Buy Netflix

David Gardner | November 21, 2019 | Buy Recommendation

CURRENT PRICE: NFLX $ 470.91 ↑ $ 2.87 (0.6%)

It's the golden age of streaming television. More people than ever are ditching cable and satellite, and their ranks are growing. Since 2012, 10 million people have dumped their traditional subscriptions in favor of over-the-top streaming services. Last year, around 3% of pay TV subscribers gave their notice. This year, that percentage will probably be higher.

But if the allure of anytime entertainment has the air of a gold rush, it should sober us to remember that gold rushes can produce more losers than winners. That seems to be the market's concern about one of the industry's biggest names. **Netflix** (NASDAQ: NFLX) might have been the first to stake a claim in this new territory, but the field is getting crowded. That explains why, despite the company's stunning growth, its stock is more than 20% off its 52-week high.

Yet Netflix is one of our favorite companies in large part because it's been so good at anticipating tomorrow's challenges. I think it will continue to stand out even as more streaming players fight for viewers. To me, this looks like an opportunity to buy another piece of a great business at a discount.

This will be our seventh recommendation of Netflix. Those of you who have bought any of the other six times can boast gains anywhere from 16,300% (December 2004) to "only" 880% (June 2013). But if you don't own shares yet, don't let yesterday's returns intimidate you. This is still an innovative company focused on the big picture. Even today, it's a great time to buy Netflix.

NETFLIX IN 1 MINUTE

WHAT IT DOES

Netflix is one of the top names in video streaming, both domestically and around the world.

WHY YOU SHOULD BUY

- Netflix's stock is down sharply in recent months over fears of slowing growth and new competition — but we think the market is underestimating it.
- Netflix's subscriber base and stable of content form a durable competitive advantage.
- The company continues to grow at a rapid pace internationally, with plenty of opportunity ahead.

BUYER'S GUIDE

- **Industry:** Entertainment
- **Size:** Large Cap
- **Region:** Global
- **Nov. 20 Price:** $305.16
- **Allocation:** We don't recommend buying too much of any stock. Many Fools choose to start with a small amount — 2% of their portfolio's overall value, for instance — and add a little at a time.

KEY DATA

Too Many Choices

Cable TV may be on the way out, but there's never been so much TV available.

Just this month we saw the launch of Disney+, the streaming service of **Disney** (NYSE: DIS), as well as the launch of Apple TV+ from **Apple** (NASDAQ: AAPL). By the end of spring, we'll also have a new service from NBC Universal/**Comcast** [(NASDAQ: CMCSA)] called Peacock, as well as HBO Max from Warner Media/**AT&T** [(NYSE: T)]. That joins well-known services like Disney's majority-owned Hulu and **Amazon**'s [(NASDAQ: AMZN)] Prime Video. Then there are some less celebrated over-the-top options like CBS All Access, **Alphabet**'s [(NASDAQ: GOOGL)] YouTube TV (aimed at providing access to existing third-party channels), and even **Facebook**'s [(NASDAQ: FB)] Watch (which is a thing).

All this might seem like bad news for Netflix, and it has certainly caused some disruption. Netflix will no longer have access to the remarkably popular 2000s sitcom *The Office* starting in 2021, since NBC wants to keep it exclusive to its own service. Netflix is also losing its very popular content licensed from Disney (think *Star Wars*, Pixar films, Marvel, etc.).

But the company's evolving strategy has been playing down licensed content to focus on originals. No streaming company is more prolific than Netflix when it comes to producing original content, and while the company catches some flak for that (ever heard of *Disjointed* or *Chasing Cameron*?), it has quickly built up a remarkable body of popular and critically praised intellectual property.

- **Headquarters:** Los Gatos, California
- **Website:** [Netflix investor relations]
- **Market Cap:** $133.7 billion
- **Cash/Debt:** $4.4 billion / $13.5 billion
- **Revenue (TTM):** $18.9 billion
- **Earnings (TTM):** $1.4 billion
- **Revenue (2016/'17/'18):** $8.8 billion / $11.7 billion / $15.8 billion
- **Earnings (2016/'17/'18):** $187 million / $559 million / $1.2 billion

Add NFLX to Your Favorites

Notably, that strategy is being imitated by Apple, which is staying out of the licensing wars and focusing *only* on original content. Disney will obviously stick to Disney content. Amazon faces the same licensing challenges Netflix does. The content available to consumers is fracturing, which means we'll have some choices to make.

