WILLIAM O'NEIL+CO.

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Netflix Inc (NFLX)

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Company Information

Bloomberg Ticker	NFLX US
Buy Price (12/18/2023)	USD 486.12
Market cap	212.98 bil
P/E	47
50-day avg vol	5.31 mil

Global Leisure-Movies & Related Team

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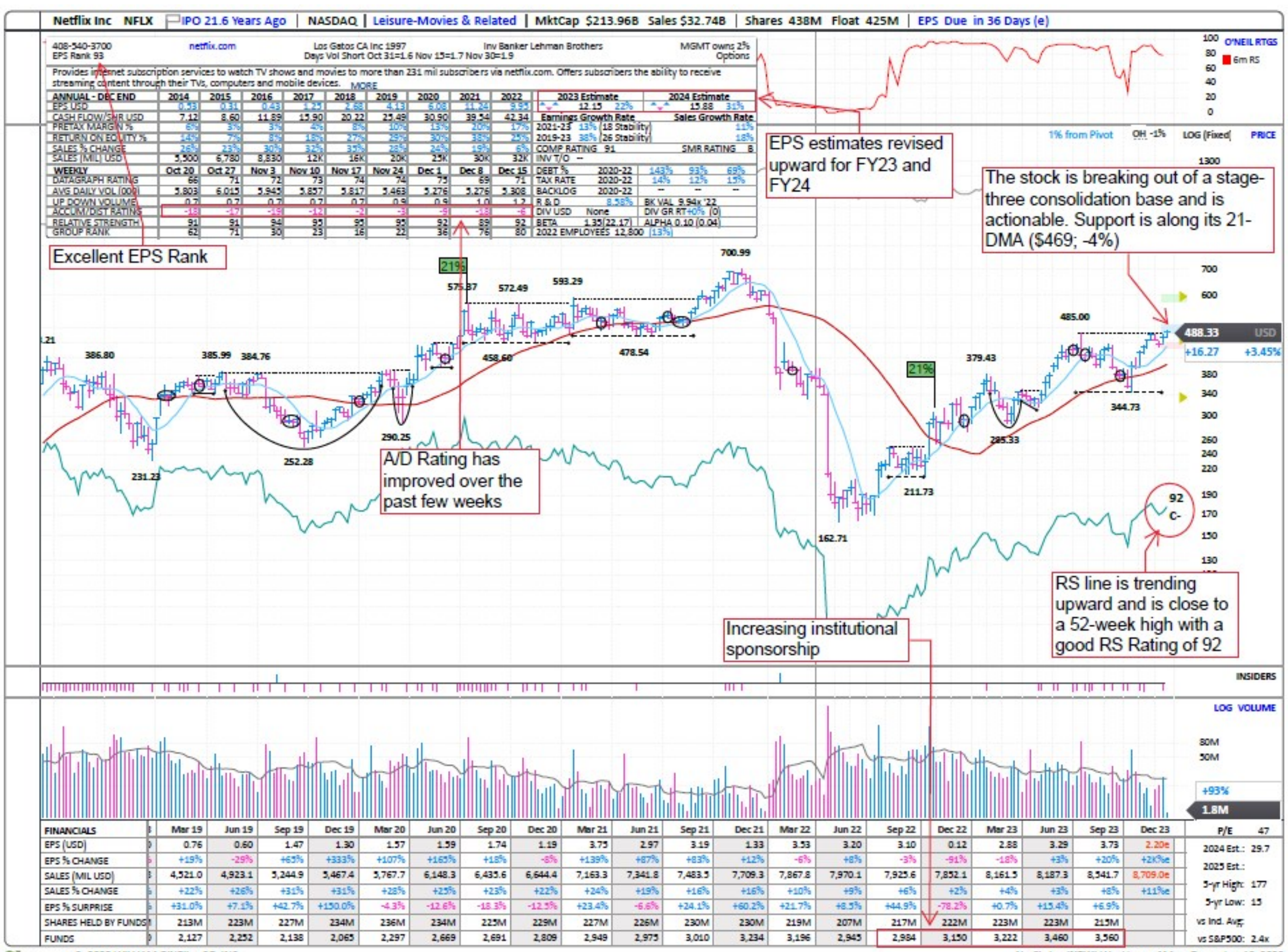
O'Neil Ratings and Rankings

EPS Rank	RS Rating	Datagraph Rating	Composite Rating	Acc/Dist Rating	SMR Rating
93	92	71	91	C-	B



