Why We're Short Netflix

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Background

We've lost a lot of money betting against Netflix, which is currently our largest bearish bet, in the form of both a short and put position. In this letter, we share our investment thesis in depth and describe why, at a stock price of $178.50 and a market cap of $9.3 billion (based on yesterday's close), we think it's an exceptional short idea.

Given the natural inclination to talk about winners and quietly sweep losers under the rug, one might ask why we're writing about one of our worst investments. We have three main reasons for doing so. First, we think it's healthy to disclose and fully analyze our mistakes (although in this case we are not yet conceding that we've made a mistake in our analysis, but we obviously made a mistake in terms of timing our entry into the position). Second, it's a useful exercise for us – it helps clarify our own thinking – to put in writing our investment thesis, especially on complex and controversial positions (for example, on June 11th we published our 10-page analysis of why we were buying BP's stock amidst the panic at that time (it was then at $33.97 and closed yesterday at $43.86)). Third, we've found that when we publish our research, we often get valuable feedback. If there's information or analyses that would cause us to change our views, we want to hear about it!

And, no, contrary to what message board bulls will surely claim, we're not publishing our research in an attempt to salvage a bad investment by driving the share price down so we can exit at a better price. We are value investors, not traders, harbor no illusions about our ability to move markets, and our total capital committed to Netflix would not even place it among our top 12 long positions.

Since we rarely buy a stock at the very bottom or short one at the very top, having a position move against us, at least initially, is a common occurrence. When this happens, we reevaluate our analysis and investment thesis and make one of three decisions: add to the position, do nothing, or exit. Making the right decision here is critical – it's often more important than the initial investment decision – and there's no easy answer or rule of thumb. (In our experience, we'd guess that we add to a position 40% of the time, do nothing 40% of the time, and exit 20% the time.)

It's often a hard decision, both for fundamental and emotional reasons. Regarding the former, the fact that a stock's price has become more attractive doesn't necessarily mean it's a better investment. A stock typically moves because something has happened to the company, industry or world, so the change in the fundamentals must be weighed against the change in the share price.

The emotional side can be even more difficult. Numerous studies of investor behavior (the field is called *behavioral finance*) show that once an investor has a position in a stock, there are tremendous biases to seek confirming information, ignore disconfirming information, and not admit a mistake. We don't claim to be immune from these emotions, but we've studied them extensively and do our best to block them out. One of the simplest techniques we use is to ask ourselves, "If our portfolio was 100% cash and we were investing from scratch, would we establish this position and, if so, how big would it be?"

In the case of Netflix, the answer is that we'd have exactly the position we do today. In other words, we're not short it in a desperate and irrational attempt to try to make back what we've lost. The price at which we initially shorted Netflix, the amount of our losses to date, and whether we will ever make back these losses are completely irrelevant to our decision to hold the position today (this is true, incidentally, of *every* position we hold).

Overview of Netflix

Our favorite shorts generally involve some or all of the following characteristics: outright frauds (our very favorite), industries in decline or facing major headwinds, lousy or faddish business models, bad balance sheets, and incompetent, excessively promotional and/or crooked management. In general, we prefer to short businesses with these traits, even when their stocks trade at seemingly low valuation multiples, rather than shorting the stocks of good businesses with strong managements, even at high valuations. Sometimes, however, the valuations become so extreme that we will short the latter, but generally only when we believe there is a catalyst that will impact the company and cause the stock to fall.

Netflix falls into this latter category. We acknowledge that the company offers a useful, attractively-priced service to customers, is growing like wildfire, is very well managed, and has a strong balance sheet. So why on earth would we be betting against this stock? In short, because we think the valuation is extreme and that the rapid shift of its customers to streaming content (vs. mailing DVDs to customers) isn't the beginning of an exciting, highly-profitable new world for Netflix, but rather the beginning of the end of its incredible run. In particular, we think margins will be severely compressed and growth will slow over the next year.

Valuation

By any measure, Netflix's valuation is extremely rich. Based on yesterday's closing price, it trades at 67.4x trailing EPS ($2.65), 63.1x the high end of the company's EPS guidance for the full year 2010 ($2.83), and 46.7x consensus analysts' estimates for 2011 ($3.82). It also trades at 4.6x sales. In short, the stock is priced for perfection and any misstep would likely trigger a huge selloff.

But the company hasn't had many missteps, so what's the catalyst? To answer this question, one must understand how Netflix's business model is changing and the resulting implications.

Core Business Model

Netflix's core business model is buying DVDs and then renting them to its customers, who pay a fixed monthly fee for unlimited rentals delivered by mail plus unlimited streaming (the fee varies by how many DVDs can be out simultaneously; currently it's $9.99/month for one DVD, up to $55.99/month for eight DVDs; there's also a bare-bones two-rentals/month plan for $4.99 and a streaming-only plan for $7.99 monthly).

This is a good business for two reasons: 1) Netflix has a better business model and better management than its bricks-and-mortar competitors such as Blockbuster and Movie Gallery, both of which filed for bankruptcy this year (the former continues to operate as it tries to restructure, while the latter has been liquidated); and 2) Netflix only has to pay once for the DVDs it rents over and over again to its customers thanks to what's called the First Sale

Doctrine, which allows anyone who buys a DVD to sell, exchange, rent, or lend it to others, without paying the content owner.

New Business Model

Netflix's core DVD-based business model is rapidly shrinking as customers shift rapidly to streaming content. Netflix has moved quickly to adapt, making its streaming service available over the internet to customers' computers as well as through various devices like iPads and iPhones, Tivos, game consoles (PlayStation3, Xbox 360 and Wii), streaming players (Apple TV, Roku), and certain internet-enabled televisions and home theater systems.

Netflix's customers have responded by rapidly switching: in its most recent quarter (Q3), the company said that 66 percent of its subscribers "watched instantly more than 15 minutes of a TV episode or movie…compared to 41 percent for the same period of 2009 and 61 percent for the second quarter of 2010. In Q4 a majority of Netflix subscribers will watch more content streamed from Netflix than delivered on DVD."

So many of Netflix's 16.9 million customers are streaming videos, in fact, that they account for 20% of all internet traffic during a typical evening, according to Sandvine, which makes network-monitoring equipment. (We find this number hard to believe, but anything close to it is still very substantial.)

With streaming, Netflix obviously doesn't have to buy DVDs or incur the cost of mailing them to and from its customers, so why don't we share the market's enthusiasm for Netflix's shift from an Old Economy company to a New Economy one? In short, our answer is that we believe that the same two factors that made Netflix a good business under its original business model don't apply under its streaming model.

New Competitors

We don't believe that Netflix has a better business model, better management or a meaningful competitive advantage in the business of streaming movies and TV shows. It does have a brand name and 16.9 million customers, but Netflix's brand and number of customers pale in comparison to its new, direct competitors like Apple (iTunes), Google (YouTube), Amazon.com (Amazon Video on Demand), Disney and News Corp. (part ownership of Hulu), Time Warner (cable, HBO, etc.), Comcast (cable, NBC Universal, part ownership of Hulu), and Coinstar's Redbox (30,000 kiosks renting DVDs for $1/night and email addresses for 21 million customers).

