titles to its Amazon Prime members. Amazon is a leading online retailer. Amazon Prime is available for \$79/year and also includes discounted shipping on purchases. In addition to the movies available through Amazon Prime, Amazon offers a wide variety of new release content on a pay-per-view model. Pricing averages \$3.99 for a new release movie and \$0.99 for a television episode. The homepage for Amazon Prime is shown at left.

In March 2011, Warner Bros. (NYSE/TWX/Not Rated) announced that *The Dark Knight* would be available for purchase over **Facebook**. Following the initial success of *The Dark Knight* offering, Warner Bros. is also making popular titles such as *Harry Potter*, *Inception*, *Yogi Bear*, and *Life as We Know It* available for approximately \$4. As of June 2011, the homepage for *The Dark Knight* (shown at right) had over 7 million “likes.” Facebook could potentially leverage its extensive user-base and behavioral data collection to quickly become a competitive threat in the internet streaming market.



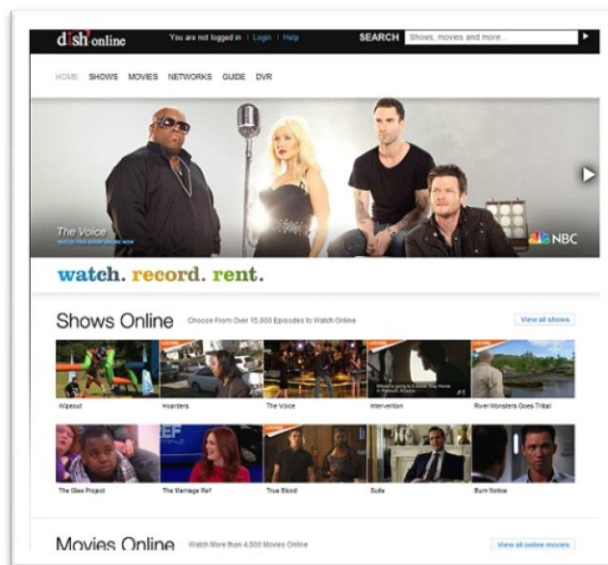
Source: Facebook.com



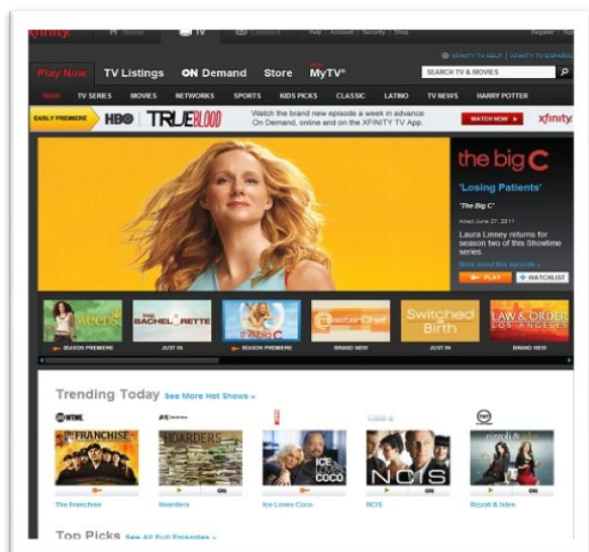
Source: Youtube.com

According to internet traffic statistics published by web information provider Alexa (an Amazon.com subsidiary), **Google’s** (Nasdaq/GOOG/Not Rated) YouTube is ranked as the third most visited site on the internet. Currently, YouTube operates through an ad-supported model and offers mainly user-generated content. Although YouTube does not currently compete directly with Netflix, because of its strong financial position if Google began to license premium content from studios this could potentially increase the competitive threat from YouTube. The Company’s homepage is shown at left.

Dish Network’s (Nasdaq/DISH/Not Rated) April 2011 announcement that they had acquired Blockbuster Video (OTC/BLOAQ.PK/Not Rated) out of bankruptcy positions Dish Network as a potential new direct threat to Netflix. Although Dish Network has not yet announced specific plans, we anticipate that the Company will attempt to expand both the on-demand content available through its satellite service and Blockbuster’s online streaming service. In addition to Blockbuster, Dish Network offers its Dish Online service (shown at right) to its satellite subscribers over the internet and various mobile devices.



