The Henry Fund
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NETFLIX INC. (NFLX)

March 11, 2022

Communications – Entertainment

Stock Rating **HOLD**

Investment Thesis

Netflix is a powerhouse in the streaming industry and is the status quo when it comes to this form of entertainment. The release of managements lower guidance has spooked investors resulting a significant drop in share price. We believe this devaluation is not a death sentence for Netflix and that slowing subscriber growth is just a reflection of a maturing industry.

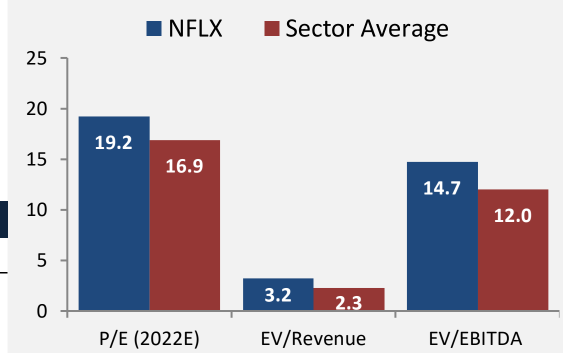
Drivers of Thesis

- Netflix has and will likely continue to invest in gaming, leveraging its streaming platform and content licenses to enter an exploding industry.
- Regions like Asia will continue to see exponential subscriber growth driven by an increasingly diverse content library, reaching 34 million users by 2025.
- Further investments into exclusive original content will make Netflix stand out compared to lower budget competitors.

Risks to Thesis

- An increasingly competitive industry could eat into Netflix's market share, requiring more investments into original content and lowering margins.
- Netflix might have to raise subscription costs significantly in order to keep up with content spending which could steer customers towards cheaper alternatives.
- The lack of a free, ad-based subscription offering puts Netflix at a potential disadvantage against peers.

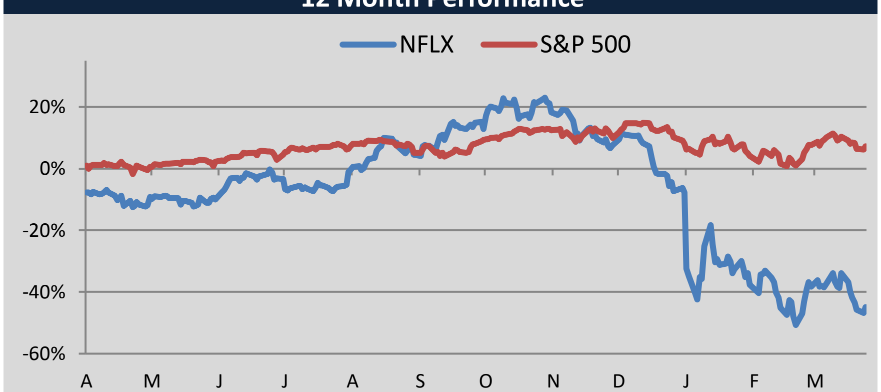
Target Price	$225-$235
Henry Fund DCF	$235
Henry Fund DDM	$195
EV/Subscribers	$870
Price Data	
Current Price	$223
52wk Range	$700 – $340
Consensus 1yr Target	$516
Key Statistics	
Market Cap (B)	$158.39
Shares Outstanding (M)	444.0
Institutional Ownership	94.9%
Beta	0.94
Dividend Yield	0%
Est. 5yr Growth	27.97%
Price/Earnings (TTM)	33.18
Price/Earnings (FY1)	32.26
Price/Sales (TTM)	5.45
Price/Book (mrq)	9.99
Profitability	
Operating Margin	20.9%
Profit Margin	17.23%
Return on Assets (TTM)	12.2%
Return on Equity (TTM)	38.0%



Earnings Estimates

Year	2019	2020	2022	2022E	2023E	2024E
EPS	$4.13	$6.08	$11.24	$11.06	$14.29	$16.57
HF est.				$12.11	$12.99	$13.21
growth	*54.1%*	*47.2%*	*84.9%*	*0.30%*	*0.32%*	*0.35%*

12 Month Performance



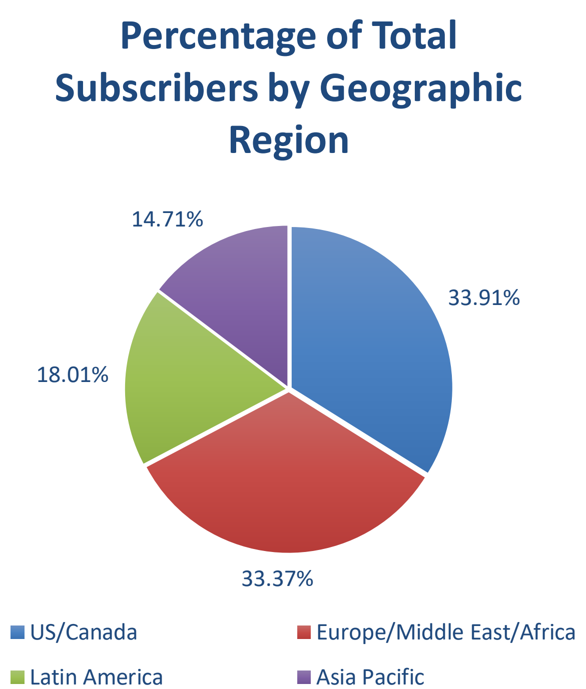
Company Description

Netflix Inc. is a subscription-based entertainment service that allows users to stream content from multiple kinds of devices. Originally in the business of mailing DVD's, Netflix has transitioned to becoming a leader in the streaming industry, with around 222 million subscribers globally. Netflix's revenue primarily derives from monthly membership fees, which varies by geographic region. In recent years, the company has increased spending on originally produced content. Netflix also operates a gaming service that is included in a standard membership.

COMPANY DESCRIPTION

Netflix is an internet streaming service that allows users to watch movies and TV on multiple different devices. They operate two main segments, streaming and DVD. As DVD continues to die out, streaming has become the focal point of Netflix's revenue. Netflix offers tier-based subscription pricing, with each tier allowing the user more flexibility in terms of accounts linked to the subscription and even video quality. The Basic plan starts at $9.99 a month and allows one user to access the account at a time. The Premium plan starts at $19.99 and can allow multiple users at once as well as 4k video quality.

Netflix is available in 190 countries with the US/Canada region being the largest and most profitable. Around 20.5% of the total adult populations of the US and Canada have a Netflix subscription. The second most developed region is Latin America, with 6% of the population having a subscription as of 2021[17].