In short, Netflix is moving from a business in which it was competing against smaller, dying, heavily-indebted companies with inferior business models to some of the largest, most powerful, aggressive and deep-pocketed companies in the world, which have big competitive advantages over Netflix.

We can't predict the outcome of the fierce competition that is emerging, but we believe it is quite likely that it will result in slower growth and a contraction in Netflix's mouth-watering margins (last quarter, Netflix had a 12.6% operating margin and 6.9% net margin).

When asked on last quarter's conference call whether competition would impact Netflix's margins, CEO Reed Hastings replied: "You tell me what happens with competition, and I'll tell you what happens to margins."

Paying for Streaming Content

The biggest impact on margins, we believe, will come from Netflix having to pay increasing amounts for streaming content. Unlike renting DVDs, in which Netflix is protected by the First Sale Doctrine (for now, anyway – see discussion below), the laws around streaming content require that Netflix must have an agreement with the content owner to stream it. This is very bad news for Netflix because content owners are generally very savvy and are seeking to carefully control their content to maximize revenues. According to numerous recent articles, content owners are also very fearful of Netflix:

1) Here's an excerpt from a recent article in the NY Times entitled "Time Warner Views Netflix as a Fading Star":

> For the past year, executives at big media companies have watched Netflix with growing resentment — for its success in delivering movies and television shows via the Internet, for its stock price nearly quadrupling, for its chief executive being named businessperson of the year by Fortune magazine.
>
> Now many of the companies that make the shows and movies that Netflix delivers to mailboxes, computer screens and televisions — companies whose stocks have not enjoyed the same frothy rise, and whose chief executives have not won the same accolades — are pushing back, arguing that the company is overhyped, and vowing to charge much more to license their content.
>
> "It's a little bit like, is the Albanian army going to take over the world?" said Jeffrey L. Bewkes, the chief executive of Time Warner, in an interview last week. "I don't think so."
>
> Netflix has been a business partner to the movie and television studios through licensing deals, but increasingly it is seen as a partner with its hands far deeper in the pockets of the media companies than anyone thought. Through its success, the company has positioned itself at the center of the media universe — at the nexus of technology and content — and is now finding it a place increasingly under attack.
>
> …Mr. Bewkes explained that in the late 1990s the media industry embraced Netflix as a new distribution outlet for renting DVDs — without foreseeing that the company would eventually accelerate the decline in the sales of DVDs, which for years had been the lifeblood of the film industry. Now, with its success online, Netflix has raised fears that consumers may stop paying for cable television — the much-debated phenomenon of cord-cutting.
>
> Mr. Nathanson agreed, saying, "The first engagement the industry had with Netflix was innocent. DVDs were selling, and it didn't seem like much of a problem."
>
> Now, however, Netflix is increasingly seen as potentially a very big problem.
>
> "In the past six months, and because of concerns of Wall Street and concerns of cord-cutting, it's influencing the investor conversations about the future of media," Mr. Nathanson said. "Now, the industry is very focused on Netflix, and what they can do."
>
> A media conference last week in New York held by the investment bank UBS became a platform for executives to express their grievances and emphasize that they will now aggressively try to tilt the economic balance between Netflix and content creators back toward the media conglomerates.

> "When Netflix first came around, the dog was the discs and the baggie," said Robert S. Wiesenthal, executive vice president and chief financial officer at the Sony Corporation of America, referring to the envelopes the discs are mailed in, "and the streaming was the tail." But very quickly, he added, that situation was reversed. "And now the economics for the content companies are going to reflect that."

2) Here are excerpts from a recent Wall Street Journal article entitled, "Netflix Rattles Rivals as It Expands on Web: Pay-TV Services, Others Plot Moves to Counter Movie Juggernaut; Hollywood Cautiously Cuts Deals":

> After years as a bit player in entertainment, Netflix Inc. is being eyed for a new role by Hollywood: industry hulk.
>
> The Silicon Valley company has successfully expanded its mail-order DVD rental service to delivering video online. Meantime, the rise of Internet-connected TVs and disc players means that Netflix's electronically streamed movies and TV shows are reaching living rooms, not just computers.
>
> All that poses a potential threat to the traditional ways consumers watch movies and TV: through cable, phone and satellite systems.
>
> …Netflix's growth surge—at a time of weak DVD sales and increasingly fragmented TV audiences—prompts concern among movie and TV studios as well as other technology companies. One big worry is that the company could end up dominating the electronic distribution of movies and TV the way Apple Inc.'s iTunes Store dominates music.
>
> To prevent that, entertainment and technology companies are exploring plans to outflank Netflix with their own offerings.

3) Finally, here are excerpts from a recent New York Times article entitled, "Netflix's Move Onto the Web Stirs Rivalries":

> In a matter of months, the movie delivery company Netflix has gone from being the fastest-growing first-class mail customer of the United States Postal Service to the biggest source of streaming Web traffic in North America during peak evening hours.
>
> That transformation — from a mail-order business to a technology company — is revolutionizing the way millions of people watch television, but it's also proving to be a big headache for TV providers and movie studios, which increasingly see Netflix as a competitive threat, even as they sell Netflix their content.
>
> …"Right now, Netflix is a distribution platform, and has very little competition, but that's changing," said Warren N. Lieberfarb, a consultant who played a critical role in creating the DVD while at Warner Brothers.
>
> …"How did Hollywood end up supplying Netflix in the first place, particularly a product that was given to them on a flat-rate, wholesale basis?" said Jonathan A. Knee, a media investment banker and co-author of "The Curse of the Mogul."
>
> …Netflix is increasingly viewed as a threat by cable companies and movie studios, who are considering a variety of ways to put the brakes on the company's growth.
>
> For example, big media companies like Time Warner are moving quickly to offer their own streaming products. Studios have pushed back on release dates, requiring Netflix to wait through a window of 28 days while studios pushed more expensive and lucrative sales of the DVD and on-demand versions on cable. And the studios are positioning themselves to demand more money in future negotiations over streaming rights, especially next year when Netflix's deal with Starz expires.

> "Though already a significant customer, they've grown faster than anyone anticipated, and going forward we expect the economics to improve significantly," said John Calkins, executive vice president of digital and commercial innovation at Sony Pictures Home Entertainment.

4) A final data point: we were recently at a lunch at which Jeff Zucker, the outgoing CEO of NBC Universal, was asked about licensing NBC's content to Netflix. His reply: "We'd be happy to – for *a lot* of money!"