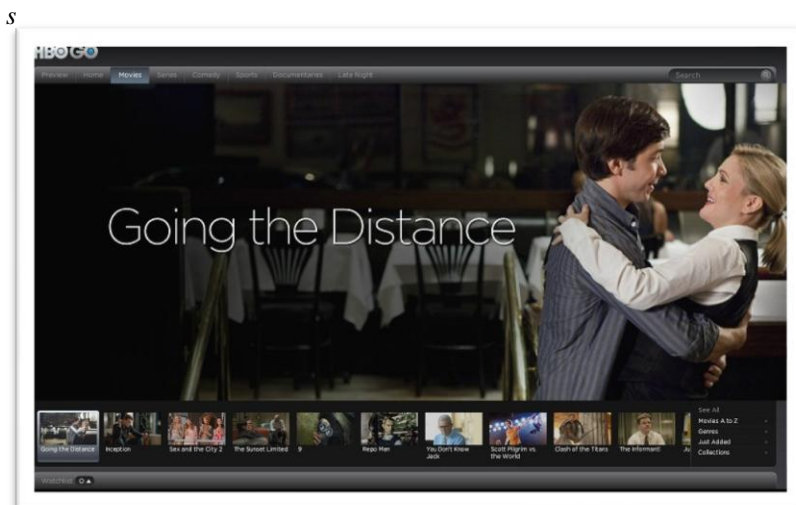
Source: Dishnetwork.com



TV Everywhere is an authentication system that allows paid subscribers of traditional content delivery companies such as Comcast (Nasdaq/CMCSA/Not Rated), Time Warner (NYSE/TWC/Not Rated), Dish Network, and DirecTV (Nasdaq/DTV/Not Rated) to view programming on various devices such as tablets and mobile phones. TV Everywhere is provided to subscribers at no additional cost. Netflix's CEO Reed Hastings has acknowledged that he views TV Everywhere as the Company's largest competitive threat. TV Everywhere has been commercially available since early 2010 and providers have steadily improved the content catalog since launch. Proprietary TV Everywhere systems include Xfinity (shown at left), HBO Go (NYSE/TWX/Not Rated) (shown below), and Dish Online.

Source: Xfinity.com

Xfinity includes access to premium channels, TNT, TBS, Cartoon Network, Comedy Central, Nickelodeon, MTV, E! Entertainment, Food Network, CBS (NYSE/CBS/Not Rated), NBC, ABC (NYSE/DIS/Not Rated) and FOX (Nasdaq/NWSA/Not Rated). The service currently offers 150,000 video choices. HBO Go is offered to subscribers of various multi-channel video programming distributors (MVPDs) but requires a premium HBO subscription. The service has received favorable reviews and is the first streaming service to meaningfully incorporate social networking.



Source: HBO.com

Recent Financial Results

The Company reported financial results for its fiscal first quarter ended March 31, 2011 in late April. Q1/2011 revenues were \$719 million, up 46% from \$494 million in Q1/2010. Netflix had 23.6 million subscribers at the end of Q1/2011, up 69% from 13.9 million at the end of Q1/2010. We believe that the largest contributing factor to the rapid growth of Netflix's subscriber base was the introduction of the less expensive streaming-only plan that widened appeal. Gross margins in Q1/2011 were 39% with a net income margin of 8.4%. Net income in Q1/2011 was \$60 million, or \$1.11 per share, an increase of 86% from net income of \$32 million in Q1/2010, or \$0.59 per share. For Q1/2011, the Company exceeded consensus earnings per share estimates of \$1.08 by \$0.03. Netflix generates all of its revenue from monthly subscription fees in the United States and Canada. The chart below outlines key financial results for Q1/2010 and Q1/2011:

<u>Quarter ended (\$000s)</u>	<u>March 31, 2010</u>	<u>March 31, 2011</u>	<u>% Change</u>
Revenues	\$493,665	\$718,553	45.6%
Operating Income	\$58,345	\$102,240	75.2%
Net Income	\$32,272	\$60,233	86.6%
Earnings per share	\$0.59	\$1.11	88.1%
Shares outstanding	54,775	54,246	-1.0%

For FY2010 Netflix reported top line revenue of \$2.1 billion, up 29% from \$1.6 billion in FY2009. The Company had sequential quarter to quarter revenue growth for all of FY2010. Paid subscribers at the end of the period rose 53% from 11.8 million in FY2009 to 18.2 million in FY2010. For FY2010, the average number of paying subscribers was 14.7 million. The Company has been effective in managing its costs, with gross margins increasing from 35.4% in FY2009 to 37.2% in FY2010 and net income margins increasing from 6.9% in FY2009 to 7.4% in FY2010. Selling, general, and administrative expenses rose by 30.6% from \$404 million in FY2009 to \$528 million in FY2010 on increased content acquisition costs. Net income in FY2010 was \$161 million, or \$2.96 per share, an increase of 39% from net income of \$116 million in FY2009, or \$1.98 per share. For FY2010, Netflix exceeded consensus earnings per share estimates of \$2.81. The chart below outlines key financial results for FY2009 and FY2010:

<u>Year ended (\$000's)</u>	<u>December 31, 2009</u>	<u>December 31, 2010</u>	<u>% Change</u>
Revenues	\$1,670,269	\$2,162,625	29.5%
Operating Income	\$191,939	\$283,641	47.8%
Net Income	\$115,860	\$160,853	38.8%
Earnings per Share	\$1.98	\$2.96	49.5%
Shares Outstanding	58,416	54,304	-7.0%

Balance Sheet and Operating Cash Flow

As of March 31, 2011 Netflix had \$342.7 million in cash, cash equivalents and short-term investments on its balance sheet, down from \$350.4 million on December 31, 2010 due primarily to positive operating cash flow offset by to the Company's repurchase of \$108 million worth of common stock during Q1/2011. Debt levels remained unchanged at \$200 million in senior notes due November 2017 at an interest rate of 8.5%. Operating cash flow for Q1/2011 was \$116 million, up 50% from \$77 million in Q1/2010 due to increased revenue from Netflix's expanded customer base. The chart below depicts cash and equivalents, long-term debt, and shareholders' equity for the year-ended December 31, 2010 and quarter ended March 31, 2011 for Netflix:

<u>(\$000s)</u>	<u>December 31, 2010</u>	<u>March 31, 2011</u>	<u>% Change</u>
Cash and Short-term investments	\$350,387	\$342,721	-2.2%
Long-term Debt	\$200,000	\$200,000	0.0%
Shareholders' Equity	\$290,164	\$275,722	-5.0%

Outlook/Growth Concerns

Netflix has consistently grown revenues by over 20% annually for the past two fiscal years, and has a large market share in the growing industry of internet content distribution. However, the stock is currently priced for perfection and there are numerous potential pitfalls in the next 24 months including:

- Average Monthly Revenue per Paid Subscriber (AMRPS) fell 8.7% from \$13.30 in FY2009 to \$12.19 in FY2010**, and will most likely continue to decrease since new subscribers are opting for less expensive plans. The decline in AMRPS is partially justified by the Company's attempts to expand its customer base, with 33% of new subscribers opting for the streaming only plan (\$7.99/month). However, Netflix experienced 69.8% subscriber growth in the less expensive one and two DVD plans and a 15% decline in premium plans offering three or more DVDs during 2010. As of Q1/2011, roughly 10% of Netflix's subscribers had monthly plans for three or more DVDs, down from 28% in Q1/2010. Additionally, Netflix's November 2010 price increase of \$1/month on its one and two DVD/month plans only returned prices to their previous 2007 levels.

- Content producers will likely attempt to **delay access to television programming** as the popularity of Netflix's online streaming model threatens traditional content delivery methods such as broadcast and cable television. An example of this is Netflix's longtime partner Starz's recent announcement that new shows, such as *Camelot*, would now become available after 90 days instead of being available immediately after airing, as has previously been the case.
- Content producers and networks, who rely heavily on advertising revenue and affiliate fees, will likely **continue to increase content acquisition costs** as Netflix becomes a larger competitor to traditional MVPDs. CEO Reed Hastings has repeatedly stated that he does not believe Netflix's streaming service leads to cable-cutting (customers eliminating cable or satellite service) because of the Company's focus on prior season programming and completeness of series, as opposed to new release content. A 2011 survey by The Diffusion Group found that 32% of users of Netflix's streaming service said they were likely to downgrade their MVPD service (cable shaving) in the next six months, up from 16% in 2010, contradicting the sentiment that Netflix is solely a supplement to traditional MVPDs. Netflix's current negotiations with Starz to renew its content deal expiring in 2012, exemplifies the trend of rising costs. Netflix's original content deal with Starz was in the neighborhood of \$30 million, with Mr. Hastings stating in June 2011 that the new deal could be north of \$200 million. Additionally, the high degree of vertical integration in the media industry (content producers, networks, MVPDs) may make obtaining content at economical costs more difficult for Netflix.
- Furthermore, we feel that Netflix risks **obsolescence by pursuing the business model of being a supplement to MVPDs**. First, we estimate that the upward trend in media delivery through the internet will continue and eventually eliminate the use of DVDs and Blu-ray discs as streaming quality continues to improve. Netflix has proactively recognized this trend and has begun to transition its business into a streaming model. However, the emergence of services such as TV Everywhere and HBO Go demonstrate that the traditional MVPD channels have also been proactive in adapting to the emerging trend. While Netflix's content catalog is currently more extensive than most TV Everywhere offerings, as TV Everywhere improves we see Netflix having a more difficult time differentiating their service and convincing users to pay an additional monthly subscription. Additionally, if the trend of cable cutting or cable shaving accelerates, we anticipate that MVPDs will increase their efforts to expand the awareness and quality of TV Everywhere.
- We anticipate that Netflix's margins will be further squeezed as the Company faces **increased pricing pressure from internet bandwidth providers**. Level 3's (Nasdaq/LVLT/Buy) April 2011 announcement of the acquisition of Global Crossing (Nasdaq/GLBC/Not Rated) represents a possible shift in pricing power towards content delivery network providers.