Source: NFLX 10k

Netflix licenses media from multiple sources including production studios and other entertainment companies. In recent years, Netflix and others in the industry have shifted more towards in-house content production, with around 40% of their content being originally produced. This has been driven by increasing competition in the industry, as many firms who once licensed content out now manage their own streaming platforms. The phenomenon has sparked increased M&A in the industry, such as Amazon acquiring MGM Studios this past year.

United States/Canada

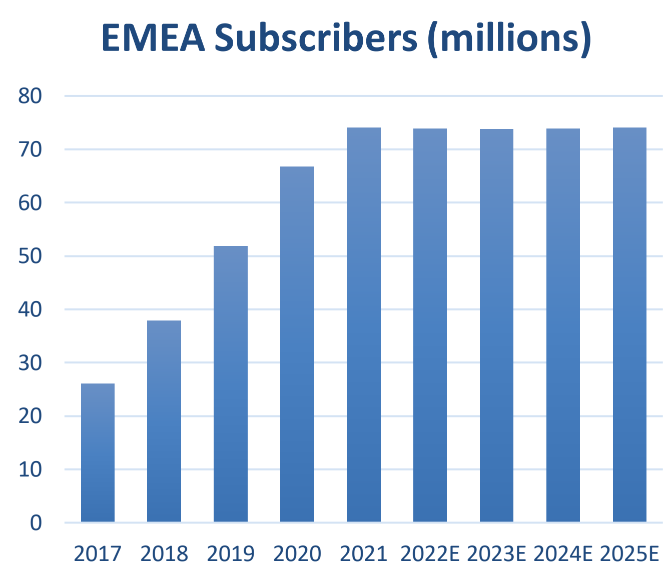
The US and Canada (UCAN) make up Netflix's largest customer base with around 75 million subscribers in total. On top of being the largest by number of customers, the region also is the most profitable, with revenue per subscriber of $14.37 per month. Subscriber growth in this region has been on the decline since 2017. While Netflix still attracts new members each year, the acceleration that was seen earlier in its lifespan has begun to reach an equilibrium.

Source: NFLX 10k

Revenue per subscriber has risen significantly since 2017. An influx of subscribers in 2020 due to the COVID-19 pandemic caused this number to become diluted, resulting in price hikes in 2021. Netflix currently has penetrated 20.5% of UCAN households. We project this penetration rate to rise to around 25.7% by 2031, implying one in four households will have a subscription by then. This will put Netflix at around 94 million subscribers in total. We also project revenue per subscriber to increase substantially in this region to around $21 by 2031. We believe price hikes in this region will be necessary to support the increased spending on content. The US and Canada will likely be less sensitive to price hikes than other regions due to the relative wealth in the area.

Europe/Middle East/Africa

The Europe, Middle East, and African segment (EMEA) is the most diverse segment Netflix operates in. The magnitude of differences seen between these regions makes it difficult to analyze. Currently, the segment boasts around 74 million subscribers, making it the second-largest in terms of subscribers. Like the UCAN region, subscription growth has started to decline in recent years, although still much higher than UCAN growth. A vast majority of these subscribers are from Europe, with Africa being the smallest component at a little over 2 million subscribers[17]. We believe that the European and UCAN markets are reaching similar equilibrium points in total subscribers, however, we also believe that there is an exponential amount of growth potential in Africa and the Middle East.



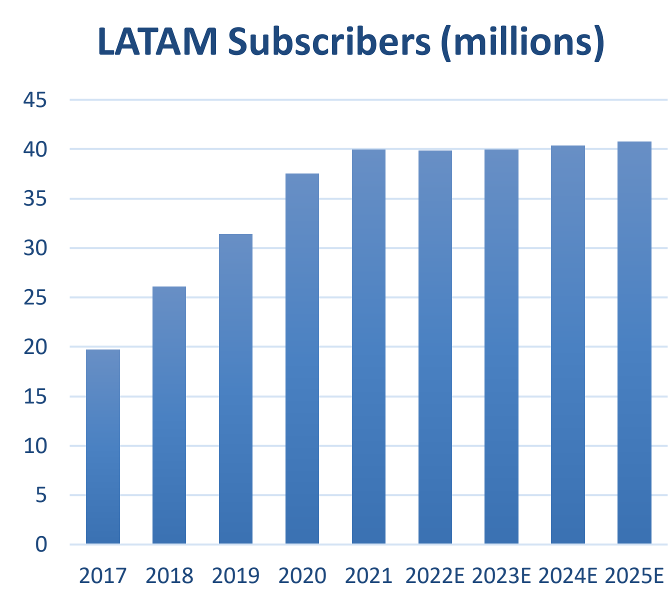
Source: NFLX 10k

As seen in the chart above, the segment has seen substantial growth since 2017. As mentioned before, much of this is due to the European market. Revenue per subscriber (per month) sits around $11 in this region, much lower than UCAN, however, it has grown significantly over the last few years as price hikes in the European market make up for lower prices in the African and Middle Eastern markets.

We believe that this segment has the potential to become Netflix's largest in the next couple of years. We project the segment to account for around 146 million subscribers by 2031, largely driven by increased internet access in Africa and the Middle East. We project Netflix to penetrate 7% of all homes in this segment by 2031 from 3.4% as of 2021. Much like in the UCAN region where better internet allowed for Netflix to take off in the first place, we are confident the same story will happen here. It should be noted however that in order to succeed in these markets, Netflix must invest in a wider and more globally conscious portfolio of content that would appeal to those users.

Latin America

The Latin America (LATAM) segment is the third-largest segment by number of users but is the smallest in terms of revenue per subscriber. The LATAM segment currently has about 40 million users with YoY growth declining like most of the other segments. The region was one of two segments to not see subscriber growth during the pandemic, the other being EMEA. We believe this is a sign that the market is elastic to services like Netflix and demand could suffer during tough times. Despite the recent slowdown, YoY growth has been substantially greater than the UCAN market.

