stock Report | 4/5/2016 |NYSE Symbol: NFLX

Netflix Inc.

Recommendation	Price	Price Target	Margin of Safety
Buy	$104.94	$116.36	10.88%

Sector: Technology
Sub-Industry: Internet Entertainment Services

Summary: Netflix is a global provider of streaming movies and TV series original and licensed.

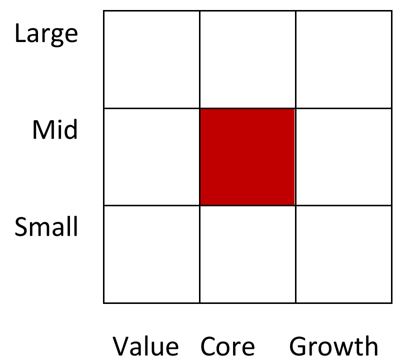
Key Stock Statistics

52-Wk Range	$58.46 - 133.27	Most Recent Dividend	-	P/B	22.01
Beta	1.21	Dividend Yield	-	ROE	5.90%
Shares Outstanding (M)	427.69	Trailing 12-Month EPS	$0.29	S&P Credit Rating	BB-
Market Capitalization (B)	$44.83	Trailing 12-Month P/E	377.50	Institutional Ownership	88%

Investment Highlights

- ✓ Increased integration into other products such as Apple TV, and mobile devices.
- ✓ Improvement and development of accessibility. How fast it takes to create an account and start watching is being decreased.
- ✓ Increasing viewer hours as well as viewers decreasing the average time it takes them to watch a show.
- ✓ Creation of original programing in comparison to licensed material.

Style Box



Performance

Covering analyst: Arman Hastings
Email: hastinar@onid.oregonstate.edu

Table of Contents

Company Overview

Netflix is the world's leading Internet television network with over 75 million members in over 190 countries enjoying more than 125 million hours of TV shows and movies per day, including original series, documentaries and feature films. Members can watch as much as they want, anytime, anywhere, on nearly any Internet-connected screen. Members can play, pause and resume watching, all without commercials or commitments.

The company was established in 1997 with its headquarters located in Los Gatos, California and started as an American DVD-by-mail service in 1998. Netflix later began their streaming segment in 2007. Since then they have expanded globally starting with Canada in 2010, and most recently in 2015 moved into Japan, Spain, Portugal, and Italy. As of 2016, it has over 75 million subscribers and now serves over 190 countries.

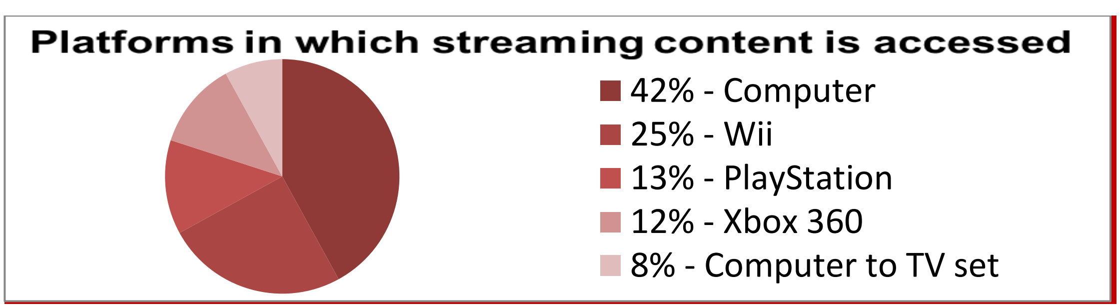
As a company Netflix has understood that people love TV content, but they don't love the linear TV experience, where channels present programs only at particular times on non-portable screens with complicated remote controls. The main attributing reason to why Netflix is so successful is that they rethought the current TV entertainment industry on the receiving end and planned it's change to me more convenient to the customer. Netflix describes this change as the change from linear TV to internet TV which is on-demand, personalized, and available on any screen.

Services

As a company they offer three services which are, streaming, disc rental, and profiles.