O'Neil Methodology

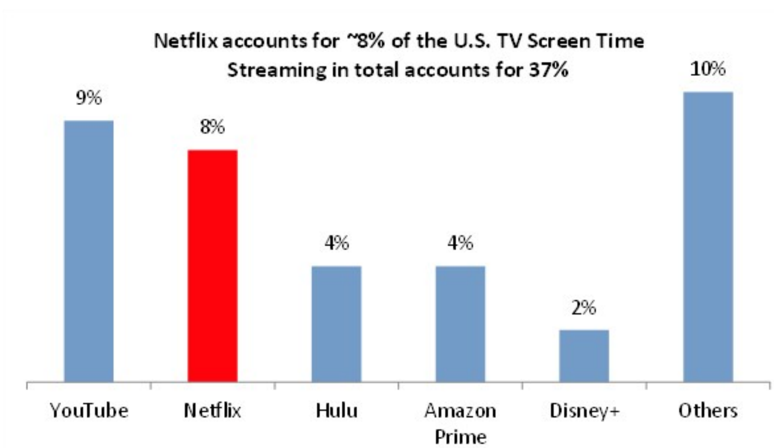
- The stock is breaking out of a stage-three consolidation base and is actionable. Support is along its 21-DMA ($469; -4%).
- Good fundamental profile: EPS Rank 93 and SMR Rating of B. Consensus expects double-digit EPS growth for FY23 and FY24.
- RS line has been trending upward since May 2022 and is at a 52-week high, with an RS Rating of 92 and an A/D Rating of C-. A/D Rating has improved over the past few weeks.
- Institutional sponsorship stood at 3,560 funds (+19% y/y; +3% q/q) as of September.

Company Description / Fundamentals

- Netflix offers subscription-based video streaming services for TV shows, documentaries, and movies to more than 245M subscribers in 190+ countries. The company produces its own content and licenses it from others. The content on the platform is from across the world in more than 25 languages with subtitles.
- **Q3 FY23 revenue by region:** UCAN, 44%; EMEA, 32%; LATAM, 13%; APAC, 11%.

Major Beneficiary of the Secular Shift to Streaming

- Consumers have been shifting to streaming entertainment, replacing traditional linear TV. It is still early in terms of this transition and the company sees a long runway for growth.
- As of September, streaming represented just 37% of the U.S. TV screen time, compared with 53% for linear television, according to Nielsen. This depicts a long runway for growth. Streaming represented 20% of the U.S. TV screen time in 2020 and 27% in 2021.
- Among streaming services, Netflix has a TV screen timeshare of 8% in the U.S., following YouTube (9%). Other platforms, such as Hulu (4%), Amazon Prime (4%), and Disney+ (2%), have a low-single-digit share.



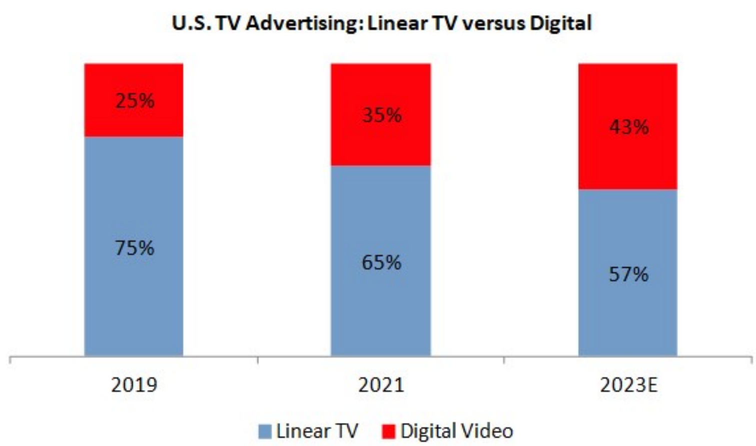
Source: Nielsen

- The company is confident that it can increase its share of screen time in the U.S. and around the world as it improves its service.
- Recently, the company released viewership data for its entire catalog. It includes a list of 18K titles along with the hours streamed. The data provides more transparency to content creators about the content that resonates with audience.

Advertising Tier Set for the Advertising Dollar Battle

- The rollout of an ad-supported tier could reaccelerate subscriber growth and add a new revenue source for the company. Netflix is expected to benefit from linear TV advertising dollars shifting toward digital video. It expects the ad-supported tier to account for at least 10% of total revenue in the long run.
- Netflix launched its ad-supported plan on November 3, 2022, in the U.S. It is priced at $7 per month, $1 lower than Disney's ad-supported tier. Ads are 15–30 seconds in length with an average of 4–5 minutes each hour (versus 20

minutes per hour for TV). It was also rolled out in various markets, including Australia, Germany, France, Japan, Korea, and Canada. The company did not see a significant number of people switching plans following the rollout.
- Economically, the company is pleased with its per-member ad plan economics. In the U.S., its average revenue per member (subscription + ads) was higher than the actual standard plan.
- Recently, the company announced that it has 15M monthly active users on its ad-supported tier, compared with 5M in May. Netflix intends to gain ad dollar share from the $180B global-branded advertising market as the cord-cutting trend accelerates. However, it does not expect a material contribution from it in the near term and anticipates gradual membership growth over time.
- Ad plan membership increased 70% q/q following 100% q/q growth in Q2. It remains a small portion of the membership base. Also, nearly 30% of new signups are toward the ad-tier.
- Per Magna, the U.S. video ad market is valued at $87B. Of this, linear TV accounts for 65%, while the rest 35% is from digital video. As the cord-cutting trend accelerates, linear TV ads are expected to migrate to digital video formats, including streaming platforms.