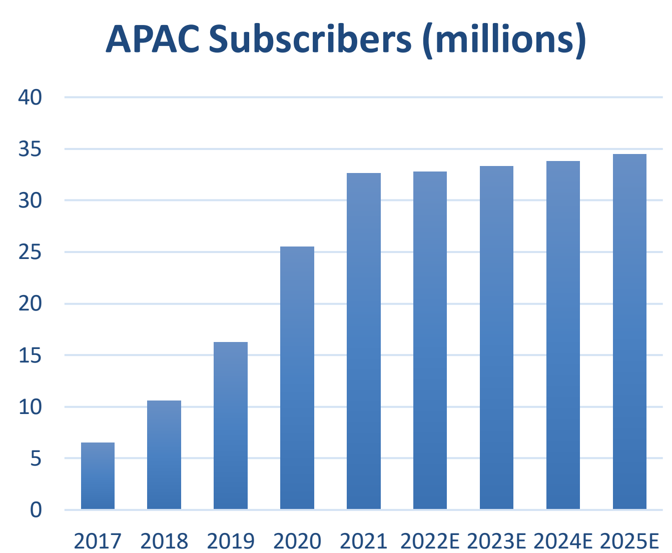


Source: NFLX 10k

As previously mentioned, the LATAM region has the lowest profitability out of Netflix's segments. Revenue per subscriber growth has been minimal over the last few years, with price cuts in 2020 resulting in -5.5% growth YoY. Despite these issues, Netflix has made good progress penetrating the region, with 6% of the population having a subscription. We project this share to grow to 14% of the population by 2031, driven by the similarity of the UCAN and LATAM markets in terms of preferred content. This will put the segments total subscriber's around 92 million, roughly on par with the UCAN market. We do believe however that revenue per subscriber growth will be slow due to the economics of the region and the perceived sensitivity to price hikes.

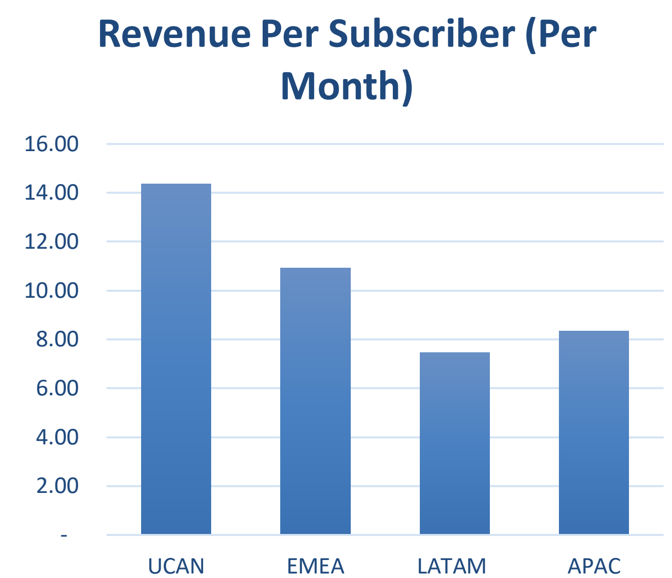
Asia Pacific

The Asia Pacific (APAC) segment has the smallest subscriber base out of the group but has seen the largest amount of growth over the last four years. This region is vast and covers continental Asia which includes India. This excludes China, as it has been outlawed there. The segment has seen incredible growth due to Netflix's overseas hits like *SquidGame* which launched Netflix into the spotlight in Korea as well as other Asian countries. Despite not being able to tap into the Chinese market due to regulation, Netflix has managed to enter a sizable portion of what initially seemed to be a very foreign market. After the release of *SquidGame,* it was realized that many overseas hits can be marketed toward UCAN consumers and vice versa.



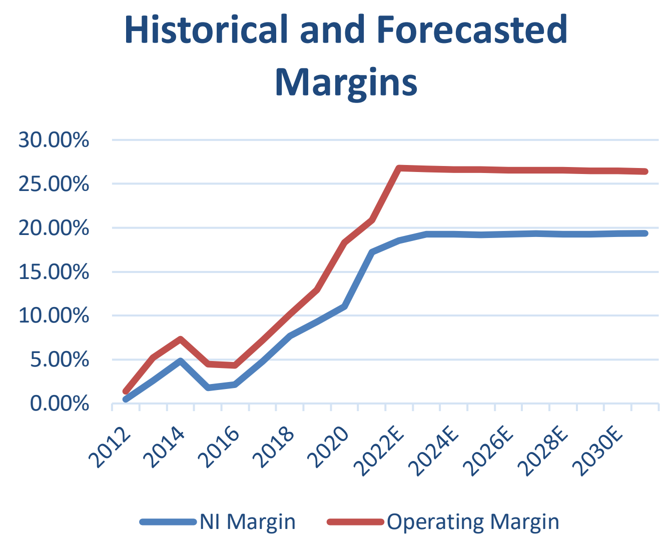
Source: NFLX 10k

The chart above perfectly summarizes Netflix's explosion in the APAC segment. With a current penetration rate of 0.72%, we believe Netflix can reach a 3% penetration in the APAC market by 2031, amassing 85.5 million subscribers. We also believe that price hikes are inevitable for this segment although not as high as the UCAN region. This is partly due to low entertainment prices in India limiting how high prices can go before users abandon ship for cheaper alternatives.



Cost Structure Analysis

Netflix's largest cash expense category is their Cost of Subscription Revenue account. This account can be broken out into two main types of expenses. The first type of expense included in this account is the amortization of content assets. Content assets include all licensed and produced content. This account is amortized overtime on an accelerated basis to reflect higher viewership at the beginning of a show's life on the platform. The other costs included in the Cost of Subscription Revenue account are expenses related to the acquisition, licensing, and production of content[17]. These costs (not including amortization) have trended upward over the years, representing about 11% of total revenue in 2017 to making up 16.5% in 2021. We attribute this to Netflix's aggressive plan to become self-reliant when it comes to content, resulting in increased spending on in-house production. We believe their cost of subscription revenue will remain at a steady margin going forward at 16.6% of revenue as the company continues to reach a steady-state and the expansive growth of the path winds down.



Source: NFLX 10k

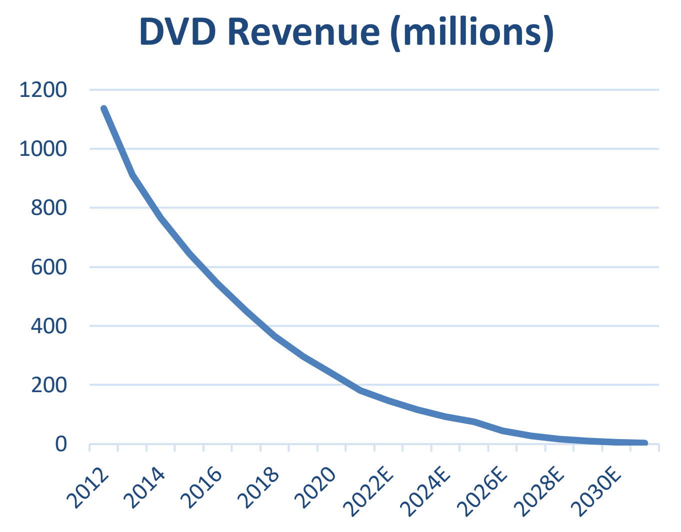
Marketing expenses make up the second-largest expense that Netflix incurs. As of 2021, these costs make up about 8.6% of their revenue. This number has been on a steady decline since 2018 which was at 15% of revenue. The decrease in these costs is likely related to Netflix having the content it acquires “sell itself” in the sense that having popular shows/movies will encourage people to sign up better than any advertisement would. We project the margin here to elevate slightly and remain consistent through the forecasted period at 11.5% of revenue. Penetration into less developed markets may require increased spending to create brand awareness, despite having blockbuster hits on the platform.