Does Netflix come out a winner in that calculus? Absolutely. Right now the web is awash in articles about choosing the best streaming services for a limited budget. And we haven't seen one that doesn't place Netflix squarely in the must-have category. There's a limit to how many streaming services we'll subscribe to (although, when you consider that the average monthly cable bill is $107, that number could be surprisingly high). But Netflix will make the cut for the vast majority of viewers.

There's also something underappreciated about Netflix's approach to generating massive quantities of content — even if some of it leaves you scratching your head. Netflix has locked up many top actors into lengthy contracts and essentially replaced network television as the place to go *watch something*. It is the core service around which other services can fill the gaps. In between your favorite shows, there's almost always something new. Competitors can chase that strategy, but they'll have a long way to go and a lot of habituation to overcome. Netflix spent around $12 billion on content last year and is on track to spend around $15 billion this year.

How Profitable Do They Want to Be?

Meanwhile, the focus on the U.S. market ignores what is going on everywhere else. Netflix's international subscribers were up 23% in the most recent quarter, driving a 31% increase in overall revenue. The company's online platform remains hugely scalable, with major opportunities for growth around the world.

Netflix spends a huge amount of money creating content, but much of it has global appeal — meaning a low marginal cost for each additional subscriber.

GET MORE INFO

Talk About NFLX

Talk about how NFLX fits into *SA* here

[See why Netflix scores a 12 on our unique 25-point Risk Rating.]

[See how you can tell if this investment is going right — or wrong.]

While the company does invest in content targeted to specific markets, this advantage should grow as the company grows.

Right now, Netflix is only modestly profitable, giving it a high price-to-earnings ratio (around 98x based on trailing GAAP earnings). But its operating margin has shot up, from 4.3% in 2016 to 10.2% in 2018, to an estimated 13% this year and 16% next year. Management's decision to sacrifice profits in favor of creating more content — some of it valuable, long-lived intellectual property — looks wise in the face of the evolving market. But the company has the opportunity to be very profitable in the future, and management has a lot of control over how it leverages its subscribers. Even subscription fees show that — the company raised prices on U.S. streaming plans early this year. Just like YouTube TV charges $50 a month because it gives access to over 70 channels, Netflix can charge more than Apple or Disney because of the breadth of its content.

Risks and When We'd Sell

We think Netflix stands tall in a competitive marketplace, but it would be small-f foolish to ignore that competition. Disney+ landed 10 million subscribers in just over a day after launch (it took HBO Now about three years to reach 5 million). That's only a small portion of Netflix's 158.3 million subscribers, but it's an impressive start. To say that we think Netflix will stand up exceptionally well to competition doesn't mean competition will have *no* impact, and investors will be watching very carefully over the next few quarters, ready to react quickly to any unpleasant news. Netflix is targeting 7.6 million net subscriber gains in the current quarter, which will be a good test of the impact from new competitors.

Moreover, in the second quarter, Netflix reported its first-ever decline in U.S. subscribers. The absolute number — 126,000 — wasn't huge (the company more than made it up in the third quarter), but it was both unexpected and not driven by competitive forces (which hadn't substantially changed in the quarter). Netflix has over 60 million domestic subscribers and hopes to reach 90 million, but recent quarters demonstrate that the remaining climb, if it's achievable, will likely be slow and difficult.

Finally, while international growth remains strong, Netflix can't merely leverage its U.S. programming. The company needs to create content for specific international markets.

The Foolish Bottom Line

Netflix is a classic growth stock of our time — a wealth-building machine that has always looked expensive (albeit a little less so these days). We're not too worried about new competitors. Rather, we see a world still early in its transition from linear television to streaming, and Netflix should retain its Top Dog position in that race. It may be tough for shareholders to gain another 16,300% from here, but this is a company that is only strengthening its hold on the world's screens for decades to come.

Karl Thiel contributed to this report.

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