Doug Blackledge

Webster University FINC 5210

INVESTMENT PROJECT – A COMPREHENSIVE VALUATION ANALYSIS OF NETFLIX, INC.

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A COMPREHENSIVE FINANCIAL ANALYSIS OF NETFLIX, INC.

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1. INTRODUCTION AND OVERVIEW

Netflix, Inc. is a widely popular CD-ROM, Blue Ray, and Streaming Video provider. According to the company profile on MarketWatch.Com, "Netflix, Inc. operates as an Internet subscription service company, which provides subscription service streaming movies and TV episodes over the Internet and sending DVDs by mail. The company operates its business through three operating segments: Domestic streaming, International streaming and Domestic DVD. Netflix obtains content from various studios and other content providers through fixed-fee licenses, revenue sharing agreements and direct purchases. It markets its service through various channels, including online advertising, broad-based media, such as television and radio, as well as various partnerships. The company was founded by Marc Randolph and Wilmot Reed Hastings Jr., on August 29, 1997 and is headquartered in Los Gatos, CA." [1]

As this company's analyst, I strongly recommend a "Sell" position. Although this company has performed well in general, I'll clearly demonstrate that the stock valuation is nowhere close to the current overvalued price.

2. FINANCIAL SUMMARY

Netflix, Inc. has been a successful company since 1997. However, their financials have been erratic. Between 2010 and 2014, although their revenue has increased 155%, their Net Income has ranged from $161M, down to $17M, and then back to $267M. During that same time frame earnings per share (EPS) ranged from $2.96 in 2010, down to $0.29 in 2012 then up to $4.32 for the year ending 2014.[2] However, their stock price has escalated. As part of the consumer services industry, they have far outperformed the industry as a whole as shown in Figure 1 below[3]:

Figure 1: NFLX vs. Consumer Services

On the surface, according to the chart, they appear to be a strong company, but as will be explained, the background numbers tell a different story.

Netflix has a huge price to earnings (P/E) ratio currently at 145 for the trailing twelve months, nearly double of what it was at the end of 2014, and significantly higher than the 2010 through 2014 P/E of the combined S&P 500 of 16.28. Some analysts might say this implies the high P/E ratio means that earnings will "catch up" to the stock price, this is a primary reason why the stock is actually overvalued. In fact the text implies that higher P/E ratios mean more room for growth[4] (although they caveat that with the acknowledgement that P/E ratio analysis is not a perfect science). As an analyst, I would say that a poor cash flow and EPS history (flat or decreasing) with a constantly increasing price is indicative of an overvalued stock. More discussion on this will follow in the "Future Valuation" section.

3. COMPETITION

Although Netflix, Inc. has a few different venues, I'll focus on the more recent developments in providing streaming video. Two primary competitors in this field are Time Warner Cable and Amazon. As can be seen in the embedded spreadsheet, a brief comparison of their key financial data shows that there is little justification for the overvalued Netflix price. Time Warner is at about $156/share while Amazon is at $422.50/share, yet (for example) the Estimated 5 yr. EPS growth is much higher for Amazon, while the Estimated EPS next year is tremendously higher for Time Warner Cable which in turn makes it's P/E ratio much more attractive than Netflix.

Stock	Revenue Growth % 1 Year	Revenue Growth % 3 Year	EPS Growth % 1 Year	Est EPS This Year	Est EPS Next Year	Est EPS Growth % 5 Year	Return on Equity FY 1 (%)	Debt/ Equity Ratio FY 1
Amazon. com Inc	19.52	22.78	--	2.15	4.44	66.51	-2.35	0.18
Netflix Inc	25.83	19.76	133.75	3.42	6.23	28.89	16.72	0.62
Time Warner Cable Inc	3.13	5.05	7.14	7.95	8.75	4.72	27.16	3.23

	Price/ Earnings	Forward Price/ Earnings	P/E 5-year Average	PEG Ratio	Price/ Cash Flow	P/CF 3-year Average	Price/ Sales	Dividend Yield (%)
Amazon. com Inc	-588.24	95.24	-611.38	1.44	20.96	27.35	1.61	0
Netflix Inc	78.74	125	135.43	4.31	1250	571.79	3.83	0
Time Warner Cable Inc	21.19	18.08	17.29	3.83	6.78	6.38	1.89	1.91

4. FUTURE VALUATION

According to the book, and a few web site sources[5], determining the intrinsic value of a stock is not an exact process and requires making some assumptions. Most of the intrinsic value determination methods incorporate projected dividend growth. However, Netflix, Inc pays no dividends. Therefore the free cash flow method is the best analysis tool.

