Project Nautilus

Presentation to the Board of Directors
January 28, 2015

Goldman Stanley

Executive Summary

- Nautilus has indicated that it needs $1.5 billion in funding to continue ramping up its international expansion efforts and for general corporate purposes
- Management has indicated a strong preference for Unsecured Senior Notes, but we believe that Convertible Bonds offer the lowest cost of funding, and that dilution can be minimized with the proper call-spread structure
- Such Convertible Bonds might offer a 45% conversion premium (conversion price of $641.58) and a 1.5% coupon rate, for an after-tax cash cost of 0.99%
- By contrast, the after-tax cost of Unsecured Senior Notes might be between 3.50% and 4.00%, and such an issuance would likely result in a credit rating downgrade for Nautilus
- Given Nautilus' share price and valuation multiples, a follow-on equity offering is also viable, but the likely discount on such an offering would imply an after-tax cost of between 1.20% and 1.40%
- The major downside of a Convertible Bond issuance is possible dilution, but the company could raise the effective conversion price by purchasing call options on its stock and selling warrants on its stock at a higher exercise price

Financial Summary – Operating Scenarios

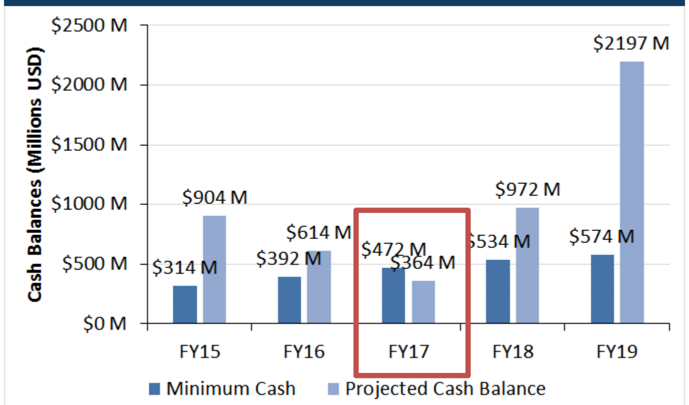
- To evaluate Nautilus' financial performance from the perspective of debt and equity investors, Goldman Stanley projected its financial statements under four scenarios:
  - **Base Case:** This scenario was in-line with consensus estimates for the company
  - **Upside Case:** This scenario aligned more closely with internal projections provided by management
  - **Downside Case:** This case corresponded to lower subscriber growth, renewal rates, and fee growth, and higher marketing expenses and cost of revenue
  - **Extreme Downside Case:** Subscriber growth, renewal rates, and fee growth were all significantly lower in this case, and marketing expenses and cost of revenue were even higher as percentages of revenue
- Despite the differences, many of the key percentage-based assumptions were the same across all scenarios:
  - **Domestic Content Additions and Amortization:** Content additions were set to 60% of FY 15 domestic streaming revenue, falling to 35% by FY 19, with amortization of 25-35% in FY 15 declining to 5-10% in FY 19
  - **International Content Additions and Amortization:** Content additions were set to 110% of international streaming revenue in FY 15, falling to 70% by FY 19, with amortization of 35-50% in FY 15 declining to 0-5% in FY 19
  - **Balance Sheet and Cash Flow Statement Line Items:** These were linked to revenue, cost of revenue, or total operating expenses, and each scenario used the same percentages

Nautilus’ Financing Requirements

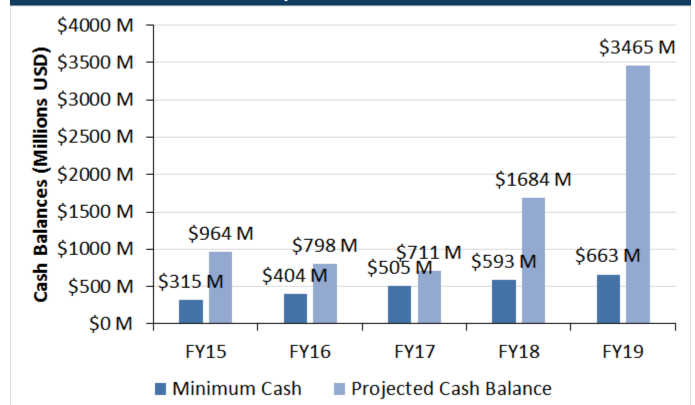
($ USD in Millions Except for $ per Share Figures)