Content spending makes up most of Netflix’s liabilities. These fees are marked down as liabilities once the content becomes available on Netflix to stream, rather than when they are purchased. They are then amortized on an accelerated basis and expensed on the income statement as Amortization of Content Assets.

Non-Streaming Products/Services

DVD

Netflix was originally started as an alternative to stores like Blockbuster, allowing users to order DVDs via mail and return them at a later date. The advent of streaming has made the industry obsolete, however, Netflix still allows US subscribers to sign up and receive DVDs at their door. Netflix essentially spun off this business back in 2011, rebranding it as DVD.com. As expected, this segment has declined significantly over the last 10 years. While there are no plans to discontinue the service as of now, we have forecasted -20% growth in revenue during the first half of our period, accelerating to -40% during the second half. The graph below depicts DVD revenue in historical and forecasted periods.



Source: NFLX 10k

Netflix Games

In November of 2021, Netflix launched Netflix Games globally. The service allows users to play mobile games based on Netflix’s original content. Requiring a mobile device and a basic subscription, users can play games add-free from anywhere with an internet connection. Titles include many of Netflix’s most popular hits, including *Stranger Things 3: The Game*. Netflix has started to ramp up investing into this area, with two recent acquisitions of game design studios. We suspect that future endeavors may include allowing users to stream the latest blockbuster games to their TV.

Debt Maturity Analysis

All of Netflix’s debt is in the form of unsecured bonds, totaling over $14.5 billion dollars, $700 million of which matured in mid-February 2022. Netflix has a credit rating of BBB from Standard and Poor’s Netflix had no reported issues paying off this principle and did not opt to refinance it either. As seen in the debt maturity schedule below, after February’s payment the next maturity will come in 2024 at around $400 million dollars. We believe Netflix will have no issue paying this off and will not likely refinance after seeing how they handled the most recent maturity. In 2025, Netflix will have a substantially larger payment to make on its debt. We also don't suspect any issues repaying this due to strong cashflows in the years leading up.

Five-Year Debt Maturity Schedule

Fiscal Year	Coupon (%)	Payment ($mil)
2022	5.5%	$700
2023		0
2024	5.75%	$400
2025	5.9%	$1,828
2026	4.3%	$1,000
Thereafter	4.71%	$11,550
Total		$15,392

Source: Bloomberg

During the forecasted period of our DCF, we break Netflix's capital structure up into two phases. The first phase is the period from 2022 to 2025. During this time, we project a constant capital structure of 40% debt to equity which is lower than in historical periods. We believe that the debt on Netflix's balance sheet that matures during that time period will likely not be refinanced, thus lowering the debt to equity during those years. The second capital structure phase takes place from 2026 to 2031. We believe that the large amount of debt on their books will likely be refinanced to some degree, which is why we raised the debt to equity to 45% during that period.

ESG Analysis

According to Morningstar's Sustainalytics, Netflix has a comprehensive ESG rating of 15.8 which is considered to be low risk compared to the entire population of corporations. Netflix is rated similarly to its competitors, with Disney having a rating of 14.4. Sustainalytics ranks Netflix 122 of 291 in the media industry for ESG[18]. They are in the 14th percentile of all companies Morningstar covers, making them a low risk business overall. Due to the nature of their business, they rank incredibly high in terms of environmental scores.

RECENT DEVELOPMENTS

Q1 2022 Results (04/19/2022)

Netflix released its first quarter results in late April. The numbers it posted were beyond disappointing to say the least. Despite beating adjusted EPS estimates by almost 20%, Netflix took a nosedive as the company reported its first net loss of subscribers in history. Management expected to add around 2 million new users over the first quarter, considerably off from a 200 thousand subscriber loss. In addition to the disappointing news of losing subscribers, Netflix said it projects to lose another 2 million users in Q2 of this year.

Management said that it has decided to move forward with a few initiatives designed to curb declining subscriber additions. The first initiative is to start charging users for sharing their passwords with those not living in the same household. Currently, views on Netflix's content exceeds the number of subscribers by around 40%. By charging users an additional fee for users not located at home, Netflix can recoup profits that are currently being exploited. Services like YouTube TV already have implemented a system like this and have achieved great success.

The second initiative Netflix plans to implement is advertisements. A majority of Netflix's competitors offer a cheaper ad-based alternative for users. In the past, Netflix has stated that they wouldn't consider offering something like this, until now. Management has said they are now pursuing this option and will phase in this new version over the course of the year.

We believe that these results confirm that Netflix, and the industry as a whole, is shifting swards a subscriber equilibrium. While there is still plenty of room for new subscriber additions, we likely will not see the incredible amounts of growth going forward as we did in the recent past. We think Netflix has realized it can no longer depend on pumping money into content spending to attract users, for example, the change in heart about adding an ad-based service. Netflix still dominates this industry, and we believe that the plan management has laid out to curb losses will be successful.

COVID-19 Impact

COVID-19 had the opposite effect on Netflix compared to most companies in the US. Total subscribers jumped 21.89% YoY[17]. As people were confined to their homes at the peak of the pandemic, many turned to Netflix for entertainment, especially in the UCAN market which saw a 9% jump YoY. Less developed markets did not follow the same trend, however. Latin America saw a reduction in growth, likely due to tougher economic conditions affecting discretionary spending.

Next Games Acquisition

On March 4th, 2022, Netflix announced it was acquiring Next Games, a video game developer from Finland. The all-cash deal is valued at $61.5 million and is expected to be completed by the end of June 2022[19]. This deal is significant in the sense that it highlights Netflix's desire to ramp up its gaming department. It has long been speculated that Netflix and others in the industry would move into the gaming space as they possess the necessary technology. As mentioned before, Netflix launched Netflix Games in late 2021, allowing subscribers to play mobile games based on popular Netflix titles. We suspect this acquisition will one of many more in the future as Netflix expands its reach into gaming.

