**Pomona College**

**Group Project: ECON 117**

**Netflix, Inc.**

**Billy Altantulkhuur, Erica Barry, Wesley Chang, Malik Power**

**ECON 117**

**Professor Mitchell**

**Spring 2019**

## I. Business Environment & Strategy

### A. *Industry Overview*

Competition within the entertainment and media market is heating up from the new digital economy, and streaming video on demand (SVOD) is growing rapidly.[1] The landscape of this market has rapidly evolved over the past few decades with the advent of technological innovations such as the internet, streaming services, and social media. This paper will provide a company overview and financial analysis of Netflix, Inc. (NASDAQ: NFLX) (hereinafter, "Netflix"). In doing so, we will provide an overview of its business environment, a comprehensive financial ratio analysis, a review of its accounting policies and footnotes, an assessment of its quality of earnings and information that would be pertinent to investors interested in Netflix. Where appropriate, we will include comparisons to a competitor within the industry, The Walt Disney Company ("Disney"). We will conclude with our recommendations for investors considering an investment in Netflix stock.

The primary business that Netflix operates is a subscription-based streaming service, which offers users online streaming of films and television programs, including those produced and capitalized/expensed in-house. In 2018, a total of 39.3 million U.S. adults stopped using cable television service[2], forcing the entertainment industry to adapt technologically since it could no longer rely on cable programming alone. Netflix was one of the first companies to offer streaming services, expanding its business in 2007 with the introduction of streaming media while retaining its original DVD and Blu-ray rental service.[3] Now, of the 1 billion hours a day

[1] "US Edition: Global Entertainment and Media Outlook 2017-2021." PricewaterhouseCoopers, 2017.

[2] https://www.statista.com/statistics/482958/number-cord-cutting-tv-households-north-america/

[3] "Long-Term View – Overview" at http://www.netflixinvestors.com

spent watching television in the United States, 10% is spent on Netflix, according to the company's latest earnings call. However, competition is heating up in the business environment in which Netflix operates, as the industry sees a new "convergence" in the players – where companies are crossing product borders and moving into different service offerings to adapt to a new environment.[4] Recognizing the success of Netflix's streaming services, many other companies are attempting to follow suit into the streaming business; Netflix already has many potential competitors seeking to enter the space, including NBCUniversal, Amazon, WarnerMedia and Apple, which are all building their own streaming services, as well as competitors outside of the streaming business, such as Fortnite and YouTube, which compete for viewers' time.[5]

One of Netflix's major potential competitors is Disney, which is also launching its own streaming service, Disney+, this year. This new service will feature Disney's own collection of animated films and movies. Disney also owns sports-focused ESPN+ and Hulu (which it acquired through its acquisition of 21st Century Fox). Disney has announced that it will stop making its content available on Netflix after Disney+ launches.[6] Because of Disney's push to enter the streaming service scene and its decision to remove its content from Netflix, we will be using Disney's financials as our primary comparison. After Disney unveiled price and programming details of Disney+ on April 11, 2019, its stock surged 12 percent while Netflix's

---

[4] Perspectives from the Global Entertainment & Media Outlook 2018-2022, "Trending Now: Convergence, Connections, and Trust," PwC

[5] Sherman, Alex. "Netflix Says It's More Scared of Fortnite and YouTube than Disney and Amazon" www. CNBC.com, 17 Jan. 2019, www.cnbc.com/2019/01/17/netflix-more-scared-of-fortnite-and-youtube-than-disney-and-amazon.

[6] Sorrentino, Mike. "Disney+ Streaming Service: Will Marvel's Netflix Shows Get a New Home?" *CNET*, CNET, 19 Feb. 2019, www.cnet.com/how-to/disney-disneyplus-streaming-service-name-release-date-shows-movies-to-expect-punisher-jessica-jones-cancelled/.

shares sank four basis points. We will address how this increased competition in the industry affects Netflix in subsequent sections of the paper.

B. *Business Strategy*

One of Netflix's key business goals is to increase the number of subscribers globally, while simultaneously expanding its array of programming. The platform currently has 139 million paid members, and this number continues to rise as a result of Netflix's various strategies to increase viewership. Through significant investments in the addition of new titles and massively popular Netflix Originals, the company hopes to retain its members while simultaneously attracting new ones, both domestically and internationally. We will analyze specific subscriber-related metrics in the next section.

Netflix sells over 139 million paid memberships in over 190 countries, providing access to TV series, documentaries and feature films across a wide variety of genres and languages. The company began as an online DVD rental service, but now streaming services and content creation are its core business operations. While continuing to provide its DVD rental service, Netflix has significantly cut overhead and logistical complexities by moving from a physical product rental service to a technology company at its core (scalability, better margins, etc.). With an emphasis on original content, Netflix as of late has an excellent overall track record. It has produced hits such as *Daredevil*, *13 Reasons Why,* and *Stranger Things* (all on the list of the top 10 most viewed Netflix Original shows). It also streams many favorite TV shows including *30 Rock* and *The Office*. To continue this success, Netflix is regularly updating and changing its content to reflect current trends.

Disney will serve as an interesting comparison to Netflix since, despite both entities being large players in the media industry, Disney has a drastically different business strategy from Netflix. Disney is a U.S-based, diversified, multinational mass media and entertainment conglomerate that was founded in 1923. Disney also operates many other business lines: media networks, parks, products, and studio entertainment. In contrast, Netflix is a younger, specialized media company that provides streaming media, video-on-demand online, and DVD by mail. Despite these differences, Disney and Netflix can both be considered large-cap companies. Large market caps are usually associated with mature, low-growth companies that pay dividends. Disney fits the typical profile of a large market cap company; in contrast, Netflix is a young, high-growth company that does not pay dividends. Thus, it is noteworthy that Netflix has such a large market capitalization. Netflix's market cap (154.88B) is not far behind that of Comcast (192.67B) and Disney (236.84B). Only mobile giants like AT&T and Verizon and tech powers like Apple and Google have larger market caps in the media industry, but media is a relatively small component of their business models.

