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Netflix, Inc. (Nasdaq/NFLX)

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Sell **Q4/11 results are strong on the surface, but trouble is lurking below**

Netflix is the leading internet subscription service for movies and television.

Investment Highlights

1) Netflix reported results for its fourth quarter and fiscal year ended December 31, 2011 in late January. The Company reported **sales of \$876 million for Q4/11, up 47% from sales of \$596 million in Q4/10**. The bulk of growth in sales is attributable to an increase in international subscribers and a domestic price increase that was phased in during September. Gross margins were unchanged from Q4/10 to Q4/11 at 34.3%, but operating margins declined from 13.2% in Q4/10 to 8.1% in Q4/11. Ultimately, net income declined from \$47 million, or \$0.87 per share, in Q4/10 to \$41 million, or \$0.73 per share, in Q4/11. Netflix's results came in ahead of our expectations for sales of \$830 million and earnings per share of \$0.54 for Q4/11.

The Company reported **sales for FY2011 of \$3.2 billion, up 48% from sales of \$2.2 billion in FY2010**. The bulk of revenue growth can be attributed to the rapid adoption of Netflix's streaming only plan, as well as expansion into new international markets. Gross margins declined from 37.2% in FY2010 to 36.3% in FY2011, while operating margins declined from 13.1% to 12% over the same time period. Net income increased 44% from \$161 million, or \$2.96 per share, in FY2010 to \$232 million, or \$4.26 per share, in FY2011. Netflix's results for FY2011 were slightly ahead of our expectations for sales of \$3.2 billion and earnings per share of \$4.03.

2) With regards to operational results, the number grabbing headlines in publications such as the *Wall Street Journal*¹ was a gain of 600,000 total domestic subscribers from 23.8 million at the end of Q3/11 to 24.4 million at the end of Q4/11. However, we consider paid subscribers to be a more meaningful measure of Netflix's performance. **Paid domestic subscribers increased by a far more sanguine 15,000 from 22.8 million at the end of Q3/11 to 22.9 million at the end of Q4/11**. Further, Netflix's paid domestic subscriber numbers have still

Current Price \$123.79

Price Target \$50.00

Estimates	F2010A	F2011A	F2012E
Revenue(\$Mil's)	\$2,163	\$3,205	\$3,705
1Q March	494	719	880 E
2Q June	520	789	910 E
3Q September	553	822	940 E
4Q December	596	876	975 E
EPS	\$2.96	\$4.26	(\$0.21)
1Q March	0.60	1.11	(0.18) E
2Q June	0.80	1.27	(0.09) E
3Q September	0.71	1.16	0.00 E
4Q December	0.87	0.73	0.06 E
P/E (x)	41.8	29.1	N/A
EBITDA/Share	\$5.22	\$7.08	\$0.18
EV/EBITDA (x)	23.8	17.5	674.5

Stock Data	
52-Week Range	\$74.25-\$304.79
Shares Outstanding (mil.)	55.4
Market Capitalization (mil.)	\$6,853
Enterprise Value (mil.)	\$6,745
Debt to Capital (12/11)	38.16%
Book Value/Share (12/11)	\$11.71
Price/Book	10.6 X
Average Trading Volume (mil.)(3-month)	8.3
Insider Ownership	5.3%
Institutional Ownership	80.3%
Short interest (mil.)	11.40
Dividend / Yield	\$0.00/0.0%



Price target and ratings changes over the past 3 years:
Initiated – July 5, 2011 – SELL – Price Target \$181.00
Price Target Decreased – September 16, 2011 – SELL – \$115.50
Price Target Decreased – October 28, 2011 – SELL – \$50.00

not recovered to the pre-price-increase high-water-mark of 23.3 million at the end of Q2/11. One positive was that Netflix's increased marketing spend during Q4/11 yielded 600,000 new trial domestic subscribers, which may foreshadow a return to more robust subscriber growth during Q1/12. By segment, paid subscribers to Netflix's streaming service declined from 20.5 million in Q3/11 to 20.2 million in Q4/11, while paid subscribers to the DVD service declined from 13.8 million to 11 million over the same time period. Additionally, Netflix's highly vaunted international expansion is seeing slower adoption rates than initially forecast. Despite the launch of service in Latin America during September 2011, international paid subscribers only increased from 1 million in Q3/11 to 1.4 million in Q4/11. Further, on the Q4/11 earnings conference call, CEO Reed Hastings acknowledged that Latin America would take longer than the initially forecast two years to achieve profitability. While growth in trial subscribers is a positive, we believe that it is premature to declare that Netflix has "turned the corner" and is set to return to robust subscriber growth in light of weakness in paid domestic subscribers in Q4/11.