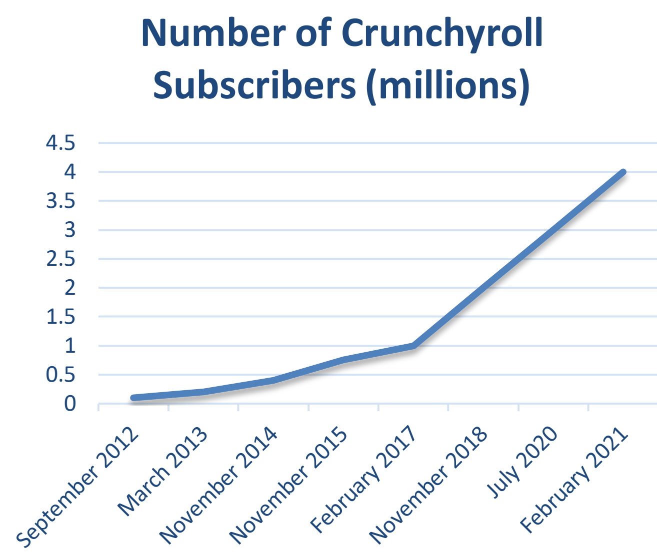
INDUSTRY TRENDS

Original Content

As new firms enter the market, the need for high-quality original programming increases. Firms like Disney who once licensed their content to Netflix now operate in competition. This has forced Netflix and others to become self-reliant and create their own entertainment. The industry is now starting to realize that exclusive content is the best way to win new subscribers, whether these subscribers stick around will be discussed later. Shows like Disney's *The Mandalorian* and AppleTV's *Ted Lasso* have attracted new users to the platform in search of the best bang for their buck when it comes to content. Social media has also played a huge role in this trend too. People on Twitter and other platforms share their opinions on these shows, making others interested and the show going viral. Such as the case of Netflix's *SquidGame* which became a global sensation after being praised on social media. Original content provides major value to subscribers who might be choosing between services. A service that consistently produces award-winning, original content is likely to outperform.

International Content

Netflix's *SquidGame* became the most streamed television show on Netflix of all time in a matter of 4 weeks[11]. Originally produced for the Korean market, *SquidGame* became a global sensation, pushing aside previous beliefs that foreign content wouldn't do well in American markets. This notion was soon dismissed as the show took over the globe like wildfire. Another example of this trend is the increasing popularity of anime, a Japanese style of cartoon targeted towards young adults. These shows have made their way on to almost every streaming platform. Crunchyroll, owned by Funimation, is a streaming service dedicated to these shows and has grown in popularity significantly over the years. The graph below shows the number of subscribers for Crunchyroll since 2012. Platforms like Netflix have increased the amount of anime they offer significantly over the years, as the shows have seen great success in American markets.

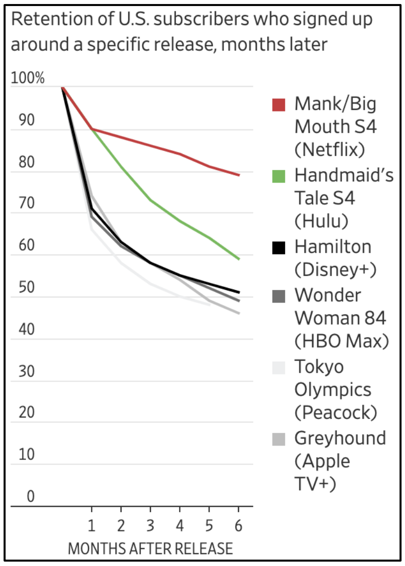


Source: Statista

The ability to air international content overseas is a huge benefit for streaming services as it allows them to maximize viewership.

Subscriber Retention Rates

Recent data has shown subscriber trends around key releases of content. New subscriptions tend to spike around anticipated releases, slowly trickling off months after the release. Some platforms see as much as 50% of their new sign ups leave after 6 months of a major release[5]. Losing subscribers is not new for any of these platforms. Almost all lose some portion of subscribers every month, these are made up for though with new subscribers to have a net overall increase. This phenomenon however sees users leaving at much faster rates than previously seen. Firms have been trying to combat this by consistently producing hits to keep people on board. The graph below shows the retention rates of subscribers after major releases.



Source: Wallstreet Journal

While this may strike an immediate concern for most, the net benefit companies realize make up for lost subscribers. Although many people leave, the net level of users is significantly higher than before the release. The population who leaves after these releases has created a new segment of customer. These individuals will likely continue this pattern of behavior in the short term, but we project this group to fully commit to a streaming service in the long term as content continues to be released on a more consistent basis.

MARKETS AND COMPETITION

Barriers to Entry

The video streaming industry has a large barrier to entry for most looking to join. Initial capital requirements including the latest tech and software make entry difficult. This is coupled with a highly skilled workforce required to maintain and innovate servers as well as perform viewership analytics. Along with physical capital requirements, a large and diverse library of digital content is necessary to stand out amongst the competition. This would require licensing from studios and possibly investing into original content. Companies that already have the technology to stream content as well as obtain media rights have a better chance at entering this industry than others. For example, a firm like Disney which already owns a large amount of content had an easy time entering the industry. Their portfolio of content is a competitive advantage, and current industry participants need to be wary of others who could potentially enter too.

Threat of Substitutes

The threat of substitutes in this industry is extremely high and will only continue to increase. As mentioned before, the average U.S. household subscribes to around 3 streaming services. This creates major competition between players in the industry as they fight to get a spot on each household's roster. Firms must continue to license popular content as well as produce their own hit pieces in order to keep up with the competition. With new services popping up all the time, firms must continually prove their worth to consumers. This usually comes in the form of acquiring the rights to blockbuster hits and original content. With monthly fees uniform throughout the industry, substitution is always a concern for players in this industry.

Peer Comparisons

The video streaming industry is dominated by entertainment and communications firms. The table below outlines the parent companies of the major streaming services. At the time of this report, the merger of Discovery and AT&T's Warner Media is still pending. The acquisition would make HBO and Crunchyroll a part of Discovery+.

Parent	Streaming Service
ViacomCBS	Paramount+, BET+, PlutoTV
Discovery Communications	Discovery+ (Acquisition of HBO pending)
Lions Gate Entertainment	STARZ
AT&T	HBO & HBO Max, Crunchyroll
Disney	Disney+, Hulu, ESPN+
Netflix	Netflix
Alphabet	YouTube Premium, YouTubeTV
Amazon	Amazon Prime

<u>ViacomCBS</u>

ViacomCBS is a media and entertainment conglomerate that operates television networks, film studios, and streaming services. Its streaming portfolio includes Paramount+, BET+, and PlutoTV. Offering some of the cheaper subscriptions in the industry, ViacomCBS offers bundling packages for a discount on their services. In total, ViacomCBS has around 4% total market share of the streaming industry[13].

