

Netflix (NFLX)

October 29th, 2008

\$21.76/Share

NASDAQ



Introduction: This report is based upon the company's most recent report, its' 8-K as reported on 10/20/2008. You can always find a company's most recent filing at www.sec.gov. This 8-K is being filed because they are reporting their financials for the 3rd quarter ending September 30th, 2008.

About Netflix: Netflix specializes in renting DVDs online to their subscriber base through the mail. In fact, they are the world's largest online movie rental service. The great thing about Netflix is that they don't have due dates on their DVDs, and they pay for all postage and handling. The company currently has over 8 million subscribers. They have a DVD library of over 100,000 titles, of which 12,000 can be downloaded instantly to your computer.



Financial Overview: On the 8-K, CEO and Co-Founder Reed Hastings states, “In the third quarter we delivered strong earnings growth despite a challenging economic environment that contributed to slower-than-expected subscriber growth. Additionally, we made important progress in our expansion into Internet delivery with significant new content and hardware partnerships announced this past quarter.”

Even though subscriber growth was “slower-than-expected,” the company still managed to grow subscribers 23% to 8,672,000 from 7,028,000 from a year ago. The company expects their subscriber base to be somewhere between 8.85 million to 9.15 million by the end of FY '08. It is fair to mention that about 2% of these subscribers are currently in a free trial period.

\$4.99 a month – 1 DVD at-a-time
(Limit 2 per month)
2 hours of instant streaming from a separate, smaller library to your PC - no additional fee.
\$8.99 a month – 1 DVD at-a-time
(Unlimited DVD exchanges)
Unlimited instant streaming from a separate, smaller library to your PC or TV - no additional fee.
\$13.99 a month – 2 DVDs at-a-time
(Unlimited DVD exchanges)
Unlimited instant streaming from a separate, smaller library to your PC or TV - no additional fee.
\$16.99 a month – 3 DVDs at-a-time
(Unlimited DVD exchanges)
Unlimited instant streaming from a separate, smaller library to your PC or TV - no additional fee.

Although subscriber growth increased 23% YOY, revenue only increased by 16% over that same time period. This can be attributed to people signing up for cheaper subscription plans. To the left you will see their current subscription plans as of 10/29/2008. Maybe some of the \$16.99/month members are finding that they really don't need three DVDs out at a time and downgraded to a lower plan. It would be interesting to see if Netflix broke down its' subscriber base over the years to show any trends in the different plans. Using subscriber and revenue data, we can deduce what

the average subscriber is paying on a monthly basis.

- 2007: $(\$294 \text{ million}) / (7,028,000 \text{ subscribers} \times 3 \text{ months}) = \$13.94/\text{month}$
- 2008: $(\$341.3 \text{ million}) / (8,672,000 \text{ subscribers} \times 3 \text{ months}) = \$13.12/\text{month}$

It is important to note that the subscribers I used to calculate 2007 & 2008 data includes the 183,000 & 182,000 free trial subscribers respectively. Here is what the numbers look like if we exclude the free subscribers.

- 2007: $(\$294 \text{ million}) / (6,845,000 \text{ subscribers} \times 3 \text{ months}) = \$14.32/\text{month}$
- 2008: $(\$341.3 \text{ million}) / (8,490,000 \text{ subscribers} \times 3 \text{ months}) = \$13.40/\text{month}$

Any way you look at it, Netflix subscribers are paying for cheaper plans than they did a year ago. This is a difference of almost a dollar. The 8-K shows slightly different average monthly revenue figures than I calculated. This is due primarily to rounding errors. They found the average revenue per month per subscriber to be \$14.57 for Q3 '07 and \$13.60 in Q3 '08. Q2 '08 came out to \$13.78. This represents a decline of 6.7% YOY.

It is interesting to note that the cost per gross subscriber addition fell from \$37.89 in Q3 '07 to \$32.21 in Q3 '08. This represents a decline of 15%. This cost in Q2 '08 was only \$28.89. This short term increase may reflect the falling economy. Perhaps people are more reluctant to take on more monthly obligations if they don't have to.

Net income for the quarter using GAAP came out to \$20.4 million (\$.33/share), compared to \$15.6 million (\$.23/share) from Q3 '07.