¹<http://blogs.wsj.com/marketbeat/2012/01/25/netflix-results-exceed-analysts-expectations-shares-jump-in-after-hours-trading/>

3) The primary weakness of Netflix's strategy shift away from its DVD service and towards its streaming service is the lack of a first-sale doctrine allowing the redistribution of electronic content (streaming movies) in perpetuity. Thus, unlike the DVD-service for which Netflix can purchase a physical disc and re-lend it into perpetuity, the Company must continually renegotiate and purchase electronic content for its streaming service. The result is that in Q4/11, the **DVD service had a contribution profit (revenue minus costs of revenue and marketing costs) of \$194 million on margins of 52.4%, while the streaming service with almost twice as many subscribers had a contribution profit of \$52 million on margins of 10.9%**. Taking at face value the Company's assertion on the Q4/11 earnings call that revenue from a new streaming subscriber translates almost entirely into contribution profit, Netflix would need to add 17.5 million new paid streaming subscribers without incurring additional costs to equate streaming margins to DVD margins through scaling. We believe that it would take Netflix at least several years (if ever) to achieve the growth and scale necessary for comparable profitability between DVD users and streaming users. Further, we believe that Netflix's assertion that it has nearly 100% margins on new streaming customers is only applicable in the short-term, as in the long-run content producers are likely to renegotiate pricing relative to subscriber growth as their content faces additional dilution.

4) While we still believe that Netflix has the most comprehensive all-you-can-eat streaming content library, there are low barriers to entry into the industry for a large internet conglomerate. For example, in their most recent letter to shareholders Netflix's management acknowledged that they anticipate that **Amazon (Nasdaq/AMZN/Not Rated) will launch its streaming service as a stand-alone platform in the near future** at a price-point below the \$7.99 per month that Netflix charges. Further, we agree with Netflix's management that the most significant competitive threat comes in the form of the various TV Everywhere platforms offered by most MVPDs (multichannel video programming distributors) and some content producers such as HBO (NYSE/TWX/Not Rated). Additionally, Netflix highlighted Showtime's (NYSE/CBS/Not Rated) Showtime Anytime platform as a high quality offering that is beginning to gain traction.

Conclusion/Stock Valuation

While a high level of attention was paid to Netflix's misguided attempt to spin-off its DVD segment into Qwikster, we believe that weakness in the Company's strategy is deeper than CEO Reed Hastings' late 2011 explanation that Netflix needed to be "extra-communicative." Netflix's growth going forward faces substantial pitfalls including: increasing competition, increasing costs to obtain content, and internet service providers placing throttles on consumer bandwidth usage. We expect that decelerating revenue growth coupled with doubling content costs will severely constrain earnings growth for the foreseeable future. Netflix has traditionally been dependent on the "virtuous cycle" of revenue growth from new subscribers outpacing the cost of content additions. With Netflix's forecasted operating losses in FY2012, the virtuous cycle has come to an

abrupt halt, and may begin reversing if Netflix cannot support the content costs needed to attract new subscribers. Therefore, we are maintaining our Sell recommendation and price target of \$50, based on applying a 20X P/E multiple to our FY2013E estimated earnings per share of \$2.50 (our model calls for an EPS loss of (\$0.21) in FY2012).