For Q2/2011E we forecast that Netflix will have sales of \$790 million, up 52% from \$520 million in Q2/2010. We expect the Company to end Q2/2011E with 25.6 million subscribers, up 70% from 15 million in Q2/2010. For Q2/2011E we estimate cost of revenue to be \$505 million; selling, general, and administrative expenses to be \$190 million; and the Company to have a profit margin of 7.1%. We estimate that Netflix will have net income of \$56 million for Q2/2011E, or \$1.03 per share, up 30% from net income of \$43 million in Q2/2010, or \$0.80 per share. The chart below outlines key financial results for Q2/2010 and Q2/2011E:

<u>Quarter ended (\$000s)</u>	<u>June 30, 2010</u>	<u>June 30, 2011E</u>	<u>% Change</u>
Revenues	\$519,819	\$790,000	52.0%
Operating Income	\$77,342	\$96,500	24.8%
Net Income	\$43,519	\$55,900	28.4%
Earnings per share	\$0.80	\$1.03	28.8%
Shares outstanding	54,324	54,100	-0.4%

Quarterly revenue and subscriber projections for FY2010 and FY2011E are provided in Table 1 below:

Table 1: NFLX Quarterly Revenue Projections

	Q1/10A	Q2/10A	Q3/10A	Q4/10A	Q1/11A	Q2/11E	Q3/11E	Q4/11E
Domestic Revenue	\$493,665	\$519,819	\$553,219	\$592,305	\$706,274	\$772,177	\$815,670	\$868,560
International Revenue	\$0	\$0	\$0	\$3,617	\$12,279	\$19,176	\$23,970	\$31,161
Total Revenue	\$493,665	\$519,819	\$553,219	\$595,922	\$718,553	\$791,353	\$839,640	\$899,721
Average Domestic Subscribers	12,757	14,100	15,220	16,899	19,670	22,189	23,850	25,850
Average International Subscribers	-	-	-	166	503	800	1,000	1,300
Total Average Subscribers	12,757	14,100	15,220	17,065	20,173	22,989	24,850	27,150
Average Subscriber Growth		10.5%	7.9%	12.1%	18.2%	14.0%	8.1%	9.3%
Domestic Monthly Revenue/Sub	\$12.90	\$12.29	\$12.12	\$11.68	\$11.97	\$11.60	\$11.40	\$11.20
International Monthly Revenue/Sub	\$0.00	\$0.00	\$0.00	\$7.26	\$8.13	\$7.99	\$7.99	\$7.99

For FY2011, we estimate that the Company's top-line revenue will be roughly \$3.2 billion, up 50% from \$2.1 billion in FY2010. We attribute the increase in growth rate to the introduction of the streaming-only plan and anticipate that for FY2012 top-line revenue for Netflix will be roughly \$4.2 billion, a 30% growth rate and more in-line with the average growth rate experienced during FY2009 and FY2010. We forecast earnings per share of \$4.32 for FY2011E, up from \$2.96 in FY2010. Revenue and subscribers projections for FY2011E and FY2012E (our revenue estimates are level with consensus for 2011E and approximately 3% below consensus for 2012E) are provided in Table 2 below:

Table 2: NFLX Annual Revenue Projections

	FY2009A	FY2010A	FY2011E	FY2012E
Domestic Revenue	\$1,670,269	\$2,159,008	\$3,162,681	\$3,974,220
International Revenue	\$0	\$3,617	\$86,586	\$268,464
Total Revenue	\$1,670,269	\$2,162,625	\$3,249,267	\$4,242,684
Average Domestic Subscribers	10,464	14,745	22,890	31,000
Average International Subscribers	-	42	901	2,800
Total Average Subscribers	10,464	14,786	23,791	33,800
Average Subscriber Growth		41.3%	60.9%	42.1%
Domestic Monthly Revenue/Sub	\$13.30	\$12.19	\$11.54	\$10.70
International Monthly Revenue/Sub	\$0.00	\$7.26	\$8.03	\$7.99

Management

Reed Hastings co-founded Netflix in 1997 and currently serves as Chief Executive Officer and Chairman of the Board. He has prior experience as CEO and founder of Pure Atria Software from 1991-1997. Mr. Hastings holds a master's degree in Computer Science from Stanford University and a bachelor's degree from Bowdoin College.

