Netflix: A Slowly Sinking Ship

I'm bearish on Netflix over the horizon of the next 1-3 years because of a lack of competitive advantage in its core competencies, curating and creating content.

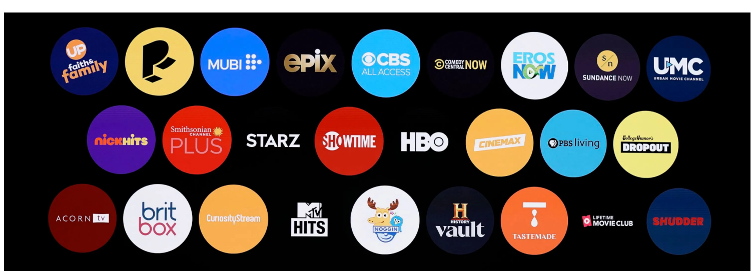
Some companies don't create much value but retain a lot of it. Other companies create a lot of value but struggle to retain it. Netflix falls into the latter category, disrupting the linear cable industry and giving users convenient access to an array of movies and TV shows, but now struggling to hold their market share over competitors like Amazon Prime and Disney Plus.

At first, business seems to be booming. Netflix owns 27% market share[1] and doubled YoY profits in Q1 of 2021[2]. But under the surface Netflix faces stiff competition, losing market share in Q3 of 2021 and struggling to maintain pricing power. The market has yet to realize this: Netflix is trading at a forward P/E multiple of 52x, almost double other blue chip tech companies like Facebook (Meta) and Apple despite experiencing half as slow revenue growth as those companies[3]. But over the next few years, Netflix's lack of competitive advantage will begin to show as it loses pricing power and market share.

Anybody Can Curate

Anyone who has spent longer looking for something to watch on Netflix than actually watching something on Netflix knows the curation algorithm isn't anything special. This isn't a result of a bad algorithm, but compared to platforms with user-generated content like YouTube, Netflix doesn't have enough content (36,000 hours total)[4] to provide better recommendations than Youtube (30,000 hours of new content per week)[5] and other social media platforms. This is the first reason Netflix will never gain a convincing competitive advantage in content curation.

The second reason is that content curation is a bidding war. As content licensers gain more potential sellers (which the legion of new streaming services provide), pricing power swings their way and streaming services have to fight for content. This has led to a rise in licensing costs, as much as a 30% increase in 2019[6] which was the same year nine new streaming services debuted their platforms.



The plethora of streaming services available to users in 2021. Source: indiewire.com

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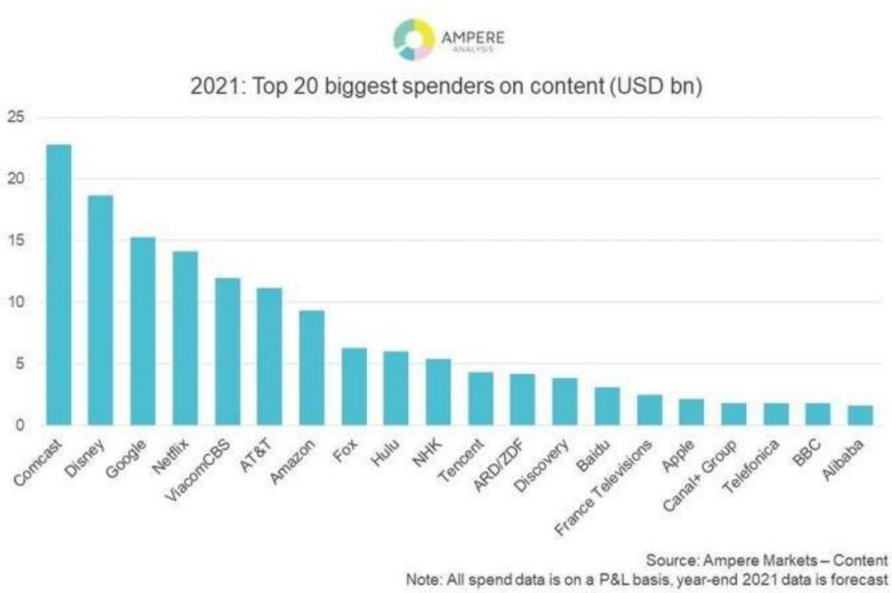
[1] https://www.tvtechnology.com/news/amazon-apple-hbo-max-grow-us-streaming-shares-in-q3
[2] https://www.fool.com/investing/2021/04/25/netflix-paid-a-price-for-doubling-its-profits/
[3] https://seekingalpha.com/article/4466616-netflix-nflx-stock-q3-update-gives-crown-challenges-ahead
[4] https://www.whats-on-netflix.com/news/how-long-would-it-take-to-watch-all-of-netflix/
[5] https://www.statista.com/statistics/259477/hours-of-video-uploaded-to-youtube-every-minute/
[6] https://www.yahoo.com/now/netflix-still-too-dependent-licensed-192221534.html