ViacomCBS	
Revenue Per Subscriber (per month)	70.47
EBITDA Margin (%)	19.47%
ROIC (%)	10.56%
P/E FY1	14.20
Debt/Total Assets	33.49%
EV/EBITDA	10.1x

Discovery Communications

Discovery Communications is a media and TV conglomerate with a broad entertainment portfolio. Their streaming service, Discovery+, has around 5.2 million subscribers[16]. Discovery is currently in the process of acquiring AT&T's Warner Media, thus bringing HBO & HBO Max into their portfolio. Management has stated that the Discovery+ and HBO platform will initially be available as a bundle, eventually moving onto the same platform. The acquisition will significantly disrupt the industry, as HBO is the third largest streaming service by subscribers.

Warner Bros Discovery	
Revenue Per Subscriber (per month)	9.23
EBITDA Margin (%)	37.39%
ROIC (%)	6.06%
P/E FY1	10.66
Debt/Total Assets	45.44%
EV/EBITDA	11.7x

Disney

The Walt Disney Company is a film, TV, and entertainment giant. Disney owns one of the largest libraries of original content that is some of the most recognized as well. They operate through multiple segments like theme parks, consumer products, and media networks. Their portfolio of streaming services rank at the top in terms of subscribers. Their largest platforms include Disney+ and Hulu. They also have a presence in vMVPD streaming with Hulu+ Live TV. Disney and Netflix both combine for over half of the entire industries market share.

Disney	
Revenue Per Subscriber (per month)	23.69
EBITDA Margin (%)	13.30%
ROIC (%)	2.20%
P/E FY1	35.56
Debt/Total Assets	28.64%
EV/EBITDA	16.9x

Amazon

Amazon.com, Inc. is an online retailer that provides a multitude of services, including cloud computing, streaming, and distribution. Their flagship service, Amazon Prime, gives users access to same-day shipping, streaming services, and grocery services. Each Prime member gets access to Amazon Prime Video which is a video streaming service that gives users access to TV and movies on-demand. It is available worldwide except for a select group of countries, China included. Amazon recently acquired Metro-Goldwyn-Mayer, expanding their studio and entertainment library. Amazon also reached a deal with Universal Pictures, adding their content to Amazon's library. Prime Video has roughly 16% market share in the streaming industry. Amazon has an advantage in the industry by offering multiple benefits for its subscribers other than just entertainment, like expedited shipping and access to Amazon's Kindle library.

Amazon	
Revenue Per Subscriber (per month)	5.85
EBITDA Margin (%)	13.77%
ROIC (%)	9.24%
P/E FY1	42.66
Debt/Total Assets	31.46%
EV/EBITDA	18.7x

Netflix

Netflix Inc. is an internet subscription service that allows users to stream TV and movies directly to their mobile devices or television. One of the original members of the video streaming industry, Netflix is the most subscribed platform in the entire industry. Netflix has expanded its presence into film studios, gaming, and film distribution. Available practically worldwide, has cemented itself into the minds of consumers who view it as "The" streaming service.

Netflix	
Revenue Per Subscriber (per month)	10.23
EBITDA Margin (%)	22.87%
ROIC (%)	17.27%
P/E FY1	33.40
Debt/Total Assets	40.63%
EV/EBITDA	20.9x

Lions Gate Entertainment

Lions Gate Entertainment own and operates several entertainment companies in the U.S. and Canada. Their flagship Lionsgate Films is a film production and distribution studio. Their streaming service STARZ has around 30 million subscribers globally making it one of the smaller players in the industry[16]. STARZ has a smaller library of content than most streaming services, however, it does come with a plethora of original content from its history as a premium cable network. Lions Gate has also ventured into gaming by licensing out its content to video game studios.

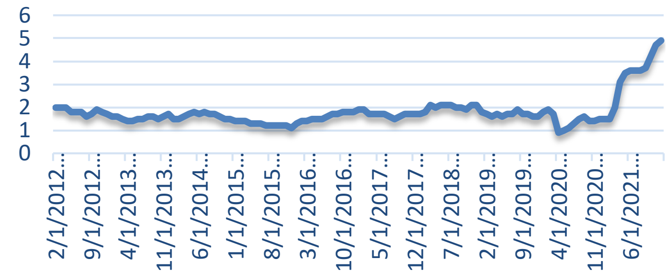
Lions Gate Entertainment	
Revenue Per Subscriber (per month)	10.99
EBITDA Margin (%)	12.36%
ROIC (%)	1.77%
P/E FY1	15.61
Debt/Total Assets	42.75%
EV/EBITDA	19.1x

ECONOMIC OUTLOOK

Consumer Spending

Consumer spending, also known as personal consumption expenditures (PCE) tracks the amount of money U.S. citizens spend on goods and services. PCE is very important to the economy as it is a direct reflection of how much companies will be earning during a given time period. It is especially relevant to streaming industry, as elevated consumption could directly tie into the number of subscribers earned. As seen from the graph below, PCE has risen significantly since 2020. This also happens to coincide with the growth of the streaming industry as a whole. We project consumption to continue to rise over the next 2 quarters but start to tail off thereafter. We believe that when spending peaks as high as it is now, there will be some pull back in spending going forward. People will be less likely to spend on discretionary items, especially products or services they have never used before.

US Personal Consumption Expenditures (%YoY)

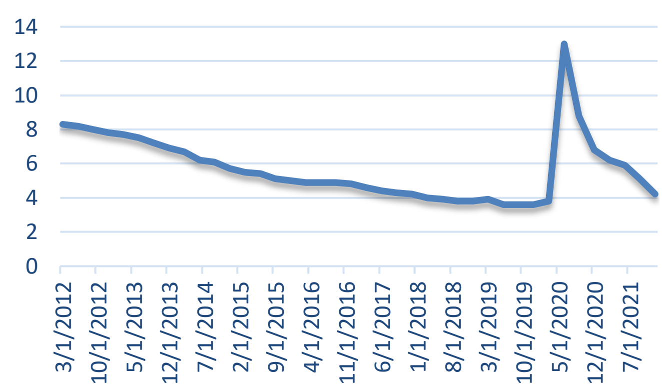


Source: Bloomberg

Unemployment

The COVID-19 pandemic raised unemployment levels to spectacular highs. Since then, unemployment has been going back down to normal levels. Unemployment has a huge impact on the streaming industry for obvious reasons. If people are not employed, they likely are not making purchases on things like entertainment. It should be noted however that the height of the pandemic saw a major increase in subscriptions, around the same time unemployment hit highs. We believe that the two are not correlated and that unemployed people are not driving the demand for subscriptions. We suspect unemployment will continue to fall as government stimulus ends and the effects of the pandemic continue to subside. We target unemployment to be around 4% over the next 6 months.