David Wells has served in various roles throughout the Company, most recently as Chief Financial Officer since 2010. He previously served as Vice President of Financial Planning from 2008-2010 and as Director of Operations Planning from 2004-2008. Mr. Wells has prior experience in various roles at Deloitte Consulting from 1998-2004. He holds a master's degree in Business Administration from the University of Chicago and bachelors' degrees in English and Accounting from the University of Virginia.

Andrew Rendich has served in various roles throughout the Company, most recently as Chief Operating Officer since 2009. He previously served as Vice President of Operations from 2007-2009 and in various other roles since 1999. Mr. Rendich has prior experience as Director of Engineering for Verax Systems. He holds bachelors' degrees in Computer Engineering and Computer Science from the Rochester Institute of Technology and Alfred State University, respectively.

Neil Hunt has served in various roles throughout the Company, most recently as Chief Product Officer since 2002. He previously served as Vice President of Internet Engineering from 1999 to 2002. Mr. Hunt has prior experience as Director of Engineering for Rational Software from 1997-1999. He holds a doctorate in Computer Science from the University of Aberdeen and a bachelor's degree from the University of Durham.

Leslie Kilgore has served as Chief Marketing Officer since 2000. She has prior experience as Director of Marketing for Amazon.com (Nasdaq/AMZN/Not Rated) from 1999-2000 and as a Brand Manager for Procter & Gamble (NYSE/PG/Not Rated) from 1992-1999. Ms. Kilgore holds a master's degree in Business Administration from Stanford University and a bachelor's degree from the University of Pennsylvania.

Patty McCord has served as Chief Talent Officer since 1998. She has prior experience as Director of Human Resources for Pure Atria Software from 1994-1997.

Ted Sarandos has served as Chief Content Officer since 2000. He has prior experience as Vice President of Product and Merchandising for Video City.

Outside directors include **Richard Barton**, CEO and Chairman of Zillow; **Charles Giancarlo**, managing director of Silver Lake; **Tim Haley**, Managing Director of Redpoint Ventures; **Jay Hoag**, General Partner of Technology Crossover Ventures; **Ann Mather**, former CFO of Pixar; and **A. George Battle**, former CEO of IAC Search and Media (Nasdaq/IACI/Not Rated).

Stock Valuation/Comparables

We have compiled a five-stock comparison group for Netflix, including a single company that provides self-service coin machines and DVD kiosks, Coinstar (Nasdaq/CSTR/Not Rated); a single company that is a leading online retailer, Amazon (Nasdaq/AMZN/Not Rated); a single company that provides online search, marketing, and internet video, Google (Nasdaq/GOOG/Not Rated); a single consumer entertainment company and cable operator, Comcast (Nasdaq/CMCSA/Not Rated); and a single satellite broadcast company and owner of Blockbuster, Dish Network (Nasdaq/DISH/Not Rated). Table 3 below outlines price/revenues for FY2011E and price/earnings for FY2011E and 2012E for Netflix and five comparable consumer entertainment companies:

Table 3. Video/Consumer Entertainment Services Comparable Company Analysis

Company	Symbol	Price	Shares		Market Cap		Calendar Year		Revenues		Calendar Year		Price/Revs Earnings	
			(millions)	(\$Millions)	EPS '11E	EPS '12E	2011E(Mil)	P/E '11E	P/E '12E	2011E	Growth	Notes		
Coinstar	CSTR	\$55.34	31	\$1,735	\$2.76	\$3.49	\$1,780	20.1	15.9	0.97	26.4%	Self Service Coin Machines and DVD Kiosks		
Amazon	AMZN	\$209.49	452	94,699	3.17	4.41	44,930	66.1	47.5	2.11	39.1%	Leading Online Retailer		
Google	GOOG	\$521.03	322	167,903	34.59	40.18	27,380	15.1	13.0	6.13	16.2%	Internet Search and Internet Video		
Comcast	CMCSA	\$25.73	2,766	71,174	1.56	1.83	55,640	16.5	14.1	1.28	17.3%	Consumer Entertainment and Cable Operator		
Dish Network	DISH	\$31.11	445	13,836	4.49	5.53	19,530	6.9	5.6	0.71	23.2%	Broadcast Satellite Provider/Blockbuster		
Average								24.9	19.2	2.24	24.4%			
Netflix	NFLX	\$267.99	54	\$14,525	\$4.32	\$5.62	\$3,249	62.0	47.7	4.47	30.1%	Internet Subscription Movie Service		