Weak Streaming Content Today

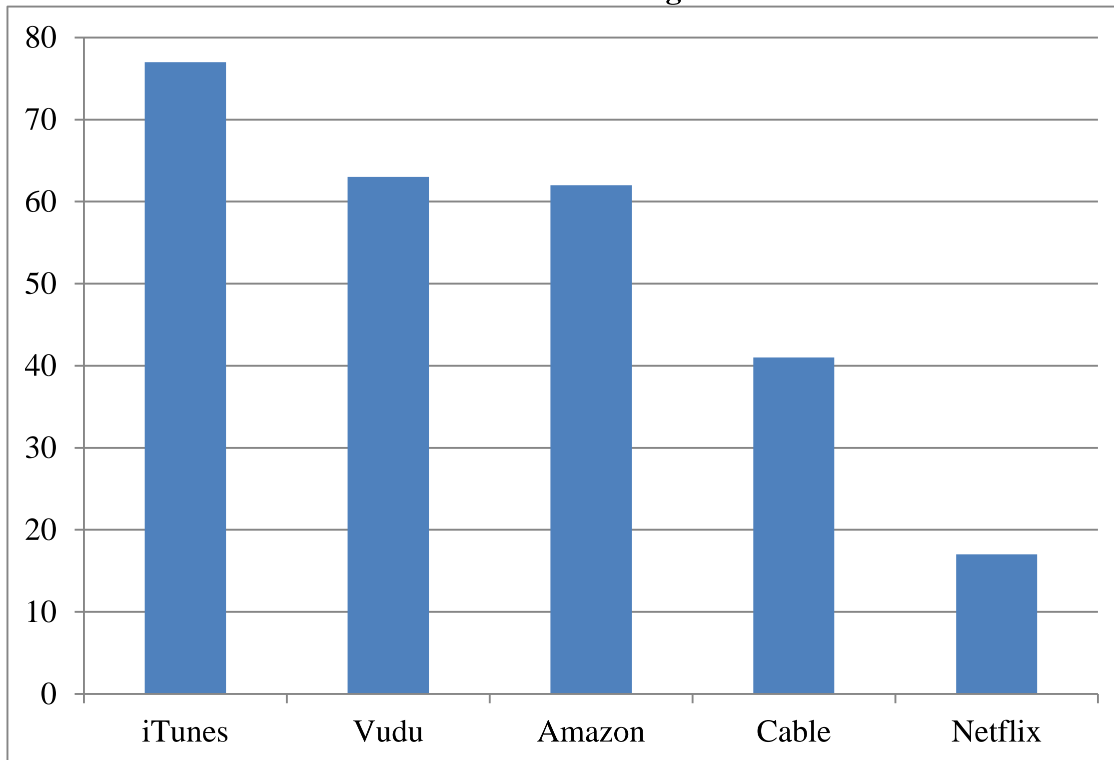
Before we address how much Netflix might have to pay to build its library of streaming content, it's important to understand how weak its current library is.

Movie Content

The bulk of Netflix's current movie content is from two deals: one struck in 2008 with Starz and one this August with Epix, which is owned by three studios, Paramount Pictures, Lionsgate and Metro-Goldwyn-Mayer.

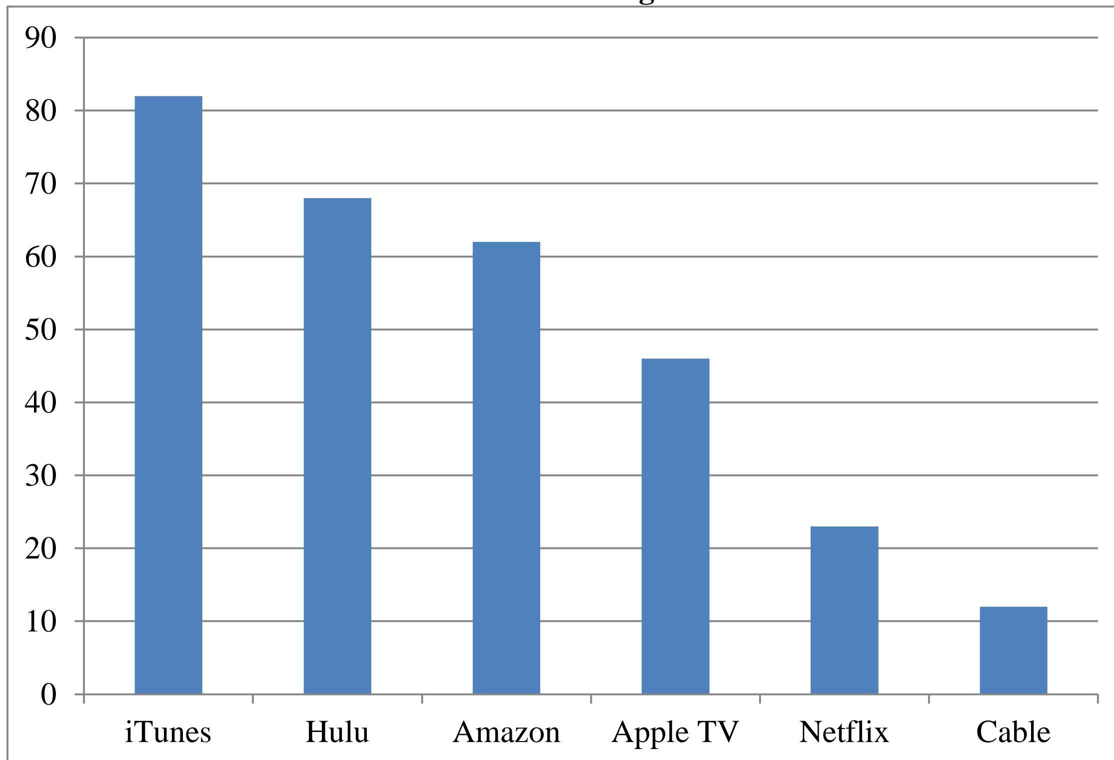
Despite these two deals, Netflix has very weak content. How weak? To answer this question, we compared streaming movie titles available on Netflix (at a fixed price per month for unlimited viewing) vs. what one can buy a la carte (generally from $1.99-$4.99/movie) on Apple's iTunes, Amazon On Demand, Vudu, and Time Warner Cable's video on demand (including HBO and Cinemax on demand). To come up with a representative list of popular movies, we took the top 50 grossing movies of all time, Internet Movie Database's 20 top-ranked movies of all time, Rotten Tomatoes's 20 top-ranked movies of all time, and the 10 top-selling, top-renting and top-video-on-demand DVDs for the week ending 11/28/10.

The full results are shown in Appendix A. Here's the summary: of these 120 movies (including duplicates), Netflix has a mere 17 (14.2%, and 0% of the current most popular movies) vs. 77 for iTunes (64.2%), 63 for Vudu, 62 for Amazon, and 41 for cable. This chart depicts the results graphically:



Television Content
For television, we did a similar comparison, looking at what Netflix offers via streaming vs. competitors' offerings (Netflix and Hulu charge a flat rate, whereas the others typically charge $1 per episode).

We took TV Guide's list of the 100 most popular TV shows and came up with the results shown in Appendix B. This chart depicts the results graphically:



Netflix's Dilemma
Why is Netflix's streaming content so weak? The primary reason is that, unlike its competitors, Netflix isn't willing to pay what content providers demand for the best movies and TV shows. For example, Netflix's competitors typically charge $4.99 to stream a popular movie, of which $3 goes to the content provider, and the economics are similar for the $1 TV shows.