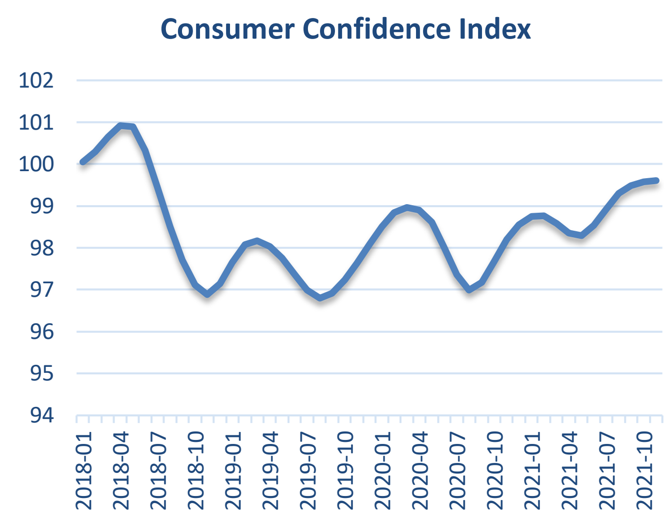
US Unemployment %



Source: Bloomberg

Consumer Confidence Index

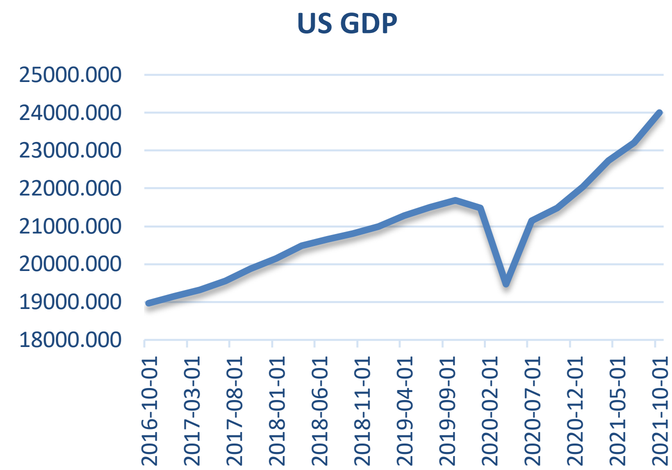
The consumer confidence index (CCI) measures the amount of pessimism or optimism in the economy. A CCI number below 100 means that there is general pessimism in the economy. People are less likely to make big purchases when the CCI is low. COVID-19 played a huge role in lowering the CCI in 2019, and since then it has been slow to recover. Although getting a streaming service isn't necessarily a "large purchase", consumer confidence still influences spending and could deter more vulnerable people from buying one. Spending during the pandemic increased, despite low consumer confidence. We attribute this to people being stuck at home with nothing to do and making purchases online. Moving forward, CCI will likely play a larger role in big purchases, especially with the threat of rising borrowing costs. We project CCI to remain at current levels for the next 2 years as the uncertainty of the pandemic remains and the realities around inflation continue to scare the public.



Source: OECD

GDP

GDP hit lows not seen in a decade during the height of the COVID-19 pandemic. It was able to rebound significantly mid-2020 and has since returned to levels slightly elevated from pre-pandemic. GDP is a broad indication of how healthy an economy is. Periods of low GDP often correspond to inefficient productivity in the economy. As a result, many industries, including the streaming industry, are tied to it. We project GDP to grow around 2.5% over the next 6 months and 5% over the next 2 years.



Source: FRED Database

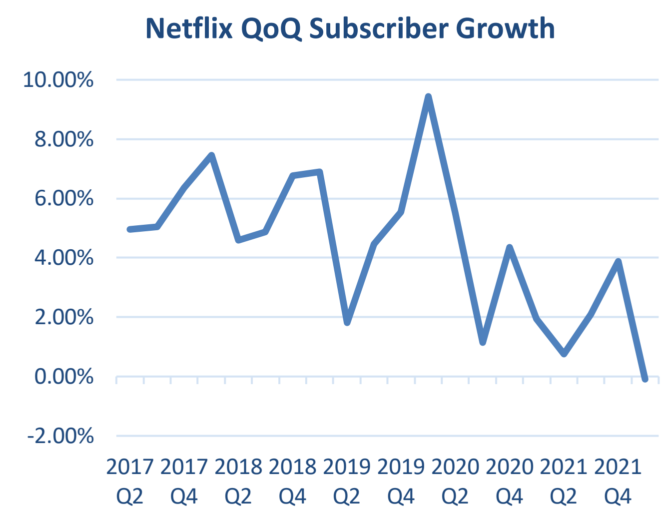
VALUATION

Revenue Decomposition

We broke revenue down into two main drivers, the first being the number of subscribers each geographic segment has, and the second being the revenue per subscriber per month that Netflix generated in those regions. We believe that this is the most accurate way to represent their profits and subsequently base forecasts off.

Subscribers

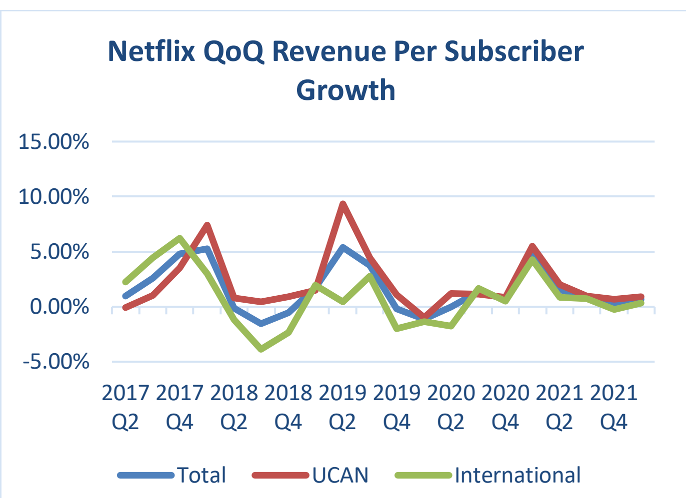
As mentioned above, subscriber count was broken down into four geographies. By looking at historical growth rates for each of those geographies, it is visible that growth has been trending lower the last few years despite stronger numbers in 2020. We believe that as Netflix invests further into gaming and original content, they will reach almost 75 million subscribers in the UCAN region by 2025. We believe that the potential Netflix has in gaming and original content is underestimated and that there is likely to be a revolution in the way people consume entertainment from the cord-cutting trend. We project around 345 million users by 2031, implying a CAGR of 10.3%. We believe the amount of people who will have access to quality wireless internet by 2031 has been greatly underestimated. With technologies like Starlink which allow highspeed satellite internet already in use, we believe access to Netflix will increase dramatically and allow regions that were previously excluded to join in.