Source: DJSI Research; FactSet

Based on valuation metrics such as price/revenues and price/earnings for FY2011E and FY2012E, Netflix shares can be considered overvalued by as much as 50-60%, perhaps reflecting investors' failure to account for

increased competition and market saturation. Table 4 below depicts a sensitivity analysis of our valuation to changes in price/earnings ratio and discount rate with the price target highlighted:

Table 4: Discount Rate Sensitivity Analysis

	5%	6%	7%	8%	9%	10%	11%	12%	14%	15%	16%
20	\$107.05	\$106.04	\$105.05	\$104.07	\$103.12	\$102.18	\$101.26	\$100.36	\$98.60	\$97.74	\$96.90
25	\$133.81	\$132.55	\$131.31	\$130.09	\$128.90	\$127.73	\$126.58	\$125.45	\$123.25	\$122.17	\$121.12
30	\$160.57	\$159.06	\$157.57	\$156.11	\$154.68	\$153.27	\$151.89	\$150.54	\$147.89	\$146.61	\$145.34
35	\$187.33	\$185.57	\$183.83	\$182.13	\$180.46	\$178.82	\$177.21	\$175.63	\$172.54	\$171.04	\$169.57
40	\$214.10	\$212.08	\$210.09	\$208.15	\$206.24	\$204.36	\$202.52	\$200.71	\$197.19	\$195.48	\$193.79
45	\$240.86	\$238.58	\$236.36	\$234.17	\$232.02	\$229.91	\$227.84	\$225.80	\$221.84	\$219.91	\$218.02

Thus, we are recommending that investors sell these shares, with a 12-18 month price target of \$181, or FY2012E EPS of \$5.62 discounted at 8.5% per year (the cost of the Company's most recent financing) for one year multiplied by a price/earnings ratio of 35, equating to a PEG ratio of 1 based upon a 35% CAGR for FY2010A through FY2012E earnings, as outlined in the box below:

FY2012E EPS:	\$5.62
Discount Rate:	8.5%
Price/Earnings:	35
CAGR: FY2010-FY2012	35%
PEG Ratio:	1

Catalysts/Investor Timeline

- 1) Second Quarter 2011 (ended June) financials released – Mid-July 2011
- 2) Cost of upcoming Starz (Nasdaq/LSTZA/Not Rated) content deal announced – Q3/2011 – Q4/2011
- 3) Third Quarter 2011 (ending September) financials released – Mid-October 2011
- 4) Announcement of the next country for international development – Late 2011
- 5) Potential acquisition of Hulu by a large internet conglomerate – Late 2011
- 6) Announcement of additional first-run content agreements – 2011-2012

Risk Factors

We believe an investment in Netflix involves the following risks:

- Growth Rates May be Sustainable – Our investment thesis is predicated on a model that Netflix's current growth rate is unsustainable. Although rare, historical examples such as Google (Nasdaq/GOOG/Not Rated), Apple (Nasdaq/AAPL/Not Rated), and Microsoft (Nasdaq/MSFT/Not Rated) demonstrate that extraordinary rates of growth can be sustained for long periods of time.
- Short Selling – We only recommend that institutions with high levels of investment expertise consider assuming a short position. For all individual investors, we only recommend closing out any already held long positions in Netflix.
- Acquisition or Buyout – The consumer entertainment industry has historically experienced a high level of merger and acquisition activity, with examples such as Comcast's (Nasdaq/CMCSA/Not Rated) acquisition of NBC from GE (NYSE/GE/Not Rated) and Dish Network's (Nasdaq/DISH/Not Rated) acquisition of Blockbuster (OTC/BLOAQ.PK/Not Rated). If a company such as Google (Nasdaq/GOOG/Not Rated) made an acquisition offer for Netflix in the future it is likely that Netflix's share price would appreciate significantly.