But this model doesn't work for Netflix because it's only charging $7.99 per month for unlimited streaming. Given that content providers aren't about to slash their prices, Netflix has three choices, all of them unpleasant:

1) It can have a weak library and maintain low prices, or

2) It can license better content and pass the cost along to its customers, which would crimp growth, or

3) It can license better content and eat the cost, which would hurt margins.

None of these options are consistent with a stock trading at nearly 70x earnings.

(Incidentally, in light of Netflix's weak content, we were initially puzzled by the fact that its customers appear to be using streaming quite a bit, but here's what we suspect is happening: many customers have recently switched to streaming and, as new users, they're finding a handful of movies and TV shows they want to watch (hence the high initial usage), but given how thin

the content is, they are likely to quickly become discouraged and stop using the streaming service. This will put a lot of pressure on Netflix to strike licensing deals for more content.)

Streaming Content Deals

Netflix clearly understands the dilemma it faces and, in light of recent deals, appears to be choosing option 3, which will deliver better value to its customers over time, but will severely crimp margins. To get an idea of how much, let's look at Netflix's primary streaming content deals.

Starz

The first major deal, signed in October 2008, was with Starz, giving Netflix access to approximately 2,500 Disney and Sony movies for a mere $25-$30 million annually, a small fraction of what Starz originally paid the studios and what Starz charges TV operators. Under the current contract, Netflix is paying Starz less than 15 cents per subscriber per month for its content vs. the $2-$4 per subscriber per month that TV operators typically pay Starz.

Here's is what some industry players are saying about the Starz deal:

1) From a recent article in the NY Times:

> The relationship between Netflix and the media companies will most likely change drastically, beginning next year when a deal between the company and Starz, the pay-TV channel, to stream movies from Sony and Disney expires.
>
> The original deal from 2008, in which Netflix paid an estimated $25 million annually — a paltry sum, executives say, compared with the hundreds of millions of dollars cable and satellite companies pay Starz for the same movies — is now seen as a major coup for Netflix, and a major mistake by Starz.
>
> Michael Nathanson, a media analyst at Nomura, called it "probably one of the dumbest deals ever. Starz gave up valuable content for tens of millions of dollars."
>
> Mr. Bewkes said that deal, which gave Netflix significant momentum into the new world of online video, potentially undermined the business model of cable television, based on the subscription fees that have steadily flowed even as other media businesses have suffered in the digital age. "Why should anyone subscribe to Starz when they can basically get the whole thing for about nothing?" he said. "That doesn't make much sense."

2) From a recent Reuters article:

> "The deal Starz did to give those movies away for $30 million obviously makes no sense. There's a day coming shortly when that deal expires. How do Starz and Netflix address the next deal?" News Corp Chief Operating Officer Chase Carey said this week at the Reuters Global Media Summit.
>
> …Pay TV operators, which spend heavily on studio fees, are also pressuring studios that offer cut rates for distribution on Netflix.
>
> "Their deal with Netflix absolutely does affect our relationship," said an executive of one of Starz's largest pay TV partners, who asked not to be named because the source was not authorized to speak on behalf of the company.
>
> "You can't sell your product to one distributor for pennies on the dollar and then expect other distributors to pay you dollars for your product."

This was an extremely attractive deal for Netflix – so much so that one must wonder what Starz could have been thinking. We assume that Starz didn't see Netflix as a potential competitor at the time – Netflix was much smaller and did very little streaming – and viewed the $25-$30 million as found money. Also, Starz was taking advantage of a loophole in its contract with Disney and Sony, neither of which anticipated that Starz would re-license their content.

All of these factors that led to Netflix getting a sweetheart deal are now gone – Starz, Disney and Sony have woken up to the value of their content and the threat that Netflix poses – so Netflix will either have to pay up or lose the Starz content when the contract expires in 10 months. Negotiations are underway and Netflix (of course) says that it doesn't need the Starz content, but we think it does – and will have to pay many multiples of the current licensing fees. We see no reason why Netflix won't have to pay Starz at least the $200 million annually that it's paying Epix.

Epix
In August, Netflix signed a deal to stream content from Epix, which is owned by three studios, Paramount Pictures, Lionsgate and Metro-Goldwyn-Mayer. The exact terms of the deal haven't been disclosed, but numerous reports say it's for up to $1 billion over five years.

Importantly, Netflix won't be able to stream Epix's movies until 90 days after they have reached Epix's distribution window, which is typically 6-12 months after a movie is first available on premium movie channels, so this deal won't address Netflix's problem that it offers no current releases.

Disney
Just last week, Netflix signed a one-year deal with Disney that allows Netflix to stream episodes from previous seasons of various ABC shows, plus the final season of the hit show *Lost*, plus current season programs from ABC Family and Disney Channel, with a 15-day delay. It's important to note that the deal does not give Netflix the right to ABC's current season, which will continue to be available only on Hulu, which is co-owned by Disney.

So how much did Netflix pay for Disney's second-tier content? According to an LA Times article, a whopping $150-$200 million.

Let's sum up the cost of these three deals:

- Let's assume the Starz deal is renewed for somewhere between $150-$250 million – that's an incremental $120-$225 million per year.

- The Epix deal is reported to be "as much as" $1 billion, which is $200 million per year, but it might be back-end-loaded (based, perhaps, on Netflix's subscribers and/or usage), so let's assume $150-$200 million in the first couple of years.

- Finally, the Disney deal is reported to be $150-$200 million.

Add it all up and it's an additional cost of $420-$625 million per year – a staggering amount, especially in light of the fact that, even with these three deals, Netflix's streaming content remains weak.

Postage and Fulfillment Savings
Ah, but what about the savings on postage and fulfillment costs due to fewer subscribers having DVDs mailed to them? In Netflix's latest 10-Q (page 21), it disclosed that there was "a 24.0% decline in monthly DVD rentals per average paying subscriber attributed to the growing popularity of our lower priced plans and growth in streaming." This decline translates into big savings – but not nearly enough to offset the additional costs of streaming content according to our estimates. Here's our math:

Netflix breaks down its cost of revenues into two categories:

1) Cost of Subscription, which consists of: a) "content delivery costs related to shipping DVDs"; b) "providing streaming content to subscribers"; and c) "expenses related to the acquisition and licensing of content"; and

2) Fulfillment expenses, which consist of: a) "content processing including operating and staffing our shipping centers"; b) "receiving, encoding, inspecting and warehousing our content library"; and c) "operating and staffing our customer service centers and credit card fees."

The costs that are most impacted by the 24% decline in DVD rentals are 1a ("content delivery costs related to shipping DVDs") plus all fulfillment expenses. Netflix doesn't disclose a breakdown of 1a, 1b and 1c, but the latter two are amortized and, as such, appear in the cash flow statement under "Amortization of content library." By subtracting this, we can get a rough estimate of 1a and then add fulfillment expenses.