C. *Key Success Factors and Business Risks*

Critical success factors for Netflix are subscriber growth, high-quality original content, increased international profitability, and revenue growth. Because Netflix is a subscriber-based business, we will analyze subscriber growth and related figures as a key metric for the company's success. Netflix itself conducts detailed analyses of this key metric from numerous angles – for example, it analyzes every TV show or movie as to its ability to sign up and retain customers as well as assign each an "enjoyment" metric.[7] During the fourth quarter of 2018, Netflix added 8.8 million global paid memberships, exceeding its stated estimate of 7.6 million. Subscriber growth is on the rise, as Netflix added 29 million paid subscribers for the full year of 2018, 33 percent

[7] "How Netflix Measures Success," Business Insider (February 1, 2016).

higher than the 22 million paid subscribers it added in 2017. Netflix and its investors watch this metric closely, with an eye to how long this growth can continue until the market is saturated.

High-quality original content is another key success factor for Netflix that enables it to continue to maintain its high levels of subscriber growth. Netflix has a vast library of titles that are streamed exclusively on Netflix, including originals and first-run titles that it premieres in some of its markets. Netflix has the “long tail” advantage, which means that it is able to offer so many more titles (even many obscure ones) than other more traditional competitors (such as Redbox) that must have physical inventory.  Businesses like RedBox that rely on physical inventory only have the capability to afford and supply popular and mainstream titles, as it needs enough people in the area to purchase these items to cover its business expenses. However, Netflix is able to carry less popular items that are not available in the retail market opening up these niche markets. Netflix has made it so easy to access these films that may have become obsolete; rival companies such as Redbox cannot keep up.  Thus, high-quality original content and a large volume of titles are keys to Netflix’s success, closely tied to subscriber growth – giving consumers a compelling reason to subscribe. For this reason, Netflix spent $12 billion for content in 2018, and it is projected that this figure will grow to $15 billion in 2019.

Another major factor for Netflix’s success is increased international profitability and global growth. Today, with the exceptions of China, Crimea, Syria, and North Korea, its streaming service is available in every country in the world. Its international streaming revenues exceeded domestic streaming revenues for the first time in the second quarter of 2018. As mentioned by CEO Reed Hastings in the latest earnings call, Netflix has been investing in high-quality local language content. For example, the Netflix Original show *Elite* has been a hit in both Spain and other Spanish speaking countries — reaching 20 million households in its first four weeks. Global growth and international penetration have not been without challenges, however – for example, in India, a potentially key market for Netflix, it faces greater challenges in subscription pricing (as its prices are considered relatively high compared to competing services and as a proportion of household income). The company is working to address these issues through a mobile-only subscription plan in India at half the cost of the basic plan, but whether this will prove to be a  successful approach remains to be seen.[8] Also, from a production standpoint, one of the most compelling sells to producers is Netflix's global distribution infrastructure. Since titles can go online globally in an instant, this allows Netflix to release originals around the world simultaneously. For traditional, linear TV, US shows are delayed for weeks or months before they reach international markets.

Revenue growth is also a critical factor in Netflix's success. Being primarily a subscription-based business, carefully calibrating subscription prices to maximize profits is critical. In January 2019, Netflix announced a price hike for U.S. customers. The cost of its mid-tier plan will increase from $10.99 per month to $12.99 per month. The price of the premium also increased by $2, reaching $15.99 per month, the basic standard-definition plan will cost $8.99 per month, up from $7.99 per month previously. On Netflix's most recent earnings call, however, CEO Reed Hastings justified this price hike by pointing out the immense value that investments from the additional revenue would create. However, more pessimistically, perhaps this is a signal that the company is concerned about market saturation or the increasing costs of the investments. Thus, Netflix is perhaps preemptively trying to curb any strain on the company that the increased competition in the market would cause. Disney+ is set to debut Nov. 12 at $6.99 a month, 22% less than Netflix's basic plan.

---

[8] Ramachandran, Naman. "Netflix Tries Out Mobile-Only Subscription Plan in India." Variety, 22 Mar. 2019, variety.com/2019/digital/news/netflix-tries-mobile-only-subscription-plan-in-india-1203169961/.

Lastly, Netflix's robust search algorithms are another key to success. Creating good original programming is half the battle, but is useless if viewers aren't watching it. Placing the right kind of shows and movies in front of the right people is equally consequential. The software Netflix uses enables users to reliably find similar shows that they would have otherwise not known about and locks them further into being loyal Netflix users. More than 80 per cent of the TV shows and movies people watch on Netflix are discovered through the platform's recommendation system.[9] Netflix's system is based on machine learning, and thus rewrites itself as it learns from users. Every time a viewer watches a TV show or a movie, Netflix collects data that informs the algorithm and refreshes it. To better identify users' preferences, content is categorized into tens of thousands of micro-genres as specific as "Critically Acclaimed Emotional Underdog Movies" or "Gritty Chinese Action & Adventure from the 1970s."[10]

While Netflix has found its niche in the explosively popular streaming market, this does not come without risks. Major business risks for Netflix include intensifying competition in this industry, challenges to continuing its track record of outstanding content development, and higher production costs. While some Netflix Originals have been very successful, others, such as *Iron Fist*, have flopped. Also, Netflix anticipates that the potential loss of licensed content such as *Friends* will hurt financially—because Warner Media plans to launch its own streaming service, it has threatened to pull *Friends* off of Netflix. It's very clear Netflix considers hit shows owned by other media companies like *Friends* critical to its business model. After subscribers revolted in December, the company paid almost $100 million (or about 750,000 annual subscriptions) to keep the show *Friends* for one more year. But there's no guarantee after that:

---

[9] "Netflix: Binging on the Algorithm." UX Planet, UX Planet, 2 Aug. 2018, uxplanet.org/netflix-binging-on-the-algorithm-a3a74a6c1f59.

[10] "How Netflix's Recommendations System Works." Help Center, help.netflix.com/en/node/100639.

AT&T, which now owns the rights to *Friends*, is launching its own streaming service by the end of 2019. Thus, the risk of competitors pulling its content off of Netflix poses a significant risk.