Even with this large net income, total assets declined by over \$100 million from Q4 '07 to Q3 '08. This can be largely attributed to the company's stock repurchase plan. During this period of three quarters, the company spent \$189,913,000 repurchasing their stock. Outstanding common stock shares declined by 5,792,917 shares over this period, representing an overall decline in outstanding shares by 8.9%. The company paid an average of \$32.78/share to repurchase these shares. This amount could be slightly different due to rounding errors.

On January 31st, 2008, the company authorized a stock repurchase program that would allow them to purchase up to \$100 million in common stock through the end of 2008. The company made these purchases up to the full amounts. On March 5th, 2008, the company authorized an additional \$150 million in stock be repurchased through the end of 2008. As of the 10-Q filing, the company had repurchased \$90 million worth of stock. This leaves \$60 million left of common stock to repurchase over the last three months of the year. This would equate to 2.4 million shares at a price of \$25/share.

The company currently has over \$111 million in cash and cash equivalents, and \$139 million in short-term investments. While it was nice for shareholders to see the company repurchase so many shares, it will be hard for them to continue this pace. Over the period of time that Netflix spent \$189,310,000 on repurchases, they only had \$60,294,000 in net income. The stock currently does not yield a dividend. Perhaps this is something that management may look into after the share repurchase program concludes.

Currently there are 8 analysts following this stock. Recommendation options for the analysts consist of Buy, Outperform, Neutral, Underperform, & Sell. To find the average recommendation, a buy will be valued at 1, and a sell valued at 5. Here is how the analysts have trended their recommendations over the past three months.

Time Period	Average Recommendation
Current	2.625
Last Month	2.75
2 Months Ago	2.714
3 Months Ago	2.57

As you can see, analysts have viewed this company as being slightly better than neutral over the past few months. Their ratings haven't fluctuated recently. Analysts appear to be taking a wait and see approach with this company.

Conclusion: Netflix has a very innovative product that obviously appeals to millions of Americans. The company has faced some competition from Blockbuster recently. What Blockbuster has going for them is that if you want to exchange a movie out right away you can just drive down to the local store. With Netflix though, you will have to wait a few days for the mail to come through. Netflix spends a lot of money on postage, and with these volatile gas prices, the cost of postage could increase. This would cost Netflix a lot of extra money.

Netflix has also made the wise investment in streaming movies online. This should help them compete with companies that offer on demand services.

The main thing that an investor should be concerned with these days is deciding whether or not Netflix is a discretionary purchase. A discretionary purchase is something that the consumer does not need, but chooses to purchase for their own enjoyment. Food would be a great example of non-discretionary spending, because it is something that you need to survive. If consumers decide that Netflix is something that they can cut out of their

budget for 2009, then the stock could be in for a bumpy road. On the opposite side of the argument though, Netflix can be seen as being cheap entertainment for families that are somewhat strapped for cash, yet still want to have a good time and enjoy themselves. Who doesn't? Netflix offers many different pricing options that are sure to satisfy the many needs of different consumers that may find themselves signing up for an account.

Price Target: When comparing Q3'07 to Q3'08, we can see that Diluted EPS rose from \$.23 to \$.33, a 43.48% gain! It might also be interesting to note that the share price of NFLX today is about the same as it was from a year ago (in the low \$20/share range). The one thing that I love about Netflix right now is that they have no long term debt. Their only somewhat long term obligations are their lease obligations on offices and distribution centers. Since the distribution centers are vital to their operations, they could just be looked upon as a normal cost of doing business. The point I am getting at here is that NFLX does not have to waste their cash to pay off long term debts.

Instead, NFLX can spend their cash on other things that might provide more value to shareholders. One might notice that their past four quarters have had negative cash flow. Typically, we don't care too much for negative cash flow as shareholders, but in this situation it works out. As I mentioned earlier in this report, NFLX has entered into a share repurchase program. Over the past four quarters, the company has retired almost \$203 million worth of company shares. This will naturally raise EPS and provide more value to shareholders, thus raising the price of the stock.

Based upon this information, I am setting a price target for NFLX of \$30.00/share for 12/31/2009. This represents over a 36% gain from its current price level. I think that this is a somewhat optimistic, yet attainable target for the company given current market conditions. In a good market, this company should be trading much higher, and I feel that the price is being weighed down by the overall market in general. Keep a watchful eye on this company once the market starts to rebound. I would highly suggest accumulating shares at this level.

Note: As of 10/29/2008, the author has no financial holdings in this company.