Then, we can calculate this cost on a per-subscriber basis and see how much it's declined over the past year. The answer: 15%, as shown in this table:

(All figures in millions)	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	TTM
Subscription costs	$233	$232	$260	$265	$292	$1,049
Amortization of content library	$57	$60	$62	$65	$77	$265
Subs costs - amort of content	$176	$171	$197	$200	$215	$784
Fulfillment expenses	$42	$44	$48	$50	$52	$193
TOTAL	$219	$215	$245	$250	$267	$977
Average paid subscribers	10.6	11.4	12.8	14.1	15.2	
Cost/paid subscriber	$20.61	$18.94	$19.19	$17.72	$17.56	
% decline (year over year)					**15%**	

A 15% drop in costs on a 24% decline in usage makes sense to us, as some costs like postage will be purely variable and decline in direct proportion to the decline in DVDs mailed, but other costs are fixed or semi-variable.

As one can see in the table, cost of revenues net of amortization of content library was $977 million over the past year, but we don't want to apply the 15% savings to this amount since

we're looking forward, so let's assume that Netflix grows 30% next year (last quarter, revenues were up 30.7%) such that $977 million grows to $1.27 billion. Applying the 15% results in savings of $191 million. This is merely an informed estimate, of course, so let's use a range of $150-$250 million in savings.

Impact on Margins
If we apply $150-$250 million of savings to the range of incremental costs for streaming content ($420-$625 million per year, discussed above), it results in Netflix's costs rising by $170-$475 million per year, or $42-$119 million per quarter.

That's a very wide range, but even the low end, $42 million, is 64% of Netflix's $65.4 million of pre-tax profits last quarter, and the mid-point, $80.5 million, would more than wipe out *all* of Netflix's Q3 profit.

But this is a forward-looking estimate, based in part on a higher amount we expect that Netflix will have to pay Starz, so let's use the $90 million of pre-tax profits per quarter that analysts are projecting for 2011. In this case, even the low end of our incremental cost estimate cuts Netflix's pre-tax profits nearly in half, and the mid-point cuts profits by 90%.

Our belief that the increased costs of streaming content will negatively impact Netflix's margins isn't just a theory. Last quarter, strong evidence emerged to support our view: in Q3, Netflix's operating margin was 12.6% and net margin was 6.9%, down from 14.9% and 8.4%, respectively, in Q2. That's a huge decline in only three months.

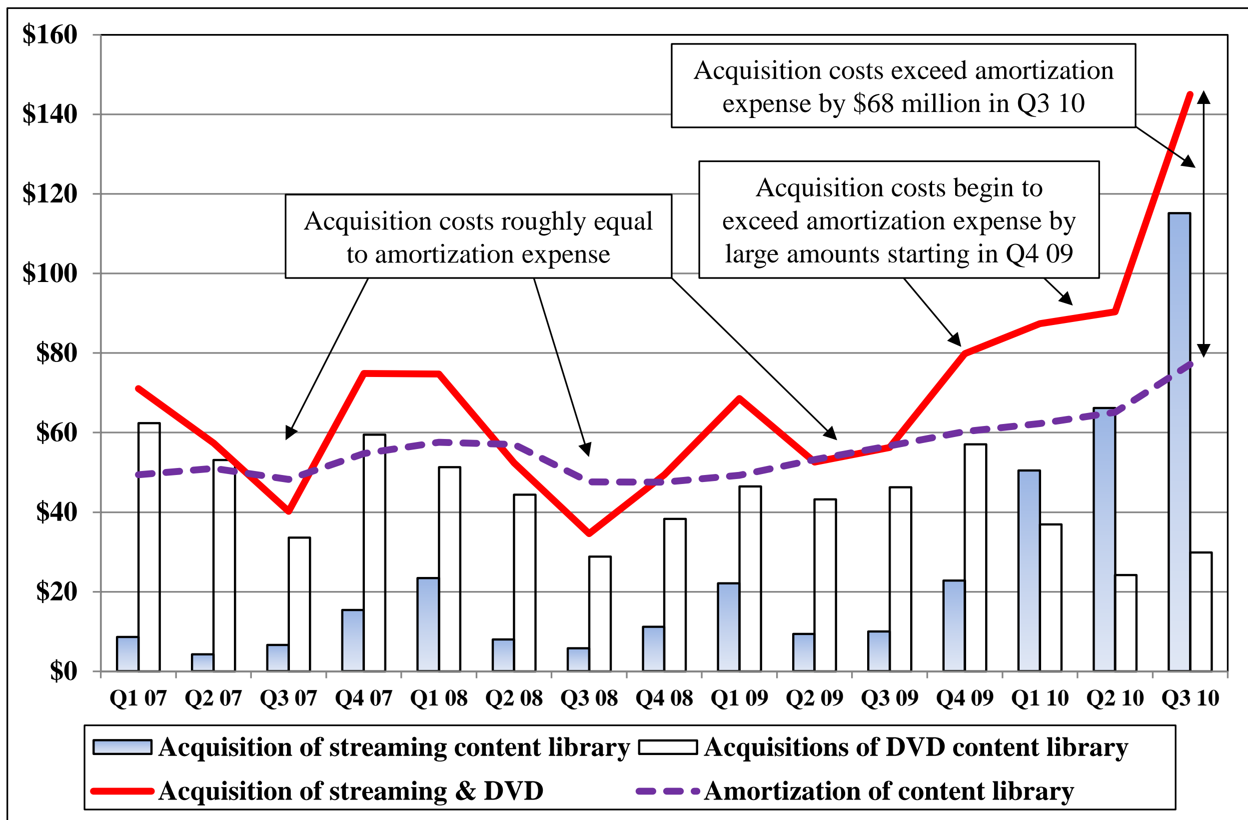
The result was a 12.5% sequential decline in earnings from $0.80 in Q2 to $0.70 in Q3.

Again, this is not consistent with a stock trading at nearly 70x earnings.

An In-Depth Analysis of the Cash Flow Statement – and the Likely Impact on Margins
The real cash cost of Netflix's streaming deals can be seen in its Q3 cash flow statement: "Acquisition of streaming content library" was a cash outflow of $115.1 million, up 74.1% from the previous quarter's $66.2 million and up 11.5x year over year (from $10.0 million).

However, this enormous increase in cash paid to bolster its streaming library didn't result in the increase in "Amortization of content library" (which also includes DVD content) that we would have expected: this was $77.1 million in Q3, up a mere 16.6% from the previous quarter's $65.1 million and 36.1% year over year (from $56.7 million).

This chart shows certain key elements of Netflix's cash flow statement each quarter going back to the beginning of 2007:



The two columns show how much Netflix is spending in cash to purchase streaming content (the blue bar) and DVDs (the white bar). The total of these two is the red line. Finally, the amount Netflix is amortizing for this content (which appears as an expense on the income statement) is the purple dashed line.

Note that from Q1 2007 through Q3 2009, the two lines parallel each other closely, which makes sense: the amount Netflix spends to acquire content should be amortized over time. (In fact, over these 11 quarters, the amount amortized is 91% of the total amount spent acquiring content – again, what one would expect, given that amortization should lag cash outlays in a rapidly growing business.)