- Under the assumption that the Nautilus minimum cash balance is 5% of its Cost of Revenue + Operating Expenses, the company requires additional funding in every scenario except for the Upside Case:

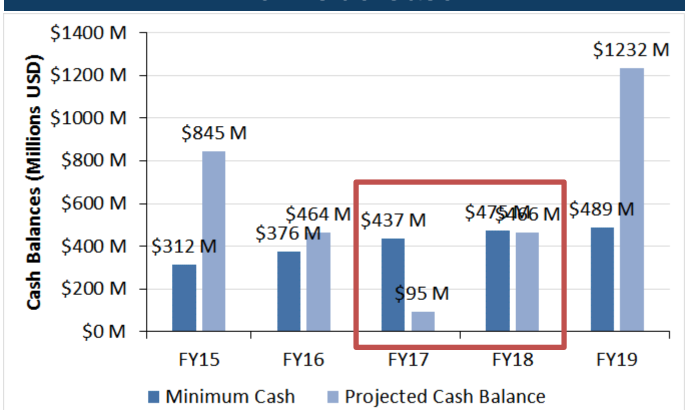
Base Case



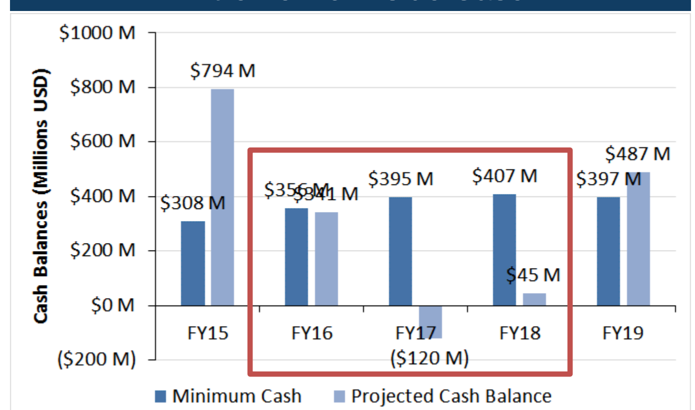
Upside Case



Downside Case



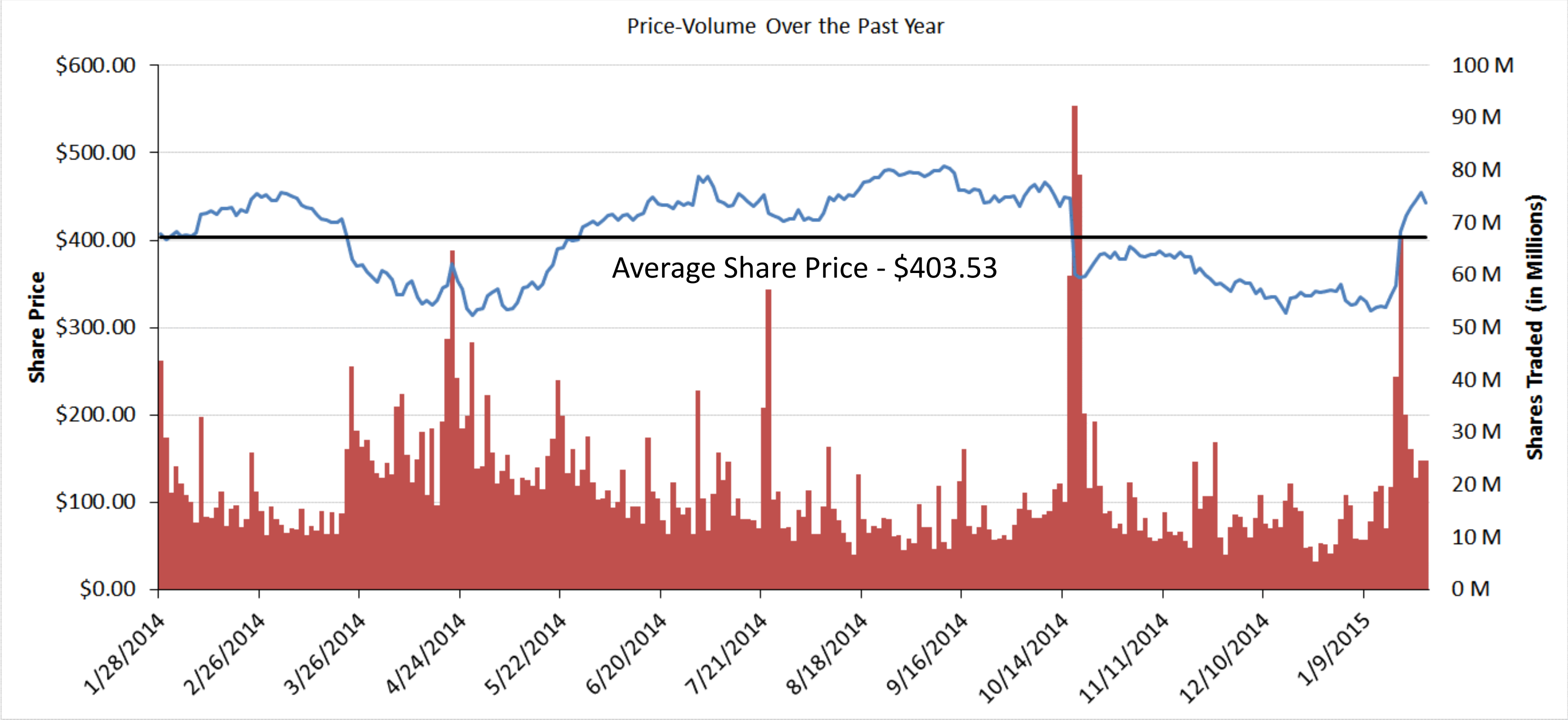
Extreme Downside Case



Rationale for Follow-On Equity Offering

($ USD in Millions Except for $ per Share Figures)

- Given Nautilus' rich valuation multiples and stock-price performance in the past several years, it is a prime candidate for a follow-on equity offering
- Because of the recent jump in the stock price, we believe the company may have to offer a higher-than-usual share-price discount to complete a $1.5 billion follow-on offering
- At discounts of 10-20%, the company's After-Tax Cost of Equity ranges from 1.24% to 1.38% in the Base Case (1.60% to 1.80% in the Upside Case and 0.85% to 0.95% in the Downside Case)



Valuation Summary

#1	Nautilus' Share Price Exceeds its Intrinsic Value	The company's share price is a 15% premium to its DCF-determined intrinsic value in the Base Case and 42% in the Downside Case (vs. a 30% discount in the Upside Case)
#2	Nautilus Trades at Premium Multiples	Despite EBITDA growth in the middle of the public comps' range, Nautilus trades at, by far, the highest EV / EBITDA and P / E multiples, exceeding even those of Facebook
#3	Nautilus' Share Price is Up ~10% in the Past Year	While this is not a tremendous increase, equity investors may still perceive the company as being richly valued, given the recent price jump and the resulting multiples
#4	But Its Share Price is Up More Than 6x in the Past Five Years	Given the company's longer-term trading history, investors are likely to demand a follow-on offering discount above the standard range

Follow-On Offering Proceeds Analysis

($ USD in Millions Except for $ per Share Figures)

- To analyze a potential follow-on offering, Goldman Stanley used the following assumptions:
  - **Offering Size:** $1.5 billion USD, with a 15% overallotment provision
  - **Primary / Secondary Split:** 90% / 10% in both the initial offering and the overallotment
  - **Underwriting Discount:** 2.25%
  - **Other Fees:** $0.5 million