Stock 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 and offers a streaming service, 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 the owner of Blockbuster, Dish Network (Nasdaq/DISH/Not Rated). Table 1 below outlines price/revenues for FY2012E and price/earnings for FY2011 and FY2012E for Netflix and five comparable consumer entertainment companies:

Table 1. Streaming/Consumer Entertainment Services Comparable Company Analysis

Company	Symbol	Price	Shares (millions)	Market Cap (\$Millions)	Calendar Year		Revenues	Calendar Year		Price/Revs Earnings		Notes
					EPS '11	EPS '12E	2012E(Mil)	P/E '11	P/E '12E	2011E	Growth	
Coinstar	CSTR	\$48.97	31	\$1,507	\$3.26	\$3.85	\$2,170	15.0	12.7	0.69	18.1%	Self Service Coin Machines and DVD Kiosks
Amazon	AMZN	195.37	455	88,845	1.18	1.88	65,310	165.6	103.9	1.36	59.3%	Leading Online Retailer
Google	GOOG	579.98	324	187,848	36.04	42.34	35,660	16.1	13.7	5.27	17.5%	Internet Search and Internet Video
Comcast	CMCSA	26.33	2,725	71,745	1.51	1.87	60,960	17.4	14.1	1.18	23.8%	Consumer Entertainment and Cable Operator
Dish Network	DISH	27.64	446	12,332	3.31	2.74	14,610	8.4	10.1	0.84	-17.2%	Broadcast Satellite Provider/Blockbuster
Average								44.5	30.9	1.87	20.3%	
Netflix	NFLX	\$123.79	55	\$6,853	\$4.26	(\$0.21)	\$3,705	29.1	N/A	1.85	N/A	Internet Subscription Movie Service

Source: DJSI Research; FactSet

Catalysts/Investor Timeline

- 1) Q1/12 (ending March) financials released – April 2012
- 2) Additional clarity on return to subscriber growth – H1 2012
- 3) Additional clarity on timeline for return to profitability – H1 2012
- 4) Announcement of additional first-run and proprietary content agreements – 2012

Risk Factors

In addition to normal economic and market risk factors that impact most equities and the common risks shared by Netflix with other companies in the industry, we believe the primary risks to our price target include the following:

- **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) have demonstrated 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 (multichannel video programming distributor) 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 Mil's)

Justin S. Colatosti

FYE December	2007	2008	2009	2010	1Q11	2Q11	3Q11	4Q11	2011	1Q12E	2Q12E	3Q12E	4Q12E	2012E	2013E
					Mar	June	Sept	Dec		Mar	June	Sept	Dec		
Revenues	\$1,205.3	\$1,364.6	\$1,670.3	\$2,162.6	\$718.5	\$788.6	\$821.8	\$875.6	\$3,204.5	\$880.0	\$910.0	\$940.0	\$975.0	\$3,705.0	\$4,260.0
Cost of revenues (excluding depreciation)	786.1	910.2	1,079.3	1,357.3	438.1	490.0	536.6	575.2	2,039.9	650.0	670.0	690.0	720.0	2,730.0	3,070.0
Gross Profit	419.2	454.4	591.0	805.3	280.4	298.6	285.2	300.4	1,164.7	230.0	240.0	250.0	255.0	975.0	1,190.0
Operating Expenses:															
Selling, general & administrative expenses	341.5	339.1	403.5	527.6	178.1	183.5	188.4	229.5	779.6	235.0	240.0	245.0	245.0	965.0	970.0
Impairment charges & other one-time	(14.1)	(6.0)	(4.5)	(6.0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total operating expenses	327.4	333.1	399.0	521.6	178.1	183.5	188.4	229.5	779.6	235.0	240.0	245.0	245.0	965.0	970.0
Income (loss) from operations	91.8	121.3	192.0	283.7	102.3	115.1	96.8	70.9	385.1	(5.0)	0.0	5.0	10.0	10.0	220.0
Other Income															
Interest income/(expense), net	19.2	10.0	0.3	(16.0)	(4.9)	(5.3)	(4.9)	(4.9)	(20.0)	(5.0)	(5.0)	(5.0)	(5.0)	(20.0)	(20.0)
Other expenses, including discontinued ops.	0.0	0.0	0.0	0.0	0.9	1.0	1.7	(0.1)	3.5	0.0	0.0	0.0	0.0	0.0	0.0
Income (loss) before tax	111.0	131.3	192.3	267.7	98.3	110.8	93.6	65.8	368.5	(10.0)	(5.0)	0.0	5.0	(10.0)	200.0
Provision for income taxes	44.3	48.7	76.3	106.8	38.0	42.6	31.2	25.1	136.9	0.0	0.0	0.0	1.5	1.5	60.0
Net income (loss)	66.7	82.6	116.0	160.9	60.3	68.2	62.5	40.7	231.7	(10.0)	(5.0)	0.0	3.5	(11.5)	140.0
Basic income per share	\$1.00	\$1.36	\$2.05	\$3.06	\$1.14	\$1.30	\$1.19	\$0.76	\$4.38	(\$0.19)	(\$0.09)	\$0.00	\$0.06	(\$0.21)	\$2.59
Diluted income per share	\$0.97	\$1.32	\$1.99	\$2.96	\$1.11	\$1.27	\$1.16	\$0.73	\$4.26	(\$0.18)	(\$0.09)	\$0.00	\$0.06	(\$0.21)	\$2.50
Basic shares outstanding	67.0	60.9	56.5	52.5	52.7	52.5	52.6	53.6	52.8	53.6	53.7	53.8	53.9	53.8	54.0
Diluted shares outstanding	68.9	62.8	58.4	54.3	54.2	53.9	53.9	55.4	54.4	55.4	55.5	55.6	55.7	55.6	56.0
Key ratios:															
Revenue growth		13.2%	22.4%	29.5%	45.6%	51.7%	48.6%	46.9%	48.2%	22.5%	15.4%	14.4%	11.4%	15.6%	15.0%
Gross margin	34.8%	33.3%	35.4%	37.2%	39.0%	37.9%	34.7%	34.3%	36.3%	26.1%	26.4%	26.6%	26.2%	26.3%	27.8%
S, G&A/revenues	28.3%	24.8%	24.2%	24.4%	24.8%	23.3%	22.9%	26.2%	24.3%	26.7%	26.4%	26.1%	25.1%	26.0%	22.8%
Profit margin	5.5%	6.1%	6.9%	7.4%	8.4%	8.6%	7.6%	4.7%	7.2%	-1.1%	-0.5%	0.0%	0.4%	-0.3%	3.3%
Operating margin	7.6%	8.9%	11.5%	13.1%	14.2%	14.6%	11.8%	8.1%	12.0%	-0.6%	0.0%	0.5%	1.0%	0.3%	5.2%
EBIT/share	\$1.33	\$1.93	\$3.29	\$5.22	\$1.89	\$2.14	\$1.80	\$1.28	\$7.08	(\$0.09)	\$0.00	\$0.09	\$0.18	\$0.18	\$3.93