Another large risk for Netflix is programming costs. The rising production costs associated with creating studio-quality content has led to greater debt load and a high cash-burn rate. Netflix is willing to incur these cost because the high investment is part of its strategy to stay ahead of the competition. A related concern is free cash flow, which for FY 2017 came in at negative $524 million. While Netflix is investing in quality content to gain subscribers, that investment will only materialize if current and prospective subscribers consider the content to be of additional value, especially value worth the price hike. If Netflix wants to increase the odds of making this happen over the long run, the company is likely going to need to keep churning out big hit after big hit. It can't rely on *The Crown* and *Orange is the New Black* forever, and soon, Netflix will lose the rights to stream Disney's content, which it has benefitted from since 2016. As more companies (Disney and Warner Bros.) create their own streaming services and pull their content off of Netflix, Netflix has and will need to continue to invest in the creation of new content, all while maintaining efficiency and profitability.

In contrast, Disney is highly diversified, giving it the ability to balance out its high-tech business lines (like Disney+) with more traditional revenue streams like cable television and theme parks. Disney has business lines that require a great number of employees, particularly operating its resorts and theme parks. When comparing Netflix and Disney, we think that some of the most important ratios will be gross profit margin to evaluate performance, the Price-Earnings ratio to determine whether Netflix can still be considered a growth company, and the debt-to-asset ratio to assess leverage. We will also look at the subscriber growth rate and subscriber acquisition cost, as these are key to the sustainability of a subscriber-based business.

Once signed up, subscribers provide steady monthly cash flows, and thus are intrinsically linked to profitability and growth.

## II. Financial Ratio Analysis

| Ratios | Netflix | | | Disney Co. | |
|---|---|---|---|---|---|
| **LIQUIDITY** | **2018** | **2017** | **2016** | **2018** | **2017** |
| Current Ratio | 1.49 | 1.40 | 1.25 | 0.94 | 0.81 |
| Current cash debt coverage ratio | -0.448 | -0.355 | -0.363 | 0.76 | 0.68 |
| **Ratios** | **Netflix** | | | **Disney Co.** | |
| **SOLVENCY** | **2018** | **2017** | **2016** | **2018** | **2017** |
| Debt to Asset | 39.89% | 34.18% | 24.77% | 0.46 | 0.53 |
| Times Interest Earned | 3.92 | 3.04 | 2.74 | 26.66 | 36.81 |
| Cash Debt Coverage Ratio | -0.15 | -0.14 | -0.16 | 0.31 | 0.24 |
| **Ratios** | **Netflix** | | | **Disney Co.** | |
| **PROFITABILITY** | **2018** | **2017** | **2016** | **2018** | **2017** |
| Return on Equity | 23.12% | 15.60% | 6.97% | 24.7% | 20.8% |
| Return on Assets | 5.38% | 3.43% | 1.57% | 13.44% | 9.97% |
| Profit Margin | 7.67% | 4.78% | 2.11% | 16.99% | 17.60% |
| Asset Turnover | 70.22% | 71.74% | 74.24% | 61.15% | 58.71% |
| Gross Profit Ratio* | 36.89% | 31.30% | 29.14% | 44.93% | 45.04% |

* Note, for gross profit ratio, the cost of revenue here is mainly represented by amortization of streaming content assets. The rest of the costs are made up of acquisition, licensing, production, and delivery of streaming content, as well as other operating costs.

**Netflix Subscriber Data:**

| | **2018** | **2017** | **2016** | **Horizontal Growth Rate (2017 → 2018)** | **Horizontal Growth Rate (2016 → 2017)** |
|---|---|---|---|---|---|
| **Marketing Cost (Domestic)** | $1,025,351,000.00 | $603,746,000.00 | $412,928,000.00 | 69.83% | 46.21% |
| **Marketing Cost (International)** | $1,344,118,000.00 | $832,535,000.00 | $684,591,000.00 | 61.45% | 21.61% |
| **Marketing Cost (Total)** | $2,369,469,000.00 | $1,436,281,000.00 | $1,097,519,000.00 | 64.97% | 30.87% |
| **Total paid memberships at end of period** | 139,259,000 | 110,644,000 | 89,090,000 | 25.86% | 25.86% |
| **Total new subscribers at end of period** | 28,615,000 | 21,554,000 | 18,251,000 | 32.76% | 18.10% |
| **Average yearly revenue per paid subscriber** | $123.72 | $113.16 | $103.32 | 9.33% | 9.52% |
| **Gross Profitability per Subscriber** | $12.37 | $7.92 | $4.13 | 56.19% | 91.67% |
| **Cost per new subscriber** | $82.81 | $66.64 | $60.13 | 24.26% | 10.81% |

A. *Liquidity*

With companies like Disney entering the market, Netflix must have a defense mechanism and enough current assets on hand to protect its brand and company. A thorough analysis of

Netflix's liquidity will indicate whether it has this protection against unexpected events and increased competition.

Netflix's current ratio suggests that it can pay off its short-term liabilities with its current assets. The increase in current ratio between 2017 and 2018 is a positive sign for Netflix's future utilization of cash. On the balance sheet, although current liabilities have increased due to an increase in current content liabilities, current content assets have also increased significantly, leading to an improved current ratio. Current content liability is a streaming obligation contract that Netflix signs on to. Netflix incurs the costs of the obligations once it signs a license agreement to obtain future titles. However, the actual price of fees are not immediately determinable since the values are difficult to estimate. Therefore, it reports the minimum amount which could be misleading and ultimately understate its reported obligations.

Netflix amortizes its titles on an accelerated basis, as it expects more upfront viewing due to additional merchandising and marketing efforts. Moreover,  film amortization is more accelerated than TV series amortization. Netflix reviews factors that impact the amortization of the content assets on an ongoing basis. Its estimates related to these factors require considerable management judgment and should be looked at with a critical eye.