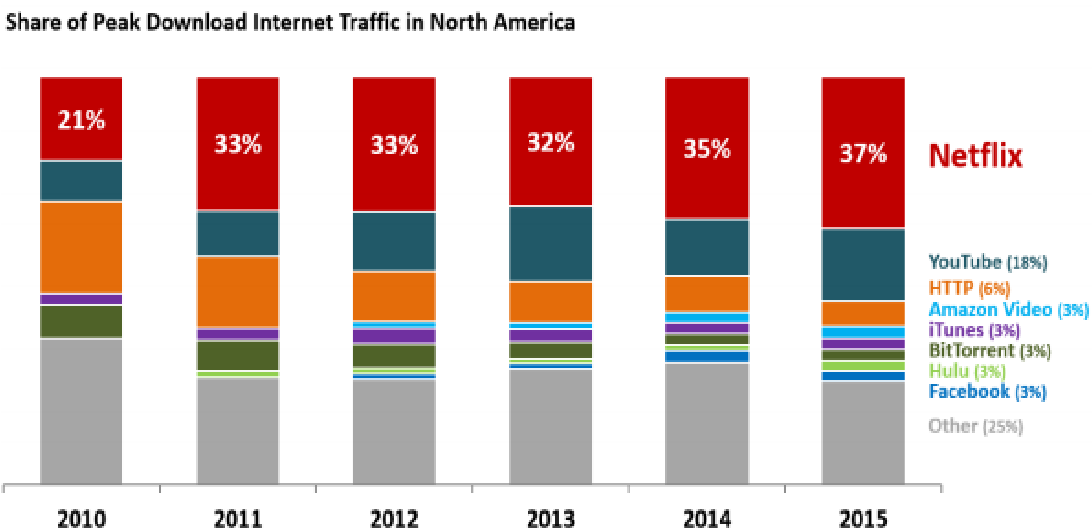
Streaming

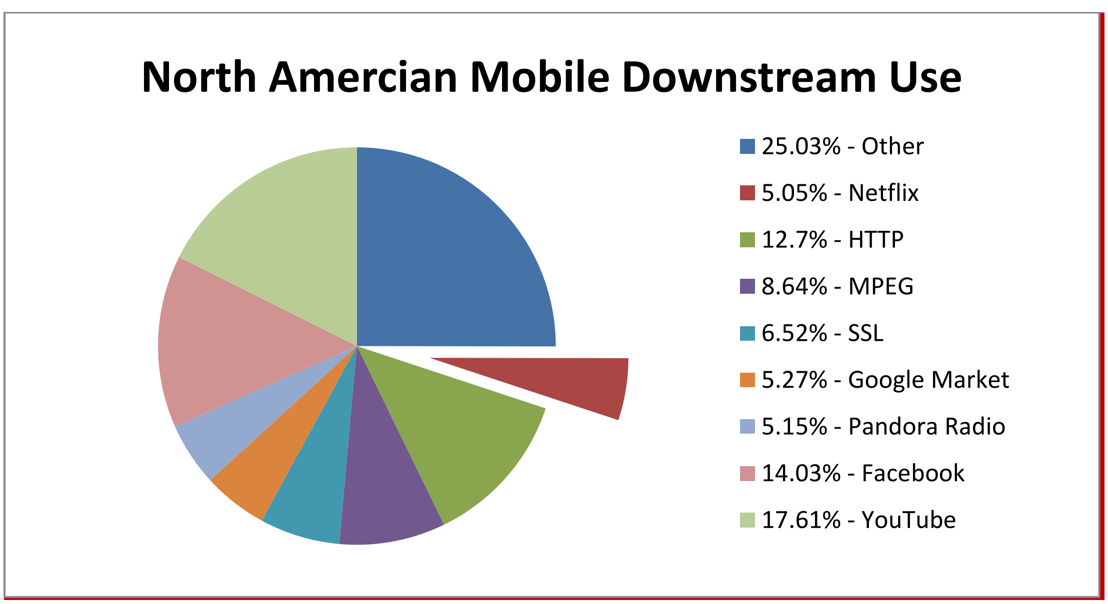
Netflix most notably is known for their streaming content. Netflix offers an Internet video streaming service which gives Internet connected devices access to Netflix's library of online content. Netflix also allows individuals to take full advantage of this streaming service by allowing them to watch whatever, whenever they please as long as they are on a device that can login to their active account. This type of accessibility is incredibly important and as can be seen below in this allows them to access more customers.



Here accessibility to Netflix's services amongst different platforms is visualized and has helped them gain customers who are not interested in changing platforms/consoles to access Netflix's services. This trend of improving streaming accessibility was also announced to be an important focus for 2016.

Additionally according to a 2014 report by Sandvine Inc, Netflix is the biggest source of North American downstream web-traffic, at 34.2%, and registered 32.09% of aggregate traffic. For mobile use of Netflix was recorded at a 5.05% for North American downstream web-traffic, and at 4.55% for registered aggregate traffic clearly showing Netflix's popularity.





Disc Rental

Netflix’s disc rental service, being the first service they primarily offered, is still available and is incorporated into Netflix’s bundle of services. Netflix provides this service for a monthly flat-fee for the rental of DVD and Blu-ray Discs. A subscriber creates an ordered list, called a rental queue, of films to rent. The films are delivered individually via the United States Postal Service from an array of regional warehouses. The subscriber can keep the rented disc as long as desired, but there is a limit on the number of discs each user can have out at a time which is determined by subscription level the user pays for.