		Follow-On Equity Filing Range - Discount to Current Share Price					
Shares Issued in Follow-On Offering:	*Units:*	(25.0%)	(20.0%)	(15.0%)	(10.0%)	(5.0%)	0.0%
Follow-On Offering Price:	*$ as Stated*	**$ 331.85**	**$ 353.98**	**$ 376.10**	**$ 398.22**	**$ 420.35**	**$ 442.47**
Base Shares Issued or Sold in Offering:	*M Shares*	**4.520**	**4.238**	**3.988**	**3.767**	**3.568**	**3.390**
Primary Shares Issued:	*M Shares*	4.068	3.814	3.589	3.390	3.212	3.051
Secondary Shares Sold:	*M Shares*	0.452	0.424	0.399	0.377	0.357	0.339
Overallotment Shares Issued or Sold:	*M Shares*	**0.678**	**0.636**	**0.598**	**0.565**	**0.535**	**0.509**
Primary Shares Issued:	*M Shares*	0.610	0.572	0.538	0.509	0.482	0.458
Secondary Shares Sold:	*M Shares*	0.068	0.064	0.060	0.057	0.054	0.051
Pre-Transaction Diluted Shares Outstanding:	*M Shares*	62.644	62.644	62.644	62.644	62.644	62.644
(+) Total Primary Shares Issued:	*M Shares*	4.678	4.386	4.128	3.899	3.693	3.509
Pro-Forma Diluted Shares Outstanding:	*M Shares*	**67.322**	**67.030**	**66.772**	**66.543**	**66.337**	**66.153**
Post-Money Equity Value @ Trading and @ Pricing:							
Implied Post-Money Equity Value @ Pricing:	*$ M*	$ 22,341.1	$ 23,727.0	$ 25,112.9	$ 26,498.8	$ 27,884.7	$ 29,270.6
Pricing Discount %:	*%*	25.0%	20.0%	15.0%	10.0%	5.0%	0.0%
Pricing Discount Amount:	*$ M*	7,447.0	5,931.7	4,431.7	2,944.3	1,467.6	-
Implied Post-Money Equity Value @ Trading:	*$ M*	29,788.1	29,658.7	29,544.6	29,443.1	29,352.3	29,270.6
Deal Size & Gross and Net Proceeds to Issuer:							
Base Deal Size (Primary + Secondary):	*$ M*	$ 1,500.0	$ 1,500.0	$ 1,500.0	$ 1,500.0	$ 1,500.0	$ 1,500.0
(+) Total Overallotment:	*$ M*	225.0	225.0	225.0	225.0	225.0	225.0
Total Offering Size:	*$ M*	**1,725.0**	**1,725.0**	**1,725.0**	**1,725.0**	**1,725.0**	**1,725.0**
Gross Primary Proceeds:	*$ M*	1,552.5	1,552.5	1,552.5	1,552.5	1,552.5	1,552.5
(-) Underwriting Discount:	*$ M*	(34.9)	(34.9)	(34.9)	(34.9)	(34.9)	(34.9)
(-) Deal-Related Fees:	*$ M*	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
Net Proceeds to Issuer:	*$ M*	**1,517.1**	**1,517.1**	**1,517.1**	**1,517.1**	**1,517.1**	**1,517.1**
% Company Sold in Follow-On Offering:	*%*	**6.9%**	**6.5%**	**6.2%**	**5.9%**	**5.6%**	**5.3%**

Comparable Debt Issuances

- Goldman Stanley examined 126 debt issuances from U.S.-based “non-investment grade speculative” companies in the software and media industries; the average coupon rate was 5.38% with a tenor of 8.3 years
- Moody’s has reported the following median Debt / EBITDA and EBITA / Interest for a broader set of BB-rated companies across all industries (note that the Moody’s “Ba” rating is equivalent to the Fitch and S&P “BB” rating):