- Success in First-Run Content – We believe that a key threat facing Netflix is their inability to create differentiation from TV Everywhere. The Company does not currently possess organizational expertise in producing or selecting successful first-run content. However, if it is able to develop or acquire this expertise and pursue a business model based upon first-run content, it could provide the Company with sufficient unique content to create differentiation. Additionally, if Netflix continues to outbid Showtime, HBO, and other networks on first-run content from independent studios, as it did with House of Cards, it could provide the Company with additional leverage in negotiating future content deals with the networks.
- Intangible Consumer Switching Costs – A portion of our investment thesis is predicated on consumers switching from Netflix to TV Everywhere. We would note however that it is difficult to estimate the intangible value a current Netflix customer may place on their time invested into ranking movies for Netflix’s suggestion algorithm. Second, although we feel that MVPDs have sufficient resources to properly market TV Everywhere, there are no guarantees that consumers will be compelled to discontinue their Netflix service even if TV Everywhere offers a similar quality content catalog.

Netflix, Inc.
Consolidated Statements of Operations
(In \$Millions)

FYE December	2007	2008	2009	1Q10 Mar	2Q10 June	3Q10 Sept	4Q10 Dec	2010	1Q11 Mar	2Q11E June	3Q11E Sept	4Q11E Dec	2011E	2012E
Revenues	\$1,205.3	\$1,364.6	\$1,670.3	\$493.6	\$519.8	\$553.2	\$596.0	\$2,162.6	\$718.5	\$790.0	\$840.0	\$900.0	\$3,248.5	\$4,250.0
Cost of revenues (excluding depreciation)	786.1	910.2	1,079.3	307.1	314.9	344.4	390.9	1,357.3	438.1	505.0	535.0	575.0	2,053.1	2,700.0
Gross Profit	419.2	454.4	591.0	186.5	204.9	208.8	205.1	805.3	280.4	285.0	305.0	325.0	1,195.4	1,550.0
Operating Expenses:														
Selling, general & administrative expenses	341.5	339.1	403.5	129.6	129.4	140.4	128.2	527.6	178.1	190.0	210.0	220.0	798.1	1,045.0
Depreciation and amortization	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Impairment charges & other one-time	(14.1)	(6.0)	(4.5)	(1.6)	(1.9)	(1.2)	(1.3)	(6.0)	0.0	(1.5)	(1.5)	(1.5)	(4.5)	(8.0)
Total operating expenses	327.4	333.1	399.0	128.0	127.5	139.2	126.9	521.6	178.1	188.5	208.5	218.5	793.6	1,037.0
Income (loss) from operations	91.8	121.3	192.0	58.5	77.4	69.6	78.2	283.7	102.3	96.5	96.5	106.5	401.8	513.0
Other Income														
Interest income/(expense), net	19.2	10.0	0.3	(3.9)	(3.9)	(4.1)	(4.0)	(16.0)	(4.9)	(4.9)	(4.9)	(4.9)	(19.6)	(20.0)
Other expenses, including discontinued ops.	0	0	0	0	0	0	0	0	1	0	0	0	0	0
Income (loss) before tax	111.0	131.3	192.3	54.6	73.5	65.5	74.2	267.7	98.3	91.6	91.6	101.6	382.2	493.0
Provision for income taxes	44.3	48.7	76.3	22.0	29.8	27.4	27.6	106.8	38.0	35.7	35.7	39.6	149.1	192.3
Net income (loss)	66.7	82.6	116.0	32.6	43.7	38.1	46.6	160.9	60.3	55.9	55.9	62.0	233.1	300.7
Basic income per share	\$1.00	\$1.36	\$2.05	\$0.62	\$0.83	\$0.73	\$0.90	\$3.06	\$1.14	\$1.06	\$1.06	\$1.18	\$4.48	\$5.84
Diluted income per share	\$0.97	\$1.32	\$1.99	\$0.60	\$0.80	\$0.71	\$0.87	\$2.96	\$1.11	\$1.03	\$1.03	\$1.15	\$4.32	\$5.62
Basic shares outstanding	67.0	60.9	56.5	52.9	52.4	52.1	52.0	52.5	52.7	52.6	52.5	52.4	52.0	51.5
Diluted shares outstanding	68.9	62.8	58.4	54.7	54.3	53.9	53.7	54.3	54.2	54.1	54.0	53.9	54.0	53.5
Key ratios:														
Revenue growth		13.2%	22.4%					29.5%	45.6%	52.0%	51.8%	51.0%	50.2%	30.8%
Gross margin	34.8%	33.3%	35.4%	37.8%	39.4%	37.7%	34.4%	37.2%	39.0%	36.1%	36.3%	36.1%	36.8%	36.5%
S, G&A/revenues	28.3%	24.8%	24.2%	26.3%	24.9%	25.4%	21.5%	24.4%	24.8%	24.1%	25.0%	24.4%	24.6%	24.6%
Net income margin	5.5%	6.1%	6.9%	6.6%	8.4%	6.9%	7.8%	7.4%	8.4%	7.1%	6.7%	6.9%	7.2%	7.1%
Operating margin	7.6%	8.9%	11%	11.9%	14.9%	12.6%	13.1%	13.1%	14.2%	12.2%	11.5%	11.8%	12.4%	12.1%
Cash Flow/share	\$0.97	\$1.32	\$1.99	\$0.60	\$0.80	\$0.71	\$0.87	\$2.96	\$1.11	\$1.03	\$1.03	\$1.15	\$4.32	\$5.62
EBITDA/share	\$1.33	\$1.93	\$3.29	\$1.07	\$1.43	\$1.29	\$1.46	\$5.22	\$1.89	\$1.78	\$1.79	\$1.98	\$7.44	\$9.59