Disney, however, has a current ratio below 1.0. This suggests that it may have more trouble paying off its current debt. From 2017-2018, it increased its current ratio and is now closer to a ratio of 1.0. Disney has an extensive content library and invests heavily in production. Thus, its accounts payable section is its largest liability. Disney does not have a section titled "current contents," but rather it clusters its current content under a section called "film and television costs," which is not calculated under current assets. Disney regularly assesses its amortization procedures, which it bases on how market participants would price the assets at the balance sheet date. The costs of television broadcast rights for acquired series, movies, and other programs are expensed based on the number of times the program is expected to be aired or on a straight-line basis over the useful life, as appropriate. Rights costs for multi-year sports programming arrangements are amortized during the applicable seasons based on the estimated relative value of each year in the arrangement. The nature of Disney's and Netflix's current assets are very different, and thus, it is difficult to compare them apples to apples.

The current cash debt coverage ratio demonstrates the relationship between the net cash from operating activities and the average current liabilities from its operations. Thus, it shows Netflix's ability to pay off its current liabilities with its income from operations. Netflix is primarily using its cash to acquire titles, produce its own content, and market its content and services. Investments in original content, in particular, content that Netflix produces and owns, require more cash upfront compared to licensed content. As Netflix begins to produce more and more of its own titles, it will use more cash. Still, according to its 2018 financial statements, Netflix believes it will manage its cash sufficiently to meet the needs of the next twelve months. Disney, on the other hand, has a ratio close to 1.0. Disney is much more liquid in this respect as its operational activities can cover its liabilities. Perhaps this is because Disney is more diversified than Netflix.

Overall, neither Netflix nor Disney are dangerously inefficient with their cash; they just spend their money in very different ways and produce films and shows at different rates. This may change when Disney releases Disney+, and may begin to look more like Netflix in that business arm. Disney may have a lower current ratio than Netflix, but it has a very stable cash-debt-coverage ratio. Since Netflix has entered the production market relatively recently, perhaps investing large amounts of cash and taking on debt to produce high-quality content is the best investment it can currently be making.

B. *Solvency*

Netflix is running the debt-to-asset ratio of an entity that would not be unlike the title of Tom Cruise's 1983 hit—*Risky Business*. Compared to its far more established, mature-phase competitor Disney, Netflix's debt-to-asset ratio of over 0.80 for the past two years is astonishingly high for a growing—albeit seemingly successful—company. One would expect a company founded just over 20 years ago to be carrying less debt financing than a world-renowned conglomerate 75 years its senior, yet Netflix holds nearly double the debt financing that Disney does. Additionally, a company as large and commercially popular as Netflix would likely not have much trouble sourcing equity financing, so the amount of debt it carries relative to its assets could be indicative of overall risky management philosophy, and, given how much debt it currently carries, that could be a concern for investors. However, investors may like the interest tax shield generated by this high debt structure.

Furthermore, despite achieving the typical target of a greater-than-2 times interest earned, Disney exceeded Netflix's value tenfold in 2018. Presumably, if things were to go south for Netflix, it would undoubtedly have a more difficult time meeting its debt obligations than its competitors given how highly leveraged Netflix is. Perhaps it carries so much debt and run such a lower times interest earned than its industry competitor because of its confidence in its continued growth and expansion. After all, the Netflix Originals have been a huge success, and it is continuing to pour money into that division. It is hard to determine, however, where the line lies between a confident, ambitious company and one which is overconfident and ultimately foolish. We may not know where Netflix stands until we see stronger competition chip away at Netflix's near-monopolistic status as an internet streaming service.

C. *Profitability*

By offering multiple price plans (basic, standard, and premium), Netflix seeks to attract customers with different willingness to pay to maximize their producer surplus (the area of profit between plan prices and the demand of consumers). This strategy has seen considerable success, as net income had more than doubled from 558.9 million in 2017 to about 1.2 billion in 2018 and annual subscriber growth has stayed high. However, the effects of its recent price hikes announced in January 2019 may lead to difficulties in the future and although immediate reactions have been relatively modest,[11] these increases in pricing may harm attracting new members in the longer term and could potentially be harmful to growth in subsequent quarters. Despite decreases in domestic growth, the international market holds a larger percentage of subscribers and arguably its most significant source of revenue and future potential. Through content investments in foreign countries like India, quarterly subscriber rates have been robust, and the company hopes to further penetrate those markets through innovative pricing.

From 2017 to 2018, all of Netflix's profitability ratios have seen improvements except for asset turnover. The core reason for these improvements is due to the massive increase in revenue, which went up by $4 billion. Their profit margin increased by about three percentage points in a single year. Revenue was the main driving force for the increase in profit margin. Its return on shareholders' equity also churned a significant improvement, from 0.1560 in 2017 to 0.2312 in 2018. As a result, profitability is very positive most likely due to the price hikes and successes in the international market as mentioned above. The increase in revenue and subsequently net income was sufficient to make up for increased operating expenses (due to increased advertising,

[11] "Why is Netflix Raising Prices & How Much Will it Cost?" Refinery 29, January 15, 2019.

licensing, and production costs), and the increased interest and tax expenses. Considering the state of the company and its current profitability ratios, we believe that profits will continue to rise in the next year.

One of the most important ratios to analyze is Netflix's operating profit margin ratio. This is a ratio that indicates how much it is making after paying variable costs. As Netflix's biggest asset is its current contents, Netflix's production of its own films will likely cause short term cost increases, but it may save on content fees over time. With exclusive Netflix Originals, it may also attract more subscribers and increase its revenue. It is essential to see if its creations of original titles lead to more profit.

Another critical ratio to analyze is Netflix's revenue percentage growth. It is vital to assess how Netflix is continually innovating and growing. With Disney+ threatening Netflix with cheaper streaming services, while Netflix raises its prices, it will be interesting to see how Netflix's revenue performs these next few quarters. Depending on consumer reaction to the price hikes, Netflix may need to decide if it wants to make more on each sale or have more subscribers at a lower price.

ROE is a third key ratio to analyze as it measures a company's ability to generate earnings for equity shareholders. Netflix's financial statements indicate that it has negative free cash flow since it is investing effectively in new content creation. Despite growing operating income, Netflix has produced negative free cash flow, which is due to growth in content spend (mostly from original content production). It pays for titles before consumers watch the content, which is amortized by estimated viewing over time. It aims to keep promoting its own content so that it can sustain growth as long as it can. Netflix believes that if it uses its money to invest in the company, shareholder value will be enhanced in the long run. Netflix must find a way to maintain and ideally improve its ROE over time to remain an attractive company for investors.