Exhibit 1

Aggregate Metrics by Rating Category

	EBITA / Average Assets	EBITA / Interest Expense	EBITA Margin	Operating Margin	(FFO + InExp) / IntExp
Aaa	16.0%	35.7	22.8%	19.0%	36.0
Aa	14.3%	21.1	21.4%	19.2%	21.1
A	13.6%	13.4	19.4%	16.8%	13.8
Baa	10.3%	7.2	15.1%	14.0%	8.4
Ba	8.6%	3.8	12.2%	10.9%	5.3
B	6.7%	1.7	9.7%	8.1%	3.1
Caa-C	5.6%	0.8	5.9%	5.4%	1.4

	FFO / Debt	Retained Cash Flow / Net Debt	Debt / EBITDA	DEBT / Book Capitalization	CAPEX / Depreciation	Revenue Volatility
Aaa	86.3%	81.5%	0.9	23.7%	1.6	8.6
Aa	62.7%	33.8%	1.3	41.1%	1.3	6.5
A	46.1%	38.8%	1.6	39.3%	1.3	10.4
Baa	31.0%	28.1%	2.5	45.8%	1.2	11.0
Ba	22.4%	22.6%	3.4	50.1%	1.2	15.4
B	13.6%	13.3%	5.1	67.3%	1.1	17.4
Caa-C	3.4%	3.4%	7.7	99.1%	0.9	11.7

Source: Moody's Financial Metrics™

Pro-Forma Credit Statistics and Ratios – Base Case

($ USD in Millions Except for $ per Share Figures)

- Immediately after raising $1.5 billion, Nautilus' Debt / EBITDA would jump from 1.8x to 4.5x, putting it in-line with B or B+-rated companies:

		Historical			Transaction Adjustments			Projected				
Credit Statistics and Ratios:	***Units:***	**FY12**	**FY13**	**FY14**	**Debit**	**Credit**	**FY14**	**FY15**	**FY16**	**FY17**	**FY18**	**FY19**
EBITDA:	*$ M*	$ 160.9	$ 348.0	$ 528.2			$ 528.2	$ 678.3	$ 634.3	$ 667.7	$ 978.8	$ 1,782.2
Free Cash Flow (FCF):	*$ M*	(67.0)	(22.2)	(128.0)			(128.0)	(346.0)	(441.8)	(412.8)	437.0	1,049.0
Total Debt (Including Finance Leases):	*$ M*	430.6	529.5	928.4			2,390.9	2,389.4	2,387.8	2,386.3	2,384.8	2,383.2
Net Debt:	*$ M*	(317.5)	(670.9)	(680.1)			(680.1)	(426.5)	(89.3)	208.2	(350.7)	(1,525.4)
Total Equity:	*$ M*	744.7	1,333.6	1,857.7			1,857.7	2,260.0	2,654.0	3,102.6	3,780.9	5,009.1
Total Capital:	*$ M*	1,383.2	2,058.4	2,972.3			4,434.8	4,887.1	5,290.7	5,672.1	6,293.6	7,486.1
Net Capital:	*$ M*	635.1	858.0	1,363.8			1,363.8	2,071.3	2,813.5	3,494.0	3,558.2	3,577.5
Total Debt / EBITDA:	*x*	2.7x	1.5x	1.8x			4.5x	3.5x	3.8x	3.6x	2.4x	1.3x
Net Debt / EBITDA:	*x*	(2.0x)	(1.9x)	(1.3x)			(1.3x)	(0.6x)	(0.1x)	0.3x	(0.4x)	(0.9x)
EBITDA / Interest:	*x*	8.2x	10.8x	9.9x			9.9x	5.1x	4.8x	5.0x	7.3x	13.4x
Total Debt / Equity:	*x*	0.6x	0.4x	0.5x			1.3x	1.1x	0.9x	0.8x	0.6x	0.5x
Total Debt / Capital:	*%*	31.1%	25.7%	31.2%			53.9%	48.9%	45.1%	42.1%	37.9%	31.8%

- While the company would still have strong liquidity and interest coverage, its leverage and capital ratios would concern lenders and might trigger a credit rating downgrade

- Additionally, lenders may view the company's EBITDA and FCF projections with skepticism, given the "hockey stick" turnaround planned for FY 18 and FY 19

- However, the real problem is that the figures look significantly worse in the Downside scenario (Debt/EBITDA rises to over 10x), which lenders focus on when assessing the company's prospects