The margins on licensed content is rapidly declining, and Netflix knows. In 2021, they spent over $13.6B on original content, a 26% increase[7].

But Anybody Can Create Content

There's much more scope to differentiate yourself by producing original content. But Netflix does not possess any asymmetric talent that gives them an edge in producing better content. They can try to outspend competitors, but there's no way to consistently produce better content over time.

Netflix has been in the game for the longest, and top ten lists of hit original content by most number of views is consistently dominated by Netflix. But there are signs of this trend reversing: Disney+ and HBO Max have begun to crack these top ten lists since emerging in the past couple of years. Disney+ in particular racked in 14.5 billion views for hit show *Mandalorian* in 2020, which is less views overall than Netflix hits like *Tiger King*, but a much higher percentage of total subscribers.[8] Netflix has had a strong footing in producing hit content, but it's peers are quickly catching up.



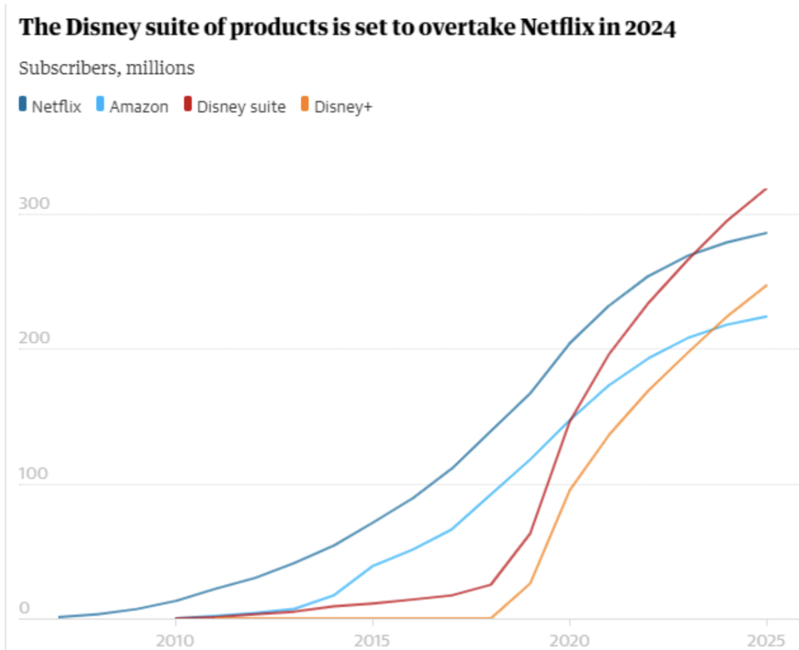
The above chart shows how competitors are able to keep up with Netflix's aggressive spending on content. The next *Squid Game* is not guaranteed to be secured by Netflix, and given that a lot of Netflix's "original content" is actually content financed by Netflix but produced by external talent means that there's no guarantee it's going to be Netflix financing these projects in the future.