For Disney, its ability to generate profits from ESPN+ and Hulu also depends on increasing subscriber counts. With these streaming services and its push for the addition of Disney+ soon, it is a prime competitor for Netflix. Although Netflix holds the dominant market cap in the entertainment streaming business, Disney ultimately has great potential to take over, considering that it has multiple business segments that allow diversification as well as more assets. A key strategy that Disney utilizes is acquisitions of other companies. Over the years, it has acquired premier enterprises such as Pixar, Marvel, and Lucas Film. Disney excels in generating profits from these investments through the creation of blockbuster movies and franchises. Its diversified business model allows for these franchises to be highly successful, as its films can spawn toys, live shows and attractions, video games, and other revenue creating platforms, which in turn showcase and market its movies.

From an analysis of its profitability ratios, Disney shows its success on the books as well. All of its ratios are superior to Netflix's, except for asset turnover. Disney is a much larger company than Netflix, generating more revenue and holding more assets, but almost one-third of its assets comprise of goodwill. This goodwill is primarily responsible for the large number of total assets that lead to a lower asset turnover. Netflix in contrast does not have goodwill recorded on its balance sheet. However, in comparing these two companies, one must keep in mind that they are fundamentally very different companies, with Disney being a larger enterprise conducting many different lines of business, with acquisitions being a central part of its business strategy. Also, it is challenging to gauge Disney's current success in the streaming business as its financial documents do not give Hulu-specific numbers. However, Disney does disclose the income from its equity investments, BAMTech and Hulu. This was a 62% decrease from the prior year due to higher programming, distribution, marketing and labor costs. Compared to Netflix, the income Disney generated from Hulu is much smaller.

D. *Subscriber Growth*

In addition to these financial ratios, subscriber numbers are one of the critical metrics of success for Netflix. Having more subscribers leads to higher revenues, which in turn leads to more cash to spend on content, which then attracts new subscribers, and this cycle continues. We see subscriber growth rates increasing between 2017 and 2018 on all metrics besides free trials, which is a positive result for Netflix.

However, the subscription growth rate is not the only metric that matters. The cost of finding subscribers provides another way to assess Netflix's prospects. Looking at marketing costs, we see that Netflix is spending significantly more in 2018 than 2017 both domestically and internationally on subscriber acquisition.

With additional competition in the market, however, perhaps retaining, rather than growing domestic subscribers, may be Netflix's smartest strategy. We calculated the gross profitability per subscriber by taking average revenue per subscriber and multiplying by the gross margin. Gross profitability per subscriber has consistently increased year over year, indicating that Netflix has seen a solid return on its expensive investments in new content; however, growth rate is slowing down.

Lastly, we calculated the cost per new subscriber by dividing total subscriber acquisition cost by total new subscribers at the end of the period. This has risen over the past two years despite fluctuations in the number of subscribers and the amount paid for them.

## III. Accounting Policies and Footnotes

In this section we will be comparing Netflix's key accounting policies to those of Disney, looking at Netflix's intangible assets, and any unrecorded economic assets or liabilities on Netflix's balance sheet.

### A. *Key Accounting Policies*

First, we will look at Netflix's inventory, depreciation, and amortization accounting policies. Given the nature of Netflix's business, primarily as a streaming service, typical LIFO inventory analysis may not be applicable. Netflix manages its inventory on a "just in time basis," where content is put onto DVDs once it is ordered from customers.[12] This on-demand inventory system minimizes the inventory Netflix holds, which makes sense given that its main business line is streaming, which effectively requires no physical inventory. Additionally, this streamlined method of inventory management is more efficient and mitigates inventory costs. Disney has a very different composition and management of inventory, and thus a direct comparison is difficult. Disney's inventory is made up of everything from vacation rental units to food to merchandise. The latter two parts of inventory stated are calculated on effectively a weighted average, and all inventory is recorded at lower of cost or market.[13]

The way that Netflix reports depreciation is also noteworthy since its assets are dominated by non-physical property. It uses straight-line depreciation typically up to 30 years according to its 10-K, which indicates that most of what it is depreciating is buildings and equipment. Nonetheless, despite its claim that this is the shorter of estimated useful life, this

---

[12] Thompson, Andrew. "Netflix Inventory Management." *Panmore Institute*, 24 Mar. 2017, panmore.com/netflix-inventory-management.

[13] Dybek, Martin. "Walt Disney Co. (DIS) | Inventory." *Stock Analysis on Net*, Stock Analysis on Net, 22 Nov. 2018, www.stock-analysis-on.net/NYSE/Company/Walt-Disney-Co/Analysis/Inventory.

depreciation timeline seems to be somewhat aggressive, which, along with prioritizing efficiency and expansion, appears to be a common characteristic for Netflix's accounting policies.

Additionally, Netflix is reporting positive net incomes while also reporting negative cash flows and undergoing general cash burning activities, in large part because of its amortization policies. Some of the content is expensed when aired, and other content has an expected license life of 10 years.[14] Given that the amortization of 90% of production costs occurs in the first four years, a lot of amortization expenses are delayed, indicating that Netflix is once again taking an aggressive accounting strategy. This is, however, not unlike its competitors. Before Disney+, Disney was much more conservative in its accounting, but its projections for amortization of Disney+ content appears to be very aggressive and more comparable to Netflix, with a $2 billion projected amortization expense for 2024.[15]

B. *Intangible Assets*

Since Netflix's main business line is online streaming, most of its assets are digital content, paid for with licensing and usage fees to the respective companies who own the content. These are intangible assets, which are divided into two categories, current, and non-current content assets. The current content assets include content available for streaming or downloading for up to one year. The non-current content assets include the remaining content that extends beyond a year before it expires, usually based upon the underlying contracts that dictate licensing and usage rights. Some other non-current content, like the Netflix Originals, is owned by Netflix outright and presumably do not expire, but which the company may decide to take off in the

[14] Levy, Adam. "How Netflix Accounts for All of Its Content Spending." *The Motley Fool*, The Motley Fool, 19 July 2017, www.fool.com/investing/2017/07/19/how-netflix-accounts-for-all-of-its-content-spendi.aspx.

