David's Recommendation:Netflix

David Gardner | September 15, 2006

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

I'm about to set a record on my side of the scorecard. Including this month's nod, I've now recommended **Netflix** (NASDAQ: NFLX) four times since 2004. Two of those resulted in great profits, but my most recent recommendation in July has lagged the S&P 500 by about 25%. While you may think the decline should have me heading for the hills, instead I'm knocking at the door. I think the stock's recent pullback is a buying opportunity, and I'm sure these prices won't last.

For those of you who have recently returned from a seven-year jungle excursion, let me introduce you to Netflix. The company is cyberspace's far superior answer to **Blockbuster** (Nasdaq: BBI) and other conventional video rental stores. It allows subscribers to get just about any DVD delivered to their mailboxes in a day or two. It does away with traffic, checkout lines, late fees, and other hassles of renting. (Come to think of it, maybe there aren't long lines at Blockbuster anymore, but that's part of my point here.) The Netflix website allows anyone to browse titles, read reviews, rate movies, share notes and ratings with friends, get recommendations, and create a personal queue of movies -- all the flawlessly executed bells and whistles we've come to expect from a top-notch e-commerce site.

It's also a well-known brand, so I'm left to think that this is a case where Wall Street just doesn't get it. I'll expand on some of the points I raised in my July rerecommendation and give you my new thinking on why this company will become a dominant entertainment force.

WHY BUY?

- Lower price represents a great opportunity to profit from misperceptions.
- Move to film distribution and production will leverage role as entertainment nexus.
- Unrivaled customer intelligence will create a better business, make it an ideal partner.

KEY COMPANY DATA

- 100 Winchester Circle
  Los Gatos, CA 95032
- Ph: 408-540-3700
- www.netflix.com

Scroll left/right to view wide tables

Market Cap:	$1,480
Recent Price:	$21.75
Risk-Level Rating:	Medium
Cash/Debt:	$342/$0
Owner Earnings Run Rate:	$55

Except price, amounts in millions.

The Media Giant

First, I want to talk about Netflix as a media company. In July, I briefly highlighted the importance of newly launched Red Envelope Entertainment, and I discussed a distribution deal for the Maggie Gyllenhaal movie *Sherrybaby*. I drew a parallel between Netflix's move and HBO's successful strategy, concluding that Netflix could use such deals to leverage its core business and generate extra revenue.

A September 2006 article in *Wired* compares Netflix not to HBO but to Miramax, the film-distributor-turned-producer originally launched by Bob and Harvey Weinstein. The point of the article mirrors my thinking: Netflix is marching up a value chain. For the past few years, the company has quietly signed deals to make unsigned films available to subscribers (getting the standard rental fees along the way), and it has been credited with giving life to films that never had much of a run in the theaters. With Red Envelope, Netflix retains distribution rights and gets an even bigger slice of the pie -- including theatrical distribution. The company is even looking into producing movies that are still in the "creative" phase. I like that Netflix doesn't need massive box office success to make such deals profitable -- it can reach the masses through the mailbox.

The Info-Tech Giant

You may think that I'm crazy to call Netflix an information technology giant. But I think the data it collects as part of its operations are vastly under-appreciated. Just think of the power behind Netflix's model. Sure, **Amazon** (NASDAQ: AMZN) can show you other products you might be interested in based on past purchases or page views. But its prescience is, in my experience, quite limited. People simply buy too diverse a range of items to allow Amazon to build a truly coherent, predictive consumer profile the way Netflix does with members' movie-viewing habits.

After all, my Netflix queue is full of just one thing: movies I want to see. And as a subscriber, I am likely to cycle through that queue at a rate of, say, five to 10 movies a month while replenishing the list. This allows Netflix to build a superb profile of my likes and dislikes, even if I don't bother to actually rate movies I've seen for my friends. As Netflix becomes increasingly sophisticated at analyzing this information, it should grow its competitive advantage. A careful scan should tell Netflix which type of customer is likely to end his membership and which is likely to stick around. Netflix can use the customer data to determine the demand for titles -- and how that demand rises and falls -- allowing it to better manage its inventory and minimize expenses. The data will also steer Netflix to the right markets for marketing new films, clearing the way for Red Envelope to make better decisions about distribution or production deals.

Who else has this kind of intelligence? Certainly not Blockbuster, which only knows what you've rented in the past and can remind you that it's been a long while since you came into the store. Not the movie studios, which have to rely on box office numbers or the rental and purchase information other companies give them. Not the on-demand companies that stream content to your television. Each of these players has bits and pieces of information, but not one can rival Netflix. To Wall Street, I ask: You still don't see the potential?

The 800-Pound Gorilla

My final point has to do with how this stock has been kept down recently. The smart money just "knows" that sending DVDs through the mail is a prosaic, doomed business model. How does it make sense to send digital information by snail mail, they ask? I see their point. But I don't see a major technological advance changing that in the near future. There aren't many people who have the bandwidth to make downloading an 8-gigabyte movie a snap. Sure, bandwidth capacities will increase, but movies are coming out in high-definition formats that take up more like 40 gigabytes. Mailing a DVD still makes sense to me.

I'm not holding my breath for change. But I am holding to my belief that when it comes, there is no company better suited to exploit (and I mean that in a positive sense) a new business model. Will studios want to start their own download businesses? Maybe, but the track record of music companies trying to go up against **Apple**'s (NASDAQ: AAPL) iTunes with their own necessarily limited libraries hasn't worked. Consumers want a one-stop shop. Netflix offers just that; studios don't -- and can't. And Netflix can even out-do Apple when it comes to being comprehensive: You can't download an original Beatles recording from iTunes, but you can rent *A Hard Days Night* from Netflix! I think that as this business evolves, the movie studios will be crazy not to want Netflix as a partner.

The Foolish Bottom Line

I haven't talked much about valuation, but suffice it to say that most fast-growing companies with this kind of disruptive potential usually trade at lofty premiums. At about 25 times next year's estimated earnings, Netflix may not be attracting hardcore value investors, but it's hardly sporting a nosebleed price. Indeed, if the company comes near its goal of reaching 20 million subscribers in the 2010-to-2012 time frame without sacrificing margins, it'll prove to be quite a bargain. Its $1.48 billion market cap is less than twice that of Blockbuster, which squeezed out a 1.5% operating margin over the past 12 months and racked up massive red ink on the bottom line (compared with Netflix's 8% net profit margin).

Blockbuster investors need to question whether the company will even survive; Netflix investors are still at the beginning of the ride. The most recent quarter showed a return to the improving gross margins the company has been steadily achieving over the past several years, and it is closing in on its first year with $1 billion (or close to it) in sales. It's a great time to buy.

David owns shares of Netflix and Amazon. Stock Advisor *team member Karl Thiel contributed to this article.*