For this service Netflix offers many different pricing tiers for DVD rentals to allow customers to have some control over how they pay in comparison to use. Blu-ray discs are also available however there is an additional fee to get them.

Profiles

Lastly Netflix introduced a “Profiles” feature in 2013 that permits accounts to accommodate up to five unique user profiles, associated either with individuals or themes of their choosing. This segregates individuals in a house hold that might share the service and allows Netflix to more accurately predict, and recommend films or TV shows more accurately. Which is incredibly important as about 75 percent to 80 percent of what people watch on Netflix comes from what Netflix recommends, not from what people search for". There has been other testing by third parties proving the user differentiation in focus-group testing can generate more viewing and engagement.

Industry Outlook and Competitive Environment

As far as entertainment sources and TV entertainment

Netflix being practically the only company working in streaming content at the scale that it is Netflix's competition has been shifted away from actual companies to competing with other leisure time activities. Instead of focusing on being out other competitors in the market Netflix's focus is more on "winning moments of truth".

Netflix’s Competitors

Amazon.com, Inc. (AMZN)

Amazon is an American electronic commerce and cloud computing company which has recently diversified into selling DVDs, Blu-rays, CDs, video downloads/streaming, MP3 downloads/streaming, audiobook downloads/streaming, Their recent move into movie and video streaming makes Amazon a fair competitor with their current customer base.

Outerwall (OUTR)

Outerwall Inc. is an American company with a network of movie and game rental kiosks as well as coin-cashing machines. Outerwall also currently owns Redbox that markets movie rental kiosks. Outerwall has also since stated they would like to focus more and expand on their movie segment

Time Warner Cable (TMX)

Time Warner Cable (TWC) is the second largest American cable telecommunications company. Time warner constantly hosts, creates, and licenses movies and TV shows.

Disney (DIS)

The Walt Disney Company, commonly known as Disney, is an American diversified multinational mass media and entertainment conglomerate. As a whole they control and create many popular titles such as StarWars and their entire Disney channel. They are also expanding into different entertainment avenues as they figure out what to do with the changes created by streaming companies like Netflix.

Viacom (VIAB)

Viacom, Inc. is an American global mass media company with interests primarily in cinema and cable television. Most notably Viacom runs cable networks such as Comedy Central, Nickelodeon, and the MTV channels. They also operate within the film business as Paramount Pictures, and Paramount Vantage.

SWOT Analysis

Strengths	Weaknesses
Development of more Netflix original content both to local and global markets. Massive North American popularity . User experience and ease of access in comparison to linear TV content or tradition rental stores. Very competitive "sweet spot", as described by management, price points.	High prices for mobile data plans are throttling Netflix's potentials for higher mobile viewers. Pricing power, and various movies and studios asking for a "28-day window" to without content release for box office profits. Terms of content distribution are not exclusive and can allow for competitors to show the same licensed content. Censorship for countries that ask for it.
Opportunities	**Risks**
Growth in global markets, especially in those where Netflix is the first mover for streaming services. Creating and expansion on kids programming that is created for both kids, and parents. (Identified to be a deprived Television entertainment market) T-mobile "Binge on!", and Verizon's "Freebie!" initiatives to allow mobile customers watch shows and movies for free up until a limit.	Foreign currency exchange rates are slowing growth in their new countries and eating into their net income. Net Neutrality risks, companies such as Comcast have been caught multiple times illegally limiting traffic speed for other competitor companies. These same companies trying to assert their power are also lobbying for changes to the net neutrality federal laws in their favor. Other companies offering streaming services such as Amazon or Hulu.

Net Income

Netflix's net income has been weaken recently in 2012 with the expansion into different countries and currency exchange rates. The decrease of net income has also been announced as a by product of Netflix and their team creating their original series. However within one to two years their net income should be grow past what we have seen it at before

Balance Sheets

Revenue and total assets have been climbing in the recent years, however so have the total liabilities. Another noticeable trend is that the equity has been decreasing in the past 4 years. Stock holders total equity has also increased by ten percent since the end of 2014 and 2015 Q1 release.

Statement of Cash Flows

Unfortunately from the representations in the net income section of this write up is it very easy to see the trend in the current cash flow. When looking at the past five years net income has been increasing not much has been changing significantly. Overall Netflix's net income has been seeing a positive trend over the past five years.

Current Events

- Netflix Cracks down against VPNs; Feb. 29, 2016
- Netflix is Now Available Around the World; Jan. 6, 2016
- Netflix Brings Their First New Original Anime Series, "Perfect Bones", to Member Worldwide; Feb. 26, 2016
- Netflix to Announce First-Quarter 2016 Financial Results, Available Apr. 18; Mar. 16, 2016

Valuation

Cost of Capital

The cost of capital, 10.92% was found using the capital to asset pricing model. Beta used to calculate this was 1.41, which came from matching up monthly average close to the monthly average close of the S&P 500. I chose this over the monthly or weekly beta, because this beta value had the highest R-Squared value. The cost of debt used came from one of Netflix's longest available bond. The cost of debt used was 5.875%.