Source: Bloomberg

<u>Revenue Per Subscriber</u>

Revenue per subscriber was also broken down by geography, as well as on a monthly basis. In general, revenue per subscriber has trended upwards over the last few years. We believe that price hikes, which is the main driver of this metric, are likely to happen in the near and long-term future. This will be due to the aforementioned investments into original content and gaming. While some regions like the UCAN are better poised for price hikes, others like LATAM and EMEA might be more sensitive to price hikes, requiring great caution and research. We see revenue per subscriber rising to around $16.51 per month by 2031 in the UCAN segment, implying a CAGR of 14.9%. International segments will see growth to around $12 per month on average in 2031.



Operating Expenses

All operating expenses were forecasted as a percentage of revenue using a historical average. Our cost of subscription revenue was forecasted as around 16.5% of revenue, advertising was projected to be 11.5% of revenue, tech expenses were projected as 8.5% of revenue, and general expenses were projected as 5% of revenue. We project Netflix's operating margin to remain steady over the forecast period, slightly decreasing each year. This gradual decline is due to the slight decline in revenue growth we built into the model each year.

EPS Estimates

We forecast consistent EPS growth in the forecasted period, despite consistent increases in shares outstanding. We believe Netflix will earn $12.11 in EPS in 2022 compared to the consensus estimate of $11.06. The discrepancies in our EPS number are likely due to management lowering subscriber guidance, which we don't fully agree with due to the entertainment pipeline in 2022 which we believe will grow subscribers more than anticipated. Our 2023 EPS estimates are lower than consensus coming in at $12.99 a share compared to $14.29 consensus[19]. We attribute this discrepancy to the overestimation of subscriber growth.

Capital Structure

We project a capital structure of 40% debt to capitalization for the years 2022 – 2025, and 30% for the remaining forecast. We split the period into two different capital structures because we believe that by 2025, Netflix will have solidified its position in the market thus requiring less debt to finance large projects. Debt to capitalization has been trending down since 2017 as the size of the equity in the company has grown substantially.

Currently, Netflix has authorized the repurchase of around $4.5 billion worth of shares. We assumed this number to remain constant over the forecast period and distributed that number evenly over our time horizon to get $440 million in share repurchases yearly. We also forecasted increases in the common stock account due to the exercising of employee stock options. We forecasted increases in shares outstanding of 3 million each year with an average option exercise price of $219.83.

Contingent Liabilities

While we did not account for any potential legal liabilities, we did consider content liabilities not reflected on the balance sheet. Content liabilities are related to the acquisition of licensing and production of content. Netflix stated in their most recent 10K that around $15.8 billion worth of these liabilities are not reflected on the balance sheet. We accounted for these liabilities in our DCF model, which will be explained in further detail.

Valuation Models

DCF

Our discounted cash flow model yielded a price of about $235. We assumed a continuing growth rate of 2% which we believe is very conservative and is a proxy for inflation growth. Using that growth rate, we calculated a continuing value of $164 billion. This number, along with free cash flows in our projection period, were discounted using the WACC. We estimated Netflix's WACC to be 6.17%. We calculated this number by using a cost of equity implied by the CAPM. We used a beta of 0.94 and calculated this by levering the betas of comparable firms and then re-levering the average with Netflix's inputs. Our cost of debt was acquired from the yield on one of Netflix's 10-year bonds. We then summed the discounted cashflows, subtracted all claims on the firm and divided that number by the outstanding shares to arrive at our share price.

We place most emphasis on our DCF model because we were able to more accurately reflect our growth assumptions like subscriber count and revenue.

DDM

Our dividend discount model produced a share price of $195. We decided that this model did not best represent Netflix, as they do not pay dividends and will likely not in the future.

Relative Valuation

We used four different metrics when assessing the relative valuation of Netflix being forward P/E in 2022 and 2023, EV/EBITDA in 2021, and EV/Subscriber count in 2021. The comparable companies we chose were Paramount, Disney, Discovery, Lions Gate, and AT&T. We chose these comps because of the industries they operate in and the similarities in end users. Our forward P/E ratios resulted in prices of $223 and $190 in 2022 and 2023 respectively. EV/EBITDA gave us a price of $181 and EV/Subscribers gave a price of $870. We took this valuation method less seriously compared to our DC. While Netflix and their comps operate in the same industry, only one company is on par with Netflix when it comes to subscriber count, and that's Disney. Therefore, our EV/Sub ratio resulted in the highest price of them all.

Sensitivity Analysis

After performing a sensitivity analysis on our DCF, we found that there were several variables that our model was most effected by. The most significant of these was the estimated beta. We found that increasing and decreasing our beta by .05 resulted in a price range of $253-$220. If the beta were to increase more or less by .05, it could significantly alter the implied price, even changing the investment recommendation. This is why we opted to go through the process of un-levering and re-levering beta to get the most accurate depiction of Netflix.

We were surprised to find how little the pre-tax cost of debt played into the share price. A 10-basis point increase/decrease in the number resulted in prices of $235 and $236 respectively. We believe this phenomenon to be caused by the low level of debt in the capital structure. Another notable result of our analysis was the model's sensitivity to the risk-free rate. A 10-basis point difference in our assumed rate resulted in a price range of $229-$242. Provided ongoing geopolitical events in Eastern Europe persist, the risk-free rate (10-year treasury yield) could climb higher, resulting in a lower valuation. However, we believe that the fed is likely to further intervene in order to raise rates due to inflation at all-time highs, raising our valuation significantly.

Valuation Summary

We place most emphasis on our DCF model as it better reflects our assumptions about key drivers. We believe that our relative valuation provides some insight into where Netflix stands compared to its peers, despite not providing the best assessment of price. While metrics like EPS are above consensus estimates, we believe that this is justified through the number of new subscribers that will be brought on through Netflix's original content and gaming investments.

The price of Netflix dropped significantly after the announcement of lower subscriber addition guidance. We projected subscriber growth in 2022 to be slightly above guidance at a 1.25 million loss.

In conclusion, we believe that although Netflix has taken a major hit recently, the portfolio should continue to hold. Netflix still is a leader in the streaming industry, which we believe isn't going anywhere anytime soon. Netflix's multiples are trading closer to their peers than ever before, which we see as a sign that its fairly valued. At this point, exiting the position would ignore the possibilities that Netflix has in gaming, ad-based subscriptions, and fees for multiple users.

KEYS TO MONITOR

Catalysts for Growth

- Continued growth in underrepresented, highly populated regions, especially in APAC
- Additions of popular international content to compete with services native to each country
- Raising revenue per subscriber to maximum levels before deterring new customers

Risks to Thesis

- Spending on original content outpaces the addition of new subscriber revenue, reducing margins
- Continued inflation worldwide deterring discretionary spending
- Unsuccessful entry into gaming arena reducing the value associated with past acquisitions

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