Unsecured Senior Note Issuance – Conclusions

#1	Currently, Nautilus' Credit Stats and Ratios Are Healthy	The company would likely be able to raise $1.5 billion in debt in two tranches of $750 million each, with coupon rates of 5.5% and 5.8% and tenors of 8 years; these figures are consistent with those of BB- technology companies
#2	Nautilus' Credit Rating Would Likely Be Downgraded Afterward	The company's pro-forma Debt / EBITDA would rise to 4.5x, putting it more in-line with B and B+-rated companies; lenders would also question its cash flow profile and margins
#3	Unsecured Senior Notes Would Reduce WACC	Since the company's Cost of Equity as determined by CAPM is 9 – 14%, Unsecured Notes could offer a significantly lower cost and therefore reduce the company's WACC
#4	A Debt Issuance Would Also Reduce Nautilus' Financial Flexibility	At a leverage ratio of 4.5x, followed by 3.5x – 4.0x, it is unlikely that Nautilus could issue additional debt on the same terms; it would have to raise equity or more expensive debt, such as Subordinated Notes or Mezzanine

Rationale for a Convertible Bond Offering

- A convertible bond offers many of the same advantages as plain-vanilla debt and equity offerings, but it comes without the disadvantages, or with diminished disadvantages:

Criterion	Follow-On Equity	Unsecured Senior Notes	Convertible Bond
After-Tax Cost of Funding	Moderate	Highest	Lowest
Impact on WACC	Increase	Moderate Decrease	Substantial Decrease
Share Price Impact	Neutral to Positive	Neutral	Neutral to Positive
Credit Rating Impact	None	Likely Downgrade	Possible Downgrade
Share Dilution	6-7%	None	4-5%, but possible to reduce
Covenants	None	Incurrence	Incurrence
Ability to Raise Additional Debt	No Impact	Reduced	Reduced, but less so than with Senior Notes
Speed of Issuance	Several Weeks	Several Weeks (144A)	Several Weeks (144A)

Convertible Bond Proposed Offering Terms

- Based on this analysis, we believe the company could issue a convertible bond in Q1 with the following terms:
  - **Offering Size:** $1.5 billion
  - **Conversion Price:** $641.58 (45.0% premium to current share price)
  - **Conversion Ratio:** 1.5586 (based on par value of $1,000)
  - **Coupon Rate and YTM:** 1.50%
  - **Maturity:** December 31, 2020 (6-year tenor)
  - **Payments:** Semiannual on June 30 and December 31 of each year
  - **Optional Redemption:** Make-whole call at T+50bps any time prior to maturity
  - **Change of Control:** Put @ 101% of principal plus accrued interest
  - **Settlement:** Cash settlement option available
- To reduce dilution and raise the effective conversion price, it is prudent to use a call-spread with the following terms:
  - **Purchased Call Options:** 2.3380 million (100% offset of convertible bond dilution) at a $641.58 exercise price
  - **Sold Warrants:** 1.7535 million (75% of call options) at a $774.32 exercise price
- Such a strategy might increase pre-tax cost of funding to ~2.6% and raise the effective conversion premium to 75%

Pro-Forma Credit Statistics and Ratios – Base Case

($ USD in Millions Except for $ per Share Figures)

- Because this convertible bond would have a cash settlement option, Nautilus would record its liability and equity components separately, thereby improving its credit stats and ratios:

Credit Statistics and Ratios:	Units:	FY14	Projected FY15	Projected FY16	Projected FY17	Projected FY18	Projected FY19
EBITDA:	$ M	$ 528.2	$ 678.3	$ 634.3	$ 667.7	$ 978.8	$ 1,782.2
Free Cash Flow (FCF):	$ M	(128.0)	(286.7)	(382.7)	(353.9)	481.4	1,100.8
Total Debt (Including Finance Leases):	$ M	2,070.3	2,121.0	2,171.6	2,222.3	922.3	920.7
Net Debt:	$ M	(993.2)	(746.7)	(416.5)	(125.7)	(2,027.4)	(3,253.9)
Total Equity:	$ M	2,170.8	2,581.6	2,983.6	3,439.7	5,464.6	6,747.4
Total Capital:	$ M	4,427.3	4,940.3	5,404.1	5,845.2	6,514.8	7,761.9
Net Capital:	$ M	1,363.8	2,072.7	2,816.0	3,497.2	3,565.1	3,587.2
Total Debt / EBITDA:	x	3.9x	3.1x	3.4x	3.3x	0.9x	0.5x
Net Debt / EBITDA:	x	(1.9x)	(1.1x)	(0.7x)	(0.2x)	(2.1x)	(1.8x)
EBITDA / Interest:	x	9.9x	5.6x	5.2x	5.5x	16.2x	35.2x
Total Debt / Equity:	x	1.0x	0.8x	0.7x	0.6x	0.2x	0.1x
Total Debt / Capital:	%	46.8%	42.9%	40.2%	38.0%	14.2%	11.9%

- In the Downside Case, Debt / EBITDA would still rise to 9.5x, but the company's capital ratios would be in a range more consistent with BB-rated companies

- The company's credit rating might still be downgraded following a convertible bond issuance, but we believe it is less likely than with a traditional Unsecured Senior Note issuance

Convertible Bond Funding Costs

($ USD in Millions Except for $ per Share Figures)

- The convertible bond would also provide a funding cost advantage, whether funding costs are measured by EPS impact or impact on WACC:

		Follow-On Equity Filing Range - Discount to Current Share Price					
Shares Issued in Follow-On Offering:	*Units:*	(25.0%)	(20.0%)	(15.0%)	(10.0%)	(5.0%)	0.0%
Follow-On Offering Price:	*$ as Stated*	$ 331.85	$ 353.98	$ 376.10	$ 398.22	$ 420.35	$ 442.47
FY 2015E Post-Transaction Diluted EPS:	*$ as Stated*	$ 4.87	$ 4.89	$ 4.91	$ 4.92	$ 4.94	$ 4.95
FY 2015E Diluted EPS Accretion / (Dilution) - $:	*$ as Stated*	(0.44)	(0.42)	(0.40)	(0.39)	(0.37)	(0.36)
FY 2015E Diluted EPS Accretion / (Dilution) - %	*%*	(8.4%)	(8.0%)	(7.6%)	(7.3%)	(7.0%)	(6.7%)
After-Tax Cost of Equity Funding:	*%*	1.47%	1.38%	1.30%	1.24%	1.18%	1.12%
After-Tax Cost of Debt Funding:	*%*	3.73%	3.73%	3.73%	3.73%	3.73%	3.73%
After-Tax Cost of Convertible Funding:	*%*	0.99%	0.99%	0.99%	0.99%	0.99%	0.99%

- In the WACC calculation, the convertible bond's after-tax cost of funding is 0.99%, compared with 3.73% for debt or 8.63% – 14.05% for equity
- While this cost would increase if the company's stock price exceeded its conversion price, the company could boost the effective conversion premium to 75% using the call-spread strategy we recommended

Convertible Bond Offering – Conclusions

#1	A Convertible Bond Would Offer the Lowest Cost of Funding	The after-tax cost would range from 0.99% to 1.74%, compared with 3.50% to 4.00% for traditional debt or 1.24% to 1.38% for equity; a convertible bond would also reduce WACC more than either of those
#2	A Convertible Would Let Nautilus Maintain Financial Flexibility	It would have less restrictive covenants than Unsecured Senior Notes, the company's leverage ratio and capital ratios would remain lower, and the company would be able to raise debt at lower rates in the future
#3	The Convertible's Market Price Would Be Close to Its Book Value	Assuming that stock-price volatility stays about the same, the convertible bond would likely trade within ~10% of its $1.5 billion book value, reducing risk from short sellers
#4	The Company Could Reduce Dilution with a Call-Spread Structure	While a 45% conversion premium is in-line with recent offerings, the company could boost the effective conversion premium to 75% with purchased call options and sold warrants, reducing economic dilution