Balance Sheets
 (\$Mils)

Assets:	12/31/10	3/31/11
Cash and equivalents	\$194.5	\$150.4
Short-term investments	155.9	192.3
Current content library	181.0	265.9
Prepaid content	62.2	74.6
Other	47.4	38.4
Total current	641.0	721.6
Property & equipment, net	128.6	134.8
Content library	181.0	197.6
Deferred tax assets	17.5	22.5
Intangible assets, net & other	14.1	13.8
TOTAL ASSETS	982.1	1,090.2
Liabilities:		
Accounts payable	222.8	301.0
Current obligations	2.1	2.1
Accrued expenses	36.5	44.1
Deferred revenue, current	127.2	143.0
Total current	388.6	490.3
Long-term debt	200.0	200.0
Long-term obligations	34.1	33.6
Other	69.2	90.6
Total liabilities	691.9	814.5
Stockholders' equity	290.2	275.7
TOTAL LIAB & EQ	982.1	1,090.2

Quarterly Earnings Comparisons

	Mar	June	Sept	Dec	Total
Revenues (in 000's)					
2009	\$394	\$409	\$423	\$444	\$1,670
2010	494	520	553	596	2,163
2011E	719	790	840	900	3,249
Earnings per Share					
2009	\$0.37	\$0.54	\$0.52	\$0.56	\$1.99
2010	0.60	0.80	0.71	0.87	2.96
2011E	1.11	1.03	1.03	1.15	4.32

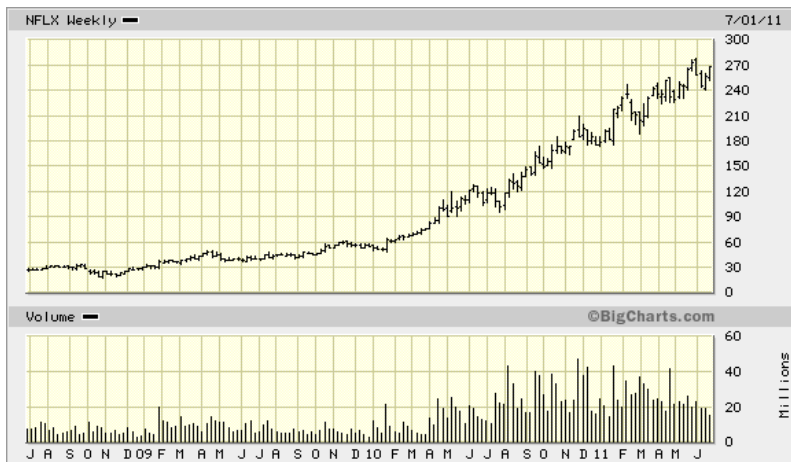
Operating Statistics

	2008	2009	2010	2011E	2012E
Subscribers by Type (000s)					
Paid subscribers	9,164	11,892	18,268		
Free Subscribers	226	376	1,742		
Total Subscribers	9,390	12,268	20,010		
Average subscribers	8,268	10,464	14,786	23,791	33,800
Average monthly revenue per sub	\$13.75	\$13.30	\$12.19	\$11.54	\$10.70

Source: Dawson James Securities, Inc. estimates; Company documents

Important Disclosures:

Price Chart:



Price target and ratings changes over the past 3 years:

Initiated – July 5, 2011 – Price Target \$181.00

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Ratings definitions: **1) Buy:** the stock is expected to appreciate and produce a total return of at least 20% over the next 12-18 months; **2) Neutral:** the stock is fairly valued for the next 12-18 months; and **3) Sell:** the stock is expected to decline at least 20% over the next 12-18 months and should be sold.

Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Buy	24	83%	8	32%
Neutral	4	14%	3	75%
Sell	1	3%	0	0%
Total	29	100%	11	38%

Information about valuation methods and risks can be found in the “STOCK VALUATION” and “RISK FACTORS” sections of this report.

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