[7] https://variety.com/2021/digital/news/netflix-content-spending-2021-amortized-1235072612/

[8] https://www.businessinsider.com/mandalorian-tops-nielsen-list-of-most-watched-streaming-tv-shows-2021-1

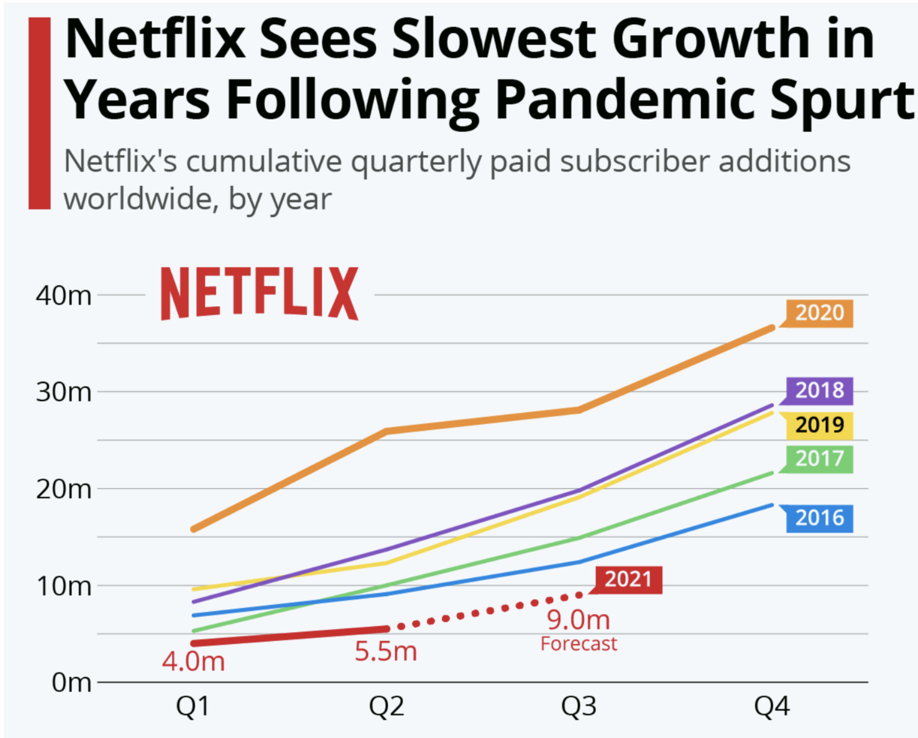
Expansion Strategies, Delaying the Inevitable

Netflix has also been pursuing the international market, expanding its market share rapidly.



Source: https://seekingalpha.com/

However, we can see that this growth is being threatened by competitors.



There are other signs of grim futures ahead for Netflix.

Region	Q1 2021	Q1 2020	YoY Growth	Revenue share in Q1 2021
Asia Pacific (APAC)	9.71	8.94	9%	23%
Europe, Middle East, and Asia (EMEA)	11.56	10.4	11%	27%
Latin America	7.39	8.05	-8%	17%
The United States & Canada.	14.25	13.09	9%	33%
Total	**42.91**	**40.48**	**6%**	**100%**

The declining ARPU in Latin America suggests that Netflix does not have a strong hold over its pricing power. It shows the slim margins that exist in the international market, making that market penetration unappealing.

Finally, the switching costs to other streamers is simply too low, and often, there's no need to even switch. The average American subscriber has four paid video streaming services, and will be subscribed to an average of 5.7 streaming services by 2024 seekingalpha article Nov 2021

- This is an indicator of Netflix's declining market share, people aren't happy with just Netflix they want other services too
- International markets may be price-constrained to choosing one service over another, but the same price constrain works to slim margins and there's no guarantee that Netflix will be the one

This suggests that increasing the number of users while maintaining margins will be difficult for Netflix, and even if user growth is expanded, that benefit is not uniquely Netflix's.

Overall, I’m bearish on the streaming industry as a whole. Having a competitive advantage at producing content is difficult, and Netflix is not fortunate to possess any unique IP or talent to help with that. Having a competitive advantage at curating content is even harder and I’m not even sure any streaming service can sustainably curate content better than competitors over time. Given that streaming is a sinking ship slowly devolving into Cable 2.0, Netflix stands the most to lose - Amazon and Disney have sufficiently profitable products that can keep their streaming product afloat. Netflix is a pure play streaming company; they only have one ship and it’s got a hole in it.