However, starting in Q4 2009, the lines diverge sharply, as Netflix began paying large amounts for streaming content (represented by the blue bars skyrocketing), which more than offset the decline in amounts spent buying DVDs (represented by the white bars shrinking). In total, acquisition costs rose 159% over the past year (from $56 million to $145 million), yet, strangely, amortization of content library rose only 35% (from $57 million to $77 million).

If we apply the 91% average ratio between amortization and cash outlays from Q1 07 – Q3 09 to the Q3 10 cash outlays of $145 million, then amortization would have been $132 million, $55 million more than the $77 million Netflix actually amortized. (To put this $55 million in perspective, recall that Netflix's pre-tax profit in Q3 was $65.4 million.)

To be clear, we don't believe that Netflix is committing accounting fraud. The rules governing how intangible assets are amortized are complex and rely on various assumptions, so there can

be a lag between when cash is actually paid out and when the amortization expense is recognized and appears on the income statement. But eventually we expect that these large streaming costs will be amortized and therefore appear as an expense on Netflix's income statement, causing a significant decline in margins and profits.

Saturation

Another risk factor we see for Netflix is that the company is much closer to saturating its market than is commonly believed. The bulls argue that the company's 16.9 million customers represent fewer than 15% of the 115 million households in the U.S., but the company's churn data presents a different picture.

We have analyzed the last decade of Netflix's quarterly statements, in which the company discloses customer additions and cancellations, and calculated that Netflix has had approximately 30 million customer cancellations. In other words, the company has had to add approximately 47 million customers – more than 40% of U.S. households – to be left with today's 16.9 million customers (and many of these will cancel in the future; the churn rate last quarter was 3.8%).

If history is any guide (we think it is), Netflix will need to somehow find another 47 million subscribers for the company to double its current subscriber count (a common medium-term objective in many analysts' view). We don't think that many potential additions exist.

Internet Bandwidth

Another major threat to Netflix is internet providers starting to charge for high usage rather than offering unlimited downloading for a flat rate. It goes without saying that streaming video is very bandwidth intensive and, as noted earlier, Netflix may account for as much as 20% of all internet traffic during a typical evening. Such high usage by Netflix's customers is slowing down the internet for everyone and is one of the reasons why Cisco predicts that internet traffic will triple by 2014. To accommodate this, carriers like AT&T and Comcast will have to invest billions of dollars – and will of course look for a return on this investment, most likely by shifting to a pay-for-usage model that would make Netflix's streaming content much more expensive.

This Business Week article nicely captures what's happening:

> While few experts expect carriers to stop investing in new capacity, there's widespread agreement that a financial crunch is coming.
>
> Sanford C. Bernstein analyst Craig Moffett has studied the issue from the perspective of the wireless carriers. As traffic soars, he expects the revenue per megabit to fall from 43 cents today to just 2 cents in 2014. That means a far lower return on investment, a key measure for telecom companies.
>
> "The carriers are faced with an incredible deflationary spiral," Moffett said.
>
> The tussle between Comcast and Level 3 Communications shows how the issue can become electric.
>
> Level 3, which operates backbone networks that quickly ship bits between cities, recently struck a deal with Netflix to help speed delivery of its streaming videos. The result was a sudden surge in Level 3's traffic, which eventually goes through Comcast's cables to reach subscribers.

> On Monday, Level 3 accused Comcast of charging exorbitant rates to carry the additional traffic. Comcast shot back that it had no obligation to bear the load for free.
>
> The exchange is a sign of the times: Even if the technology is up to the task of shipping huge data packets, no one is sure how to pay for it.
>
> Ultimately, most experts expect that people who are the heaviest data users will have to start paying more, most likely in the form of tiered pricing plans. These are already common in Europe and Asia, but Americans are used to no limits.
>
> The wireless networks have already moved in this direction: In June, AT&T discontinued its $30-a-month unlimited data plan, forcing mobile consumers to choose between an 0.2-GB-per-month plan or a 2-GB-per-month plan. On Wednesday, Federal Communications Commission Chairman Julius Genachowski approved limits for fixed-line networks that carry data to home or businesses, and said carriers should have "meaningful flexibility ... to address the effects of congestion."
>
> Such changes are new enough that the big data senders like Netflix haven't yet adapted to them. But on an otherwise triumphant earnings call on Oct. 20, Hastings did concede that AT&T's data plans might limit demand for watching movies on mobiles devices.
>
> To Bernstein's Moffett, it was a striking admission.
>
> "That was the first time I've heard one of those tech CEOs admit what should be obvious: that you can't simply bet on continued bandwidth availability."

Netflix and others will, of course, complain about "network neutrality," but that's not the issue here because Comcast isn't favoring its own streaming service over Netflix's. The Chairman of the Federal Communications Commission, Julius Genachowski, recently endorsed the "usage-based pricing" idea, so we see little chance that Netflix's argument will prevail.

Legal Risk

As noted earlier, Netflix's core business of renting DVDs to its customers depends on the First Sale Doctrine, which is coming under legal attack by content owners who argue (correctly, in our opinion) that it's inconsistent and unfair. After all, if Netflix is prohibited from renting another company's content over and over again without compensation if the delivery mechanism is the internet, why should this principle be any different if the delivery mechanism is a DVD?

In September, the U.S. Court of Appeals for the Ninth Circuit issued a decision that calls into question the First Sale Doctrine. Though it was a case related to re-selling software, the court observed that the policy implications might affect movies as well.

According to Eric Goldman, an associate professor at Santa Clara University School of Law, "The ruling could potentially have profound implications. Simply by using the right legal terminology, copyright owners can license their works instead of selling them and restrict how anyone, even third parties, use the copyrighted material."

This legal risk isn't a key pillar of our investment thesis, as the case will likely be tied up in courts for years, but this ruling will likely change the negotiations between Netflix and the content providers over the terms of DVD access in a way that isn't favorable to Netflix.

CFO Resignation
Netflix's long-time CFO, Barry McCarthy, resigned last week, citing "a desire to pursue broader executive opportunities outside the company." (This sounds forced and clichéd to us)

We have no insight into what the real story here is, but our experience is that the sudden, unexplained resignation of a CEO or CFO is usually not a good sign, especially when in this case McCarthy was very highly regarded, had served in this capacity since 1999, and led the company's IPO in 2002.

What If We're Wrong? Could Netflix Be the Next Amazon?
In any position, long or short, we always ask ourselves, "What if we're wrong and what would that scenario look like?"

The best bull case we can make for Netflix is that it becomes the next Amazon.com, which today has a market cap of $80 billion and a stock trading at more than 70x trailing EPS. The company has confounded all of its skeptics (and short sellers), who confidently (and wrongly) predicted that numerous competitors, both online and offline, would put it out of business.

Like many millions of others, we are loyal customers of Amazon for two main reasons:

1) A full selection of books and other merchandise, including the latest titles and products; and

2) Low prices, driven in part by low margins (in the first three quarters of the 2010 fiscal year, Amazon's operating margin was 4.4% and its net margin was 3.5%).

Also, Amazon is able to take advantage of the existing delivery infrastructure (U.S. Postal Service, UPS, FedEx, etc.).