[15] Aycock, Jason. "Disney Shows off Disney Plus App, Plans Global Rollout (Updated with Price)." *Seeking Alpha*, 12 Apr. 2019, seekingalpha.com/news/3450193-disney-shows-disney-plus-app-plans-global-rollout-updated-price.

future. These content assets are what comprise the core of Netflix, and it holds a critical role in future cash flows, as the choices and popularity of its content library will dictate what types of audiences Netflix will attract in the future. Notably, Disney will soon be removing all of its content from Netflix to put onto its streaming service, Disney+. This may hurt Netflix's future cash flows. However, Netflix is producing more and more original content. Its original content has been very popular in the past and has earned many accolades including the first high profile streaming service to receive an Academy Award nomination and first streaming service to win a Primetime Emmy Award.

C. *Unrecorded Assets and Liabilities*

As of December 31, 2018, Netflix had $10.8 billion of streaming content obligations that were not included on the consolidated balance sheets as they did not meet the requirements for asset recognition. These costs are associated with the acquisition, licensing, and production of streaming content. These obligations are incurred when contractual agreements for content licensing and acquisition are made. However, only when the title is made available are these obligations recorded onto the consolidated balance sheets. These unrecorded obligations increased from $10.2 billion on December 31, 2017. All of the streaming content obligations, both reflected and not reflected on the balance sheets, are placed onto a contractual obligations table that details the payments due by period. Additionally, Netflix also expects $2-3 billion in future obligations for unknown titles to be paid in the next three years, with the vast majority after 12 months. These future obligations are not recorded on the contractual obligations table. Netflix also has lease financing obligations for its facilities that it must fulfill. The future minimum payments not recorded on the consolidated balance sheets are worth $11 million. This financing lease results from operating ownership of its Los Gatos, CA headquarters. It recorded improvements and renovations as an asset and thus has obligations to pay on the financing lease. The future minimum payments for both operating and financing leases total to about $1.7 billion, for a period from 2019 to 2034. These payments have not yet been recorded, but will be recorded when the company occupies the facilities during the dates specified in the lease agreements. The future year by year lease obligation payments on average ($153 million) are larger than in comparison to 2018 ($135 million) but are otherwise appear to be ordinary.

## IV. Quality of Earnings

Between the aggressive amortization of its content and the substantial amounts of obligations Netflix has incurred, it is difficult to analyze precisely the quality of its earnings. The aforementioned aggressive accounting policies, along with prioritizing efficiency and expansion, seem to be a common characteristic of Netflix's financial reporting style. While one must take into account that Netflix is currently investing heavily in original content to cultivate subscriber loyalty and stay ahead of the rapidly approaching competition, these numbers still seem largely optimistic.

Netflix's delay in amortizing contents is excusable in the short run but ultimately may affect their reported earnings. It reportedly plans on running negative cash flows for several years as it continues to pump money into original content, which itself will make an analysis of quality of earnings difficult. Additionally, Netflix's 10-K reports that at year-end 2018, of the company's $19.3 billion of obligations, $10.8 billion were not reflected on the financials "as they did not yet meet the criteria for asset recognition." That means that over half of the company's recognized obligations went unreported, which would lead to a gross overstatement of its real ability to pay off said obligations. This could be concerning for the company in the future.

Regardless, this is an indication that Netflix's positive net income is not telling the whole story. It is important to note as well that Netflix is trading at seven times revenue while Disney trades at less than half of that.[16] Netflix asserts that this is due to the significant investments on content assets to produce original content, but time will tell whether this investment will have just a temporary effect on free cash flows, or if this will be a long term issue for Netflix. This