Source: Magna and Bloomberg

Incremental Revenue Opportunity from Password Sharing Crackdown

- Netflix has started to crack down on password sharing starting from early 2023. This could lead to an incremental revenue opportunity for the company. In May, it launched paid sharing in more than 100 countries. It plans to launch paid sharing in all the remaining countries soon.
- It is already net revenue positive across regions when accounting for additional spin-off accounts and extra members, churn, and changes to the plan mix.
- Earlier in 2022, Netflix identified that apart from its 230M paying households, 100M+ households were using Netflix through a shared account. These include 30M in the U.S. and Canada. Subscriber losses in Q1 FY22 were also attributed to password sharing.
- The company followed an iterative process to limit password sharing and monetize shared accounts by testing multiple methods in LATAM. Primary account holders were to pay an additional fee for users outside their households. Account holders were able to add an extra member for less than the cost of a separate Netflix plan.
- Netflix has landed on an approach to monetize account sharing that will begin to roll out widely in 2023.
  - It plans to roll out "Profile Transfer" widely. This lets users using other people's account to easily transfer their personalized recommendations, viewing history, saved games, and other settings to a new account.
  - Netflix will also offer subscribers the option to establish "subaccounts", paying more to allow others to use their subscription.
- This could have some near-term impact on membership growth. Members using shared accounts might stop watching as Netflix cracks down on password sharing. Over time, these borrowers could sign up to their own accounts, resulting in improved overall revenue. This is in line with what the company witnessed while testing password sharing in LATAM.
- Assuming 50% of the 100M households that share passwords subscribe to a $3/month plan (the amount Netflix charged for a subaccount in Argentina), Netflix could generate $1.8B in annual revenue (6% of 2022 revenue).

Narrative Shifted Toward Profitability

- Netflix is the only player in the market that has successfully built a profitable pure-play streaming business. Operating margin expanded to 20% in FY22 compared with 4% in FY16. The company turned FCF-positive in FY20 and expects this to sustain going forward.
- It is exercising pricing power through price hikes. In October, Netflix raised prices by 20% for some of its plans in the U.S., U.K., and France. Ad-tier ($7) and standard plan ($15.5) will remain the same, while Basic and Premium plans will cost $12 and $23, respectively.
- Most other streaming players, including Disney, Paramount, and Warner Bros. Discovery, are facing operating losses due to increased investments in their streaming platform as well as a decline in their linear TV revenue. On the other hand, Netflix enjoys a ~$6B annual operating profit.
- Netflix has an operating margin of ~20% and expects margin expansion to continue ~3% every year. However, near-term margins are to be under pressure amid unfavorable macro conditions. Walt Disney Company's Media Network segment had a 30% operating margin in the pre-pandemic period, indicating room for margin improvement for Netflix over the years.

Mixed Q3 FY23 Results

- Revenue increased 7% y/y to $8.5B, in-line with estimates. Revenue increased 8% y/y, excluding the foreign currency impact. Revenue growth was driven by subscriber additions. ARPU was down 1% y/y despite strong subscriber additions amid higher growth from the lower ARPU region and limited price increases over the last 18 months.
- Operating income was $1.9B (+25% y/y), leading to an operating margin of 22.4% (+310 bps y/y). Margins beat estimates by 30 bps due to the timing of content and other spending.
- Net income was $1.7B (+20% y/y), beating estimates by 7%.
- Diluted EPS was $3.73 (+20% y/y), beating estimates by 7%. This included a $173M non-cash unrealized loss from FX re-measurement on its euro-denominated debt.
- **Better-than-expected subscriber additions:** The company added 8.8M subscribers compared with estimates of 6.2M and 2.4M additions in Q3 FY22. This was the highest quarterly net additions since Q2 2020, aided by the rollout of paid sharing. It added more than 1M subscribers across each region. In the EMEA region, it added 3.9M subscribers (+550% y/y), which came ahead of estimates of 2.2M adds.
  - Overall, it had 247.1M subscribers (+11% y/y), beating estimates by 1%.
  - Overall ARPU was $11.69 (+1% q/q; -1% y/y), missing estimates by 1%.

Looking Forward

- **Q4 FY23 guidance:** Revenue is expected to be $8.7B (+11% y/y). It expects revenue growth to be driven by subscriber growth. Q4 FY23 paid net additions are expected to be like that of Q3 FY23. ARPU is expected to be flat y/y due to limited price increases in the last 18 months. It expects $200M F/X headwinds on Q4 revenue due to strength in USD (included in guidance). Operating margin is expected to be 13.3% (+630bps y/y).
- **FY23 guidance, raised FCF guidance:** For FY23, it expects operating margin of 20%, at the high end of its prior guidance of 18–20%. It expects FCF to be $6.5B from a prior forecast of at least $5B. This includes ~$1B in lower-than-planned cash content spending in 2023 due to actors' strike.
- **FY24 Outlook:** Cash content spend is expected to be $17B, up from ~$13B in 2023 (impacted by actors' strike). This is expected to create lumpiness in FCF over 2023–24. It still plans to deliver substantially positive FCF. For FY24, it expects operating margin of 22–23%.
- **Next catalyst:** Q4 FY23 results in January 2024.

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Disclosures