Netflix's old business was highly successful for similar reasons: customers could access a full selection of movies at an excellent price, and Netflix could piggyback on the existing delivery infrastructure.

But Netflix's new streaming business doesn't have the same advantages. While $7.99/month for unlimited streaming is an excellent price, the selection is very weak and Netflix may soon encounter obstacles to unlimited usage of the internet, as we discussed earlier.

Conclusion
We don't think there are any easy answers for Netflix. It is already having to pay much more for streaming content and may soon have to pay for bandwidth usage as well, which will result in both margin compression (Netflix's margins are currently double Amazon's) and also increased prices to its customers, which will slow growth.

Under this scenario, Netflix will continue to be a profitable and growing company, but not nearly profitable and rapidly growing enough to justify today's stock price, which is why we believe it will fall dramatically over the next year.

Appendix A

			Netflix Streaming	Starz	Epix	iTunes	Amazon	Vudu	TWC/HBO/Cinemax
Top Grossing Movies of All Time									
Rank	$(MM)	Title							
1	$761	Avatar (2009)							x
2	$601	Titanic (1997)							
3	$533	The Dark Knight (2008)				x		x	
4	$461	Star Wars: A New Hope (1977)							
5	$436	Shrek 2 (2004)							
6	$435	E.T.: The Extra-Terrestrial (1982)							
7	$431	Star Wars: Episode I - The Phantom Menace (1999)							
8	$423	Pirates of the Caribbean: Dead Man's Chest (2006)							
9	$415	Toy Story 3 (2010)				x	x	x	x
10	$404	Spider-Man (2002)				x		x	x
11	$402	Transformers: Revenge of the Fallen (2009)							
12	$380	Star Wars: Episode III - Revenge of the Sith (2005)							
13	$377	The Lord of the Rings: The Return of the King (2003)				x		x	
14	$373	Spider-Man 2 (2004)				x			
15	$370	The Passion of the Christ (2004)							
16	$357	Jurassic Park (1993)							
17	$340	The Lord of the Rings: The Two Towers (2002)				x		x	
18	$340	Finding Nemo (2003)				x		x	
19	$337	Spider-Man 3 (2007)				x	x	x	
20	$334	Alice in Wonderland (2010)	x	x	x	x		x	
21	$330	Forrest Gump (1994)	x		x	x	x	x	
22	$328	The Lion King (1994)							
23	$321	Shrek the Third (2007)							
24	$319	Transformers (2007)					x	x	
25	$318	Iron Man (2008)	x		x	x	x	x	
26	$318	Harry Potter and the Sorcerer's Stone (2001)				x	x	x	x
27	$317	Indiana Jones and the Kingdom of the Crystal Skull (2008)							
28	$314	The Lord of the Rings: The Fellowship of the Ring (20(	x	x	x				
29	$312	Iron Man 2 (2010)				x	x	x	x
30	$311	Star Wars: Episode II - Attack of the Clones (2002)							
31	$309	Pirates of the Caribbean: At World's End (2007)							
32	$309	Star Wars: Return of the Jedi (1983)							
33	$306	Independence Day (1996)				x	x		
34	$305	Pirates of the Caribbean: The Curse of the Black Pearl (2003)				x			
35	$302	Harry Potter and the Half-Blood Prince (2009)				x			x
36	$301	Eclipse (2010)				x	x		
37	$297	New Moon (2009)				x	x		
38	$294	The Sixth Sense (1999)	x	x	x	x			
39	$293	Up (2009)	x	x					
40	$292	Inception (2010)				x	x		x
41	$292	Harry Potter and the Order of the Phoenix (2007)				x	x	x	x
42	$292	The Chronicles of Narnia: The Lion, the Witch and the Wardrobe (2005)						x	
43	$290	Star Wars: Episode V - The Empire Strikes Back (1980)							
44	$290	Harry Potter and the Goblet of Fire (2005)				x	x	x	x
45	$286	Home Alone (1990)				x	x	x	x
46	$281	The Matrix Reloaded (2003)	x		x	x	x	x	
47	$279	Meet the Fockers (2004)							
48	$277	The Hangover (2009)							x
49	$268	Shrek (2001)							
50	$262	Harry Potter and the Chamber of Secrets (2002)				x	x	x	x
		Count:	**7**	**4**	**6**	**25**	**16**	**19**	**12**

IMDB Top-Rated Movies of All Time

Rank	Rating	Title	Netflix Streaming	Starz	Epix	iTunes	Amazon	Vudu	TWC/HBO/Cinemax
1	9.2	The Shawshank Redemption (1994)	x	x	x	x	x	x	
2	9.1	The Godfather (1972)				x	x	x	
3	9.0	The Godfather: Part II (1974)				x	x	x	
4	8.9	The Good, the Bad and the Ugly (1966)				x			
5	8.9	Pulp Fiction (1994)							
6	8.9	Inception (2010)				x	x	x	x
7	8.9	Schindler's List (1993)							
8	8.9	12 Angry Men (1957)				x	x		
9	8.8	One Flew Over the Cuckoo's Nest (1975)	x		x	x	x	x	
10	8.8	The Dark Knight (2008)				x	x	x	
11	8.8	Star Wars: Episode V - The Empire Strikes Back (1980)							
12	8.8	The Lord of the Rings: The Return of the King (2003)				x	x	x	
13	8.8	Seven Samurai (1954)	x		x				
14	8.7	Star Wars: A New Hope (1977)							
15	8.7	Goodfellas (1990)				x	x	x	
16	8.7	Casablanca (1942)				x	x	x	
17	8.7	Fight Club (1999)				x	x	x	
18	8.7	City of God (2002)							
19	8.7	The Lord of the Rings: The Fellowship of the Ring (20	x	x	x				
20	8.7	Rear Window (1954)				x	x	x	
		Count:	**4**	**2**	**4**	**13**	**12**	**11**	**1**

Rotten Tomatoes Top-Rated Movies of All Time

Rank		Title	Netflix Streaming	Starz	Epix	iTunes	Amazon	Vudu	TWC/HBO/Cinemax
1		Toy Story 2 (1999)				x	x	x	x
2		Man on Wire (2008)	x		x	x	x	x	
3		Taxi to the Dark Side (2007)							
4		Bus 174 (Ônibus 174) (2002)							
5		Toy Story (1995)				x	x	x	x
6		A Hard Day's Night (1964)							
7		The Wizard of Oz (1939)				x	x	x	
8		Deliver Us From Evil (2006)	x		x	x	x	x	
9		The Godfather (1972)				x	x	x	
10		Rear Window (1954)				x	x	x	
11		Dr. Strangelove Or How I Learned to Stop Worrying and Love the Bomb (1964)				x	x	x	
12		North by Northwest (1959)				x		x	
13		Afghan Star (2008)							
14		Le Gout Des Autres (The Taste of Others) (It Takes All Kinds) (2000)							
15		The Third Man (1949)	x		x	x	x		
16		Aruitemo Aruitemo (Still Walking) (2008)	x		x				
17		All About Eve (1950)	x		x	x	x		
18		Citizen Kane (1941)							
19		The Sweet Hereafter (1997)	x	x	x				
20		Modern Times (1936)							
		Count:	**6**	**1**	**6**	**11**	**10**	**9**	**2**