Discounted Cash Flow Model

For the DCF I used a three stage growth model. It is worth noting stage one, and two are both 1 year in length while stage three is three years in length. For my estimates I used both the year over year mean and percentage of Revenue as references. The main reason for using a mixture of both percentage revenue and year over year is to accurately predict the direct of the next years for stage one and two without some of the anomalies found within the data. As for the overall revenue growth I projected 26% for stage one, 28% for stage two, and 38% for stage three. These estimates where not only based on the prior trends with Netflix's revenue, but also with the current management strategy in mind.

Generally throughout this discounted cash flow valuation I tended to stick to a fair, or optimistic, estimate of growth as projected within the discounted cash flow growth rates for stages one and two. As for stage three, years 2017 to 2019, I projected a sizable jump in their revenue and current assets. The main reason for this is because of time it inherently takes to grow and to become established in these new markets. With some of the biggest challenges in these new markets being accepting of currency, and creating systems available for these new regions. Netflix is and will be for the next two years, as commented on by guidance, be fighting against accessibility and currency exchange rates. Netflix also plans on developing Netflix original content exclusive to the region to win over favor of the locals, and to convert more individuals over to their services. This creation of local specialized content will also take time but will be very beneficial to Netflix's growth in other countries, therefore adding to the reason I projected a jump in revenue and assets for stage 3 I weighted this at 80%.

Relative Valuation Model

For the relative valuation model, I used the competitors listed: Amazon, Outerwall, Time Warner, Disney, and Viacom. I then assigned weights for each company based on market cap, price to earnings, price to sales, price to book and their price to earnings growth. Their main products were also considered when deciding weights.

This is also a good time to address NFLX's P/E ratio of 153.85 and why it is so high in comparison to its peers. Some may think this P/E ratio means that NFLX's growth rates are way overvalued however again this is not the case. The reason why NFLX's P/E is so high is because NFLX has outpaced its peers in terms of sheer returns by a wide spread margin. Other factors that contribute to this is that Netflix is the current leader in video streaming with a large gap over its rivals in Amazon Prime and Hulu. It is rapidly growing, especially in the all-important international market reporting 75% year-over-year growth in the last quarter of 2014 and lastly its increasing quarterly profit margins since 2012 all play into its high P/E

This gave me an intrinsic value of $105.76 which I believe is an undervalued evaluation for Netflix. Netflix in the entertainment/technology field is a fairly unique company that other platforms have been able to replicate but not on the same level as Netflix. Even though Amazon, Outerwall, Timewarner, Disney, and Viacom are fair companies to relate to Netflix their services they offer are either diversified or not directly in the same field. These relative companies however may offer some of exact same services Netflix does, again do not dedicate enough focus to operate on the same scale Netflix does. This problem of finding appropriate companies to compare these newer and innovative technology companies to is not an uncommon one. I weighted this at a 10%.

Historical Valuation Model

The 5 year historical model gave me a discounted intrinsic value of $46.21, while the 3 year historical model gave me an intrinsic value of $74.34. I believe that both of these valuations from the historical model to be underselling the value of Netflix however I believe the 3 year is a more accurate look at Netflix therefore that is the value I used in my final valuation. The main reason to why I prefer the 3 year valuation over the 5 years is that it doesn't include the massive change in Netflix's earnings per share in 2011 to 2012. Netflix's EPS can be seen dropping from $4.16 in 2011 to $0.29 in 2012. This drop in EPS was actually a result of manage management decisions within Netflix that was anticipated as they focused on tackling global markets. Therefore I felt the 5 year timeline does no appropriately represent Netflix's current value because of that anomaly. I weighted this at 10%.

Final Valuation

I believe that NFLX is currently **undervalued** with the current price of NFLX's stock at 104.94, and with an estimated price target of $114.34.

Therefore I recommend a **BUY** for the Oregon State Investment Group considering that the group is currently underweight in technology sector. For many reasons I have detailed in this report I believe foremost that the move to global markets, first movers advantage at their current scale, and creation of original content will allow them to grow fantastically within the next 5 years. Revenue has also be growing consistently for the past five years. I do understand there may be a concern of Netflix's growing operating expenses eating into their net income however if they can maintain their slow recovery over the next year or so we should see substantial growth back into the net income. To conclude I approve the changes and strives that Netflix has made for the longer term success in global markets, and I also do not feel that the value has been fully realized.

Covering analyst: Arman Hastings
Email: hastinar@onid.oregonstate.edu