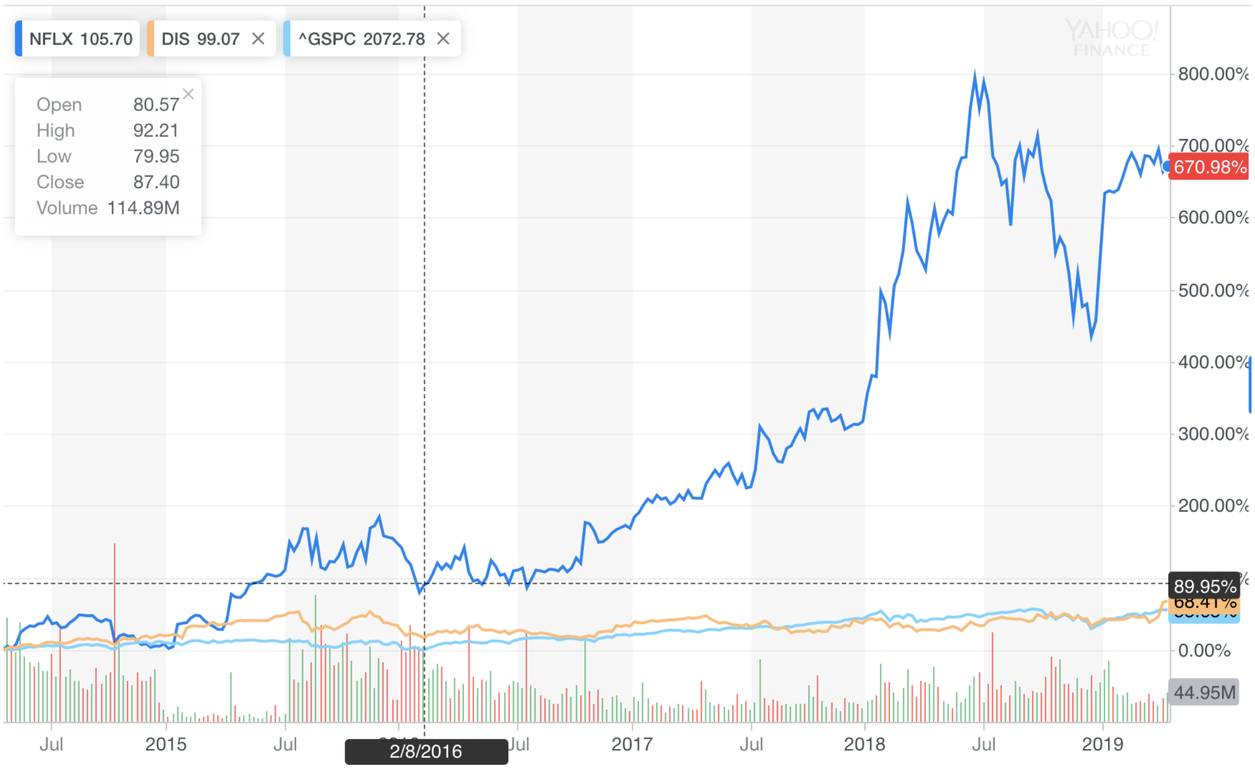
---

[16] "Netflix, Disney and Time Warner: Investment Prospects as Streaming Media Matures." *Value Expectations*, 24 May 2018, valueexpectations.com/2018/05/24/netflix-disney-and-time-warner-investment-prospects-as-streaming-media-matures/.

will depend on whether or not Netflix will be able to create content more efficiently in the future as it solidifies its new business model.

## V. <u>Considering Investment in the Company</u>

As exhibited by the chart below, Disney is an older, mature company that moves with the market (the green line is the S&P 500), whereas Netflix is a high growth company that has outperformed the market significantly in recent years. The big question for investors is for how long Netflix can sustain this growth, especially as new competitors look to join the market.




| | |
|---|---|
| **<u>PE Ratio</u>** | 130.18 (April 15, 2019) |
| **<u>Market to Book Ratio</u>** | 29.08 |
| **<u>Dividend Ratio</u>** | 0.00 |

A. *Interpretation of Ratios*

The price-to-earnings ratio indicates the dollar amount an investor can expect to invest to receive one dollar of that company's earnings, showing if a company is under or overvalued. Netflix's price-to-earnings ratio is exceptionally high and has extreme spikes and drops day to day. Disney's ratio is around 18 and generally moves with the market. The market-to-book ratio compares a company's book value to its market value. Netflix's value is extremely high at over 29. Disney has a value of under 3.0. Netflix's dividend ratio is 0.00 because it does not pay dividends. Netflix uses all of its available cash to reinvest in its business. It puts money into producing and marketing its original content, which will likely continue to be its biggest strategic priority for many years to come. Netflix does not intend to pay dividends anytime soon.

B. *Analyst Report Summaries*

An analyst report written by Argus Research Company on April 17, 2019, maintains a 12-month hold rating and 5 year buy rating for shares of Netflix stock. They advise a hold for those who currently own stock of Netflix, as recent announcements of subscriber rate increases have led to a run-up in stock price. Argus's view is that due to the uncertainty in the market for streaming video in the future, Netflix stock is not valued high enough to be able to recommend a buy at its current price. It argues that as more and more large competitors join the market and the production and licensing costs increase, Netflix's days of dominance in the streaming industry may be numbered. The report also details recent developments for Netflix metrics in the first quarter of 2019. Global streaming net paid additions rose to 9.6 million, with increases in both domestic and international sectors and beating management's projections. First quarter revenues increased by 22% to $4.52 billion and operating income increased by 3%, suggesting that Netflix may be overcoming increasing content costs. As we mentioned earlier, the report confirms that the international market is the key to new subscriber growth. The report also discusses the financial strength of Netflix, which it deemed to be low. This was due to an increase in streaming content obligations to $18.9 billion (up from $17.9 billion last year), and a decrease in free cash flow, which was negative $3 billion in 2018 and is expected to be similar in 2019. Netflix's debt to capital ratio has consequently been increasing as well, from 33% in 2014 to 66.4% in 2018. Considering its strained financial situation, along with other factors, Argus concludes that Netflix is a risky company to invest in, as its share prices are highly volatile and its financial success is highly dependent on the popularity of its new content releases.

We also looked at a MarketGrader report which gives Netflix a grade of 47.6/100 based on its own rating scale and maintains a sell rating. Growth was given a B grade, as Netflix has consistently beaten earnings estimates in the past; however, profits have declined in the prior quarter. Company stock subsequently fell 3.99% following this announcement. Under the Value category, Netflix was given a D grade. MarketGrader believes Netflix to be severely overvalued, as its share prices are more than double its optimum P/E ratio of 32.62 and over 130 times higher than its 12-month earnings per share. This high trading price is not optimal considering they view as the poor financial strength of Netflix as discussed in both this report and the aforementioned Argus report. If the company does not successfully manage profitability or liquidity, a major decrease in stock price can result. Profitability was given a B+. Although a solid grade, the shortfalls reflected in it come from its below industry average operating margin in the past quarter, these weaker margins result from high costs of licensing and production. Other than this, profitability is strong, as return on equity has increased to 23.12% in the past year from 15.6% in the year before. Also, EBITDA has increased by 31.89% over the course of a year. The category of Cash Flow was given a B-. They concluded that while net cash flows have declined by 153.11% in 12 months and are now negative, the cash flows from operations will be enough to fulfill debt obligations with ease.

Lastly, SmarterAnalyst gives Netflix a buy rating. They analyzed its recent Q1'19 conference earnings call, in which CEO Reed Hastings stated that Netflix has always had competition and that Disney+ and other entrants probably would not affect growth too much. They also noted that revenue and earnings per share both beat analyst expectations for the quarter, which were $4.5 billion and $.076 respectively, versus the projected $4.5 billion and $0.57. Also, they discuss that, for the next quarter, profit expectations went down due to a higher than usual corporate tax rate, which would be a one-time item, but management foresees operating margin to increase as the subscription price hikes go into effect for all subscribers by May. Although SmarterAnalyst expects that subscriber rate growth in Brazil, Mexico and parts of Europe may be lower due to these price increases, Netflix expects that in the U.S., where the effects of the hikes have already begun to be set in place, gross additions will be unchanged. The report concludes that subscriber growth will most likely normalize and the long-term narrative is positive. They also emphasized the risk/reward aspect of the company's success and detailed that 25 out of 32 analysts polled in the last three months are bullish and advise to buy.