Rentrak Top Selling DVDs for the week ending November 28, 2010								
Rank	Title	Netflix Streaming	Starz	Epix	iTunes	Amazon	Vudu	TWC/HBO/Cinemax
1	The Search for Santa Paws				x	x	x	
2	The Expendables				x	x	x	x
3	Disney's A Christmas Carol				x			
4	Beauty and the Beast				x		x	
5	Toy Story 3				x	x	x	x
6	Eat Pray Love				x	x	x	x
7	The Blind Side							x
8	Grown Ups				x	x	x	x
9	Avatar							x
10	How to Train Your Dragon				x	x	x	x
	Count:	**0**	**0**	**0**	**8**	**6**	**7**	**7**
Rentrak Top Renting DVDs for the week ending November 28, 2010								
Rank	Title	Netflix Streaming	Starz	Epix	iTunes	Amazon	Vudu	TWC/HBO/Cinemax
1	The Expendables				x	x	x	x
2	Grown Ups				x	x	x	x
3	Eat Pray Love				x	x	x	x
4	The Last Airbender				x	x	x	x
5	Lottery Ticket				x	x	x	x
6	Charlie St. Cloud				x	x	x	x
7	Toy Story 3				x	x	x	x
8	The Cats & Dogs: Revenge Of Kitty Galore				x	x		x
9	Disney's A Christmas Carol				x	x		
10	Scott Pilgrim vs. The World				x	x	x	x
	Count:	**0**	**0**	**0**	**10**	**10**	**8**	**9**
Rentrak Top Movies on Demand Titles for the week ending November 28, 2010								
Rank	Title	Netflix Streaming	Starz	Epix	iTunes	Amazon	Vudu	TWC/HBO/Cinemax
1	The Expendables				x	x	x	x
2	Eat Pray Love				x	x	x	x
3	Grown Ups				x	x	x	x
4	Lottery Ticket				x		x	x
5	Charlie St. Cloud				x	x	x	x
6	The Karate Kid				x	x	x	x
7	The Kids Are All Right				x	x	x	x
8	Cats & Dogs: The Revenge of Kitty Galore				x			x
9	Ramona And Beezus				x	x	x	x
10	How to Train Your Dragon				x	x	x	x
	Count:	**0**	**0**	**0**	**10**	**8**	**9**	**10**
	GRAND TOTAL (including duplicates):	**17**	**7**	**16**	**77**	**62**	**63**	**41**

Appendix B

TV Guide Most Popular TV Shows		Netflix Streaming	Apple TV	iTunes	Hulu	Amazon	TWC/HBO/Cinemax
1	Dancing with the Stars			x	x		
2	Glee		x	x	x	x	
3	NCIS		x	x	x		x
4	Criminal Minds		x	x	x		
5	American Idol						
6	Keeping Up with the Kardashians	x	x	x			
7	Big Brother 12			x			
8	Mad Men		x	x		x	
9	True Blood		x	x		x	x
10	Weeds	x		x	x	x	x
11	The Bachelorette			x		x	
12	So You Think You Can Dance				x		
13	Deadliest Catch	x		x		x	
14	Teen Mom			x	x	x	x
15	Dancing with the Stars			x	x		
16	American Idol						
17	Lost	x		x	x	x	
18	NCIS		x	x	x		
19	Grey's Anatomy	x	x	x	x	x	
20	24	x	x	x		x	
21	Criminal Minds		x	x	x		
22	Keeping Up with the Kardashians	x	x	x			
23	Desperate Housewives	x	x	x	x	x	
24	Bones	x	x	x	x	x	
25	House		x	x	x	x	
26	Bad Girls Club			x	x	x	
27	Smallville		x	x	x	x	
28	Vampire Diaries			x	x	x	
29	Days of Our Lives			x	x		
30	Biggest Loser		x	x	x	x	x
31	Secret Life of the American Teenager			x	x		
32	One Tree Hill		x	x	x	x	
33	Damages	x		x		x	
34	The Game						
35	Nip/Tuck	x		x		x	
36	Big Bang Theory				x		
37	iCarly		x	x	x	x	x
38	Chuck			x	x	x	
39	Lost	x		x	x	x	
40	Supernatural			x	x	x	
41	Ghost Whisperer			x	x		
42	Wizards of Waverly Place	x	x	x			
43	Family Guy	x		x	x	x	
44	Young and the Restless	x			x	x	
45	90210		x	x	x		
46	Brothers & Sisters		x	x	x	x	
47	Gossip Girl			x	x	x	
48	Oprah Winfrey				x		
49	Law & Order: Special Vicims Unit	x	x	x		x	
50	Hannah Montana	x	x	x	x	x	

		Netflix Streaming	Apple TV	iTunes	Hulu	Amazon	TWC/HBO/Cinemax
51	Legend of the Seeker	x		x	x	x	
52	The Office	x	x	x	x	x	x
53	Fringe		x	x	x	x	
54	Friday Night Lights	x		x	x	x	
55	CSI: Miami		x	x	x		
56	Glee		x	x	x	x	
57	Eastwick						
58	Heroes	x		x	x	x	
59	Two and a Half Men			x	x	x	x
60	The Mentalist				x		
61	Teen Mom			x	x	x	
62	The Good Wife		x	x	x		
63	Jersey Shore			x	x	x	
64	The Unit		x	x	x	x	
65	Burn Notice		x	x	x	x	
66	How I Met Your Mother		x	x	x	x	
67	Private Practice			x	x	x	x
68	Sons of Anarchy		x	x	x	x	
69	Medium			x	x		
70	Dr. Oz Show						x
71	General Hospital			x	x		
72	Law & Order		x			x	
73	Ugly Betty		x	x	x	x	
74	America's Next Top Model			x	x		
75	White Collar			x		x	
76	Castle			x	x	x	
77	Phineas amd Ferb		x	x			
78	Army Wives		x	x		x	
79	Modern Family		x	x	x	x	
80	NUMB3RS		x	x			
81	Cold Case				x	x	
82	Dateline NBC						
83	Project Runway			x	x		
84	All My Children				x		
85	Masterpiece						
86	True Blood		x	x		x	x
87	Human Target		x	x	x	x	
88	Make It Or Break It			x	x		
89	Bold and the Beautiful			x	x		
90	CSI: Crime Scene Investigation		x	x	x		
91	Scrubs			x		x	
92	Leverage		x	x		x	
93	Cops			x	x	x	
94	The Deep End					x	
95	Spartacus: Blood and Sand		x			x	
96	Dora the Explorer	x		x		x	
97	Dollhouse	x	x	x		x	
98	Mad Men		x	x		x	
99	NCIS: Los Angeles		x	x	x	x	x
100	20/20				x		
	GRAND TOTAL:	23	46	82	68	62	12
Notes: Some shows appear twice, likely due to different seasons. This analysis doesn't differentiate between current vs. old seasons.							