Using the text's spreadsheet 18.2, I was able to input data to derive an intrinsic value. Compared to the current stock price of $557, the Intrinsic value is much lower at $135.53. (Spreadsheet attached).

5. SYNOPSIS AND RECOMMENDATION

When analyzing the financials associated with Netflix, it's clear that the stock is significantly overvalued. This results in a strong "Sell" and/or "Sell Short" recommendation. The comparative analysis of some of the industry competitors show that they are priced in a more realistic range while Netflix has been hyped up with a lack of future valuation evidence to support the price increase.

REFERENCES

1. http://www.marketwatch.com/investing/stock/NFLX/profile
2. http://financials.morningstar.com/ratios/r.html?t=NFLX&region=usa&culture=en-US
3. http://www.marketwatch.com/investing/stock/NFLX/charts
4. Bodie, Kane, Marcus Investments, 9th ed, 607
5. http://www.investopedia.com/university/stockpicking/stockpicking1.asp

Attachment: Netflix IV Assessment using spreadsheet 18.2 from the text

		2011	2012	2013	2014	2015						
A. Input data												
P/E		16.70	322.60	263.40	204.20	145.00						
Cap spending/shr		-2.50	-1.51	-0.84	-0.17	0.50						
LT Debt		400	200	933	1667	2400						
Shares		5400	5900	6000	6100	6200						
EPS		4.16	0.29	1.47	2.66	3.84						
Working Capital		606	565	1220	1875	2530						
B. Cash flow calculations												
Profits (after tax)		226.0	17.0	90.3	163.7	237.0						
Interest (after tax)		9.4	4.7	21.8	39.0	56.2			= (1-tax_rate) x r_debt x LT Debt			
Chg Working Cap			-41.0	655.0	655.0	655.0						
Depreciation		45000.0	45000.0	48000.00	51000	54000.0						
Cap Spending			-8909.0	-4906.0	-903.0	3100.0						
							Terminal value					
FCFF			53971.7	52363.2	51450.7	50538.2	780540.4					
FCFE			53767.0	53074.7	52145.0	51215.3	731929.2		assumes fixed debt ratio after 2016			
C. Discount rate calculations												
Current beta	0.9								from Value Line			
Unlevered beta	0.842								current beta /[1 + (1-tax)*debt/equity)]			
terminal growth	0.02											
tax_rate	0.35								from Value Line			
r_debt	0.036								YTM in 2012 on A+ rated LT debt			
risk-free rate	0.02											
market risk prem	0.08											
MV equity		3774				34365			Row 3 x Row 11			
Debt/Value		0.10	0.09	0.08	0.07	0.07			linear trend from initial to final value			
Levered beta		0.900	0.895	0.890	0.885	0.880			unlevered beta x [1 + (1-tax)*debt/equity]			
k_equity		0.092	0.092	0.091	0.091	0.090	0.090		from CAPM and levered beta			
WACC		0.085	0.086	0.086	0.086	0.086	0.086		(1-t)*r_debt*D/V + k_equity*(1-D/V)			
PV factor for FCFF		1.000	0.921	0.848	0.781	0.719	0.719		Discount each year at WACC			
PV factor for FCFE		1.000	0.916	0.840	0.770	0.706	0.706		Discount each year at k_equity			
D. Present values									**Intrinsic val**	**Equity val**	**Intrin/share**	
PV(FCFF)			49717	44426	40199	36358	561536		732237	731837	135.53	
PV(FCFE)			49255	44558	40133	36149	516614		686709	686709	127.17	