C. *Investment Recommendation*

Netflix has produced excellent content, is releasing promising new shows, has a huge market cap despite its young age, is consistently increasing subscriber count, and continues to grow its international outreach. Ultimately, though, we believe that its stock is overvalued given the inherent risk associated with its aggressive reinvesting, demonstrated by its negative free cash flows and its assumption that it will be able to effectively transform its business model from a content distributor to a content producer. This, along with the growing uncertainty within the market from incoming and growing competitors, leads us to maintain a recommendation of HOLD for Netflix (NFLX) stock.

As Netflix gains subscribers, as it has done consistently every year, it drops further and further into debt. Netflix hopes that spending aggressively now will eventually lead to big profits in the future, a mentality similar to other tech companies like Uber and Tesla. However, with many competitors close behind, success is not guaranteed. We see no immediate need to sell the stock, and we do not see a threat of bankruptcy within its financial statements and ratios. However, we also would not currently recommend buying the stock at its current price, since the future of Netflix is hugely dependent on what happens in the next several quarters: how the price increase will affect subscriber growth, how the international market fares, how Netflix manages costs as it increases production, and how competitors, particularly ones undercutting Netflix's price like Disney+, affect the market as a whole.

Given the high volatility in NFLX stock in the past year alone, we maintain our hold recommendation for quite a large range. If the stock price, which as of close on April 18th is $360.35 a share, dips below $230, which it neared in December, then we would recommend a buy, considering any relevant information regarding the company’s prospects available at that time. However, if the stock inflates near $430 a share, which it neared in July of 2018, then we would recommend a sell, again, considering any relevant information regarding the company's prospects available at that time. Ultimately this is a massive range for the stock, but we have determined these numbers based on historical data and the fundamental instability of the stock as it stands in the streaming industry.

The original content Netflix is producing seems promising, and could solidify its dominance in the industry amidst increasing competition; however, this ultimately assumes that its aggressive investment strategies will pay off. Thus far its investments have fared well, but it is unclear whether this pattern will continue. We look forward to following Netflix closely as it continues to operate and attempts to thrive in its tumultuous business environment.

## **References**


Aycock, Jason. “Disney Shows off Disney Plus App, Plans Global Rollout (Updated with Price).” Seeking Alpha, 12 Apr. 2019, seekingalpha.com/news/3450193-disney-shows-disney-plus-app-plans-global-rollout-updated-price.

Cardenal, Andrés. “Disney's Business Model Is Downright Brilliant.” The Motley Fool, The Motley Fool, 5 Oct. 2016, www.fool.com/investing/2016/10/05/disneys-business-model-is-downright-brilliant.aspx.

Dybek, Martin. “Walt Disney Co. (DIS) | Inventory.” Stock Analysis on Net, Stock Analysis on Net, 22 Nov. 2018, www.stock-analysis-on.net/NYSE/Company/Walt-Disney-Co/Analysis/Inventory.

“How Disney Makes Money? Understanding Disney Business Model Core Elements.” Revenues & Profits, 31 Jan. 2019, revenuesandprofits.com/how-disney-makes-money-understanding-disney-business-model-core-elements/.

“How Netflix's Recommendations System Works.” Help Center, help.netflix.com/en/node/100639.

“How Netflix measures success,” Business Insider (February 1, 2016).

Levy, Adam. “How Netflix Accounts for All of Its Content Spending.” The Motley Fool, The Motley Fool, 19 July 2017, www.fool.com/investing/2017/07/19/how-netflix-accounts-for-all-of-its-content-spendi.aspx.

“Long-Term View – Overview” at http://www.netflixinvestors.com

“Netflix: Binging on the Algorithm.” UX Planet, UX Planet, 2 Aug. 2018, uxplanet.org/netflix-binging-on-the-algorithm-a3a74a6c1f59.

“Netflix, Disney and Time Warner: Investment Prospects as Streaming Media Matures.” Value Expectations, 24 May 2018, valueexpectations.com/2018/05/24/netflix-disney-and-time-warner-investment-prospects-as-streaming-media-matures/.

Perspectives from the Global Entertainment & Media Outlook 2018-2022, “Trending Now: Convergence, Connections and Trust,” PwC

Poletti, Therese. “Netflix Is Growing at a Stunning Rate - and so Is Its Profit.” MarketWatch, MarketWatch, 21 Apr. 2018, www.marketwatch.com/story/netflix-is-growing-even-faster-and-streaming-to-record-profit-totals-2018-04-16.

Ramachandran, Naman. “Netflix Tries Out Mobile-Only Subscription Plan in India.” Variety, 22 Mar. 2019, variety.com/2019/digital/news/netflix-tries-mobile-only-subscription-plan-in-india-1203169961/.

Snider, Mike. “Netflix Price Increases Could Cause Some Subscribers to Downgrade, Cancel Streaming Service.” USA Today, Gannett Satellite Information Network, 17 Jan. 2019, www.usatoday.com/story/tech/talkingtech/2019/01/17/netflix-price-increase-may-lead-subscribers-downgrade-cancel/2602458002/.

Sorrentino, Mike. “Disney+ Streaming Service: Will Marvel's Netflix Shows Get a New Home?” CNET, CNET, 19 Feb. 2019, www.cnet.com/how-to/disney-disneyplus-streaming-service-name-release-date-shows-movies-to-expect-punisher-jessica-jones-cancelled/.

Telford, Taylor, and Steven Zeitchik. “Netflix Raises Prices to Pay for Original Content.” The Washington Post, WP Company, 15 Jan. 2019, www.washingtonpost.com/business/2019/01/15/netflix-raises-prices-pay-original-content/?noredirect=on&utm_term=.20040a201a11.

Thompson, Andrew. “Netflix Inventory Management.” Panmore Institute, 24 Mar. 2017, panmore.com/netflix-inventory-management.

“US Edition: Global Entertainment and Media Outlook 2017-2021.” PricewaterhouseCoopers, 2017.