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Like no business

The share price of Netflix, Inc., leapt by 10% on Tuesday. It has risen by 102% since the start of 2017, putting Amazon.com, Inc., the second-best performing FAANG, in the shade with a gain of 82%. No mystery about the common equity of the producer of "Stranger Things." Pure and simple, it goes up, just now to the exalted heights of 96 times earnings. The mystery rather concerns the Netflix bonds. To repeat the question we raised in the issue of March 10, 2017, Why does anyone buy them?

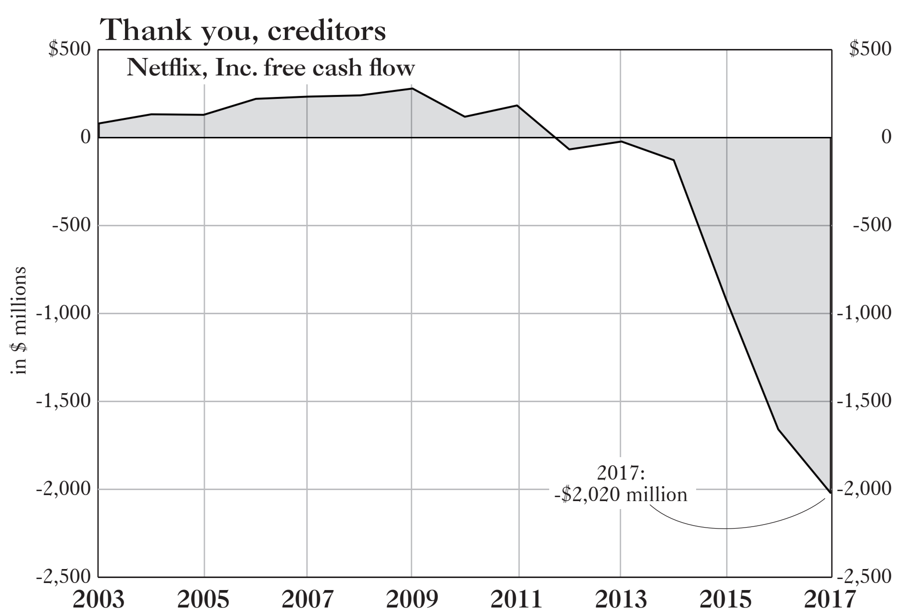
Well, we know why. There are dedicated buyers of such things. For instance, the euro-denominated Netflix 3⅝s of 2027 change hands at 102⅛, a price to yield 3.4%, 308 precious basis points over the corresponding German government bund. For the financially repressed European-yield fixed-income manager, the premium is more precious than bitcoin.

Fourth-quarter Netflix income-statement data were mostly in line: revenues of $3.28 billion, up 33% year over year, vs. an expected $3.27 billion; net income of $186 million, up 178% year over year, vs. an expected $184 million. What the market really cheered was the $524 million cash burn ($211 million better than analysts estimated). The buyers and sellers seemed not to notice that the surprise was owing to the timing of content payments, which shifted to 2018. Full-year 2017 free cash flow was negative $2.02 billion, worse than the negative $1.66 billion in 2016 but better than management's projections of $3 billion to $4 billion of negative cash flow in 2018—never mind that the street was estimating $2.5 billion.

How to plug the cash hole? Double-B-rated Netflix has a friend in the unsecured wing of the junk-bond market. The company issued $500 million of debt in 2013, $400 million in 2014, $1.5 billion in 2015, $1 billion in 2016 and $3.02 billion in 2017. More is on tap in 2018, with the same old value proposition. To wit: It's a speculative business, the content business, but if it works, you, the creditors, will get your money back. The stockholders get rich. Everybody's happy.

"It's ridiculously overvalued," Michael Pachter, managing director and research analyst at Wedbush Securities, and the rare bear on Netflix common, tells colleague Fabiano Santin. "I have a sell because I care about cash flow. When I went to business school we valued companies based on the net present value of future cash flows. All these other people that I compete with covering the stock, any one of them that says they have a $250 price target based on discounted cash flow, they're pulling DCF out of thin air. All I can tell you is that in 2013 free cash flow was negative $27 million and then it went to negative $120 and then negative $1 billion and then negative $1.7 billion, and now it is going to negative $3.5 billion. It got worse every year."

Part of the value that the market sees in Netflix derives from its content library. You may count Pachter a skeptic on this point, too. "Can you name the content that Netflix owns? Is it worth the $14.8 billion on the balance sheet? Just to put that in perspective, Lionsgate's full market value is $11 billion. But they



sources: The Bloomberg, company reports

own 'Mad Men,' 'Orange Is the New Black,' 'Dirty Dancing' and a hundred other TV shows and 4,000 other movies. What does Netflix have that is as big as 'Orange Is the New Black'? The answer is 'Stranger Things,' but it has only two seasons. "Orange Is the New Black" has six. What does Netflix have that is as good as 'Mad Men'? Nothing. Where's Netflix's 4,000 movies?"

Welcome, then, Netflix, to the $100 billion market-cap club.

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