Balance Sheets
 (\$Mils)

	12/31/10	12/31/11
Assets:		
Cash and equivalents	\$194.5	\$508.1
Short-term investments	155.9	289.8
Current content library	181.0	919.7
Prepaid content	62.2	56.0
Other	43.6	53.8
Total current	637.2	1,827.4
Property & equipment, net	128.6	136.4
Content library	181.0	1,046.9
Other	35.3	55.1
TOTAL ASSETS	982.1	3,065.7
Liabilities:		
Accounts payable	222.8	1,012.6
Accrued expenses	38.6	54.7
Deferred revenue, current	127.2	148.8
Total current	388.6	1,216.1
Long-term debt	200.0	400.0
Non-current liabilities	48.2	739.6
Other	55.1	61.7
Total liabilities	691.9	2,417.4
Stockholders' equity	290.2	648.3
TOTAL LIAB & EQ	982.1	3,065.7

Quarterly Earnings Comparisons

	Mar	June	Sept	Dec	Total
Revenues (in Mil's)					
2010	\$494	\$520	\$553	\$596	\$2,163
2011	719	789	822	876	3,205
2012E	880	910	940	975	3,705
Earnings per Share					
2010	\$0.60	\$0.80	\$0.71	\$0.87	\$2.96
2011	1.11	1.27	1.16	0.73	4.26
2012E	(0.18)	(0.09)	0.00	0.06	(0.21)

Operating Statistics

	2008	2009	2010	2011	2012E
Subscribers by Type (000s)					
Paid subscribers	9,164	11,892	18,268	24,305	32,300
Free Subscribers	226	376	1,742	1,948	2,100
Total Subscribers	9,390	12,268	20,010	26,253	34,400
Domestic Streaming Subscribers				21,671	28,000
Domestic DVD Subscribers				11,165	8,500
International Subscribers				1,858	4,700

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 – SELL - Price Target \$181.00
 Price Target Decreased – September 16, 2011 – SELL - \$115.50
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Sell	1	4%	0	0%
Total	25	100%	11	44%

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