

An Economic Overview, Stocks vs. Bonds, and An Update on Three Stocks

Whitney Tilson
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T2 Accredited Fund, LP
Tilson Offshore Fund, Ltd.
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T2 Partners LLC

An Update on Netflix

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Netflix Over the Past Three Years

T2 Partners LLC



- We published an 18-page report, “Why We’re Short Netflix,” in December 2010 (when the stock was at \$181.65)
- Two months later, we published a 13-page report, “Why We Covered Our Netflix Short” (when the stock was at \$222.29)
- In November 2011, we published a 9-page report, “Why We’re Long Netflix and Short Green Mountain Coffee Roasters” (with the stocks at \$87.75 and \$43.71, respectively)
- All three reports are available on the web

- Stock price: \$54.44
- Diluted shares outstanding: 58.9 million
- Market cap: \$3.2 billion
- Net cash: \$413 million
- Enterprise value: \$2.8 billion
- Revenues (TTM): 3.5 billion
 - YOY growth: 30.1%
 - Sequential growth: 2.2%
- EV/revenues: 0.80
- Free cash flow (TTM): \$61 million
 - YOY growth: -69.2%
 - Sequential growth: 420% (from \$2.1 million in Q1 to \$11.2 million in Q2)
- Paid subscribers: 28.3 million (25.2 million domestic)
 - YOY growth: 17.1%
 - Sequential growth: 4.3%
- EV/paid subscriber: \$99
- Short interest: 28.7%

- Market leader (more than 10x the size of its nearest competitor) in a rapidly growing global business (estimated 30-40% annual growth in steaming video)
- Lots of talk about competition, but very little is currently detectable
- Difficult to value the company because it has chosen to forego current profitability to drive growth by investing in: a) more, better streaming content and b) international expansion
- Enormous optionality on the upside and very cheap on an EV/revenues (0.80) and EV/paid subscriber (\$99/sub) basis
 - In April, Disney and News Corp. bought the 10% of Hulu owned by Providence Equity Partners for \$200 million in cash, valuing the business at \$2 billion – and each of Hulu’s two million paid subscribers at **\$1,000**
- Downside protection due to Netflix’s attractiveness as an acquisition candidate
 - Netflix would be a bite-size acquisition for any number of companies
 - I can think of nearly a dozen companies that would want to own Netflix’s 28+ million paid subscribers for \$100/sub
 - If someone put Netflix into play, the mother of all bidding wars would erupt

Comparing Netflix to Another Well-Known Consumer-Oriented Technology Company a Decade Ago

- Similar sales, number of customers, growth, and market cap
- But Netflix has much higher margins, profits, and free cash flow

<u>Income Statement</u>	<u>Netflix (2011)</u>	<u>Co. A (2001)</u>	<u>Comment</u>
Paid subs/customer accounts (millions)	24	25	Virtually the same number of customers
YOY growth	33%	25%	Netflix growing slightly faster
Revenues	\$3,205	\$3,122	Virtually the same revenues
YOY revenue growth	48%	13%	Netflix growing revenues much faster
Fulfillment costs	\$250	\$374	Netflix quite a bit lower fulfillment cost
Other cost of revenues:	\$1,790	\$2,324	
Gross profit	\$1,165	\$424	
Gross profit margin	36%	14%	Netflix much higher gross profit margin
Operating expenses:			
Marketing	\$403	\$138	Netflix much higher marketing spending
Technology and development	\$259	\$241	
General and administrative	\$118	\$90	
Other	\$9	\$368	
Total operating expenses	\$789	\$837	
Operating income (loss)	\$376	-\$412	Netflix solidly profitable vs. significant losses
Operating margin	12%	-13%	
Net income (loss)	\$226	-\$567	
Net income (loss) per share (diluted):	\$4.16	-\$1.56	
Diluted shares outstanding:	54	364	
Year-end share price	\$69.29	\$12.25	
Year-end market cap	\$3,767	\$4,462	Netflix slightly lower market cap
<u>Cash Flow Statement</u>			
Net cash provided by operating activities	\$318	-120	
Cap ex (incl. DVD content library)	-\$135	-50	
Free cash flow	\$183	-\$170	Netflix has healthy free cash flow

Comparing Netflix to Another Well-Known Consumer-Oriented Technology Company a Decade Ago (2)

- Netflix has a much stronger balance sheet

<u>Balance Sheet</u>	<u>Netflix (2011)</u>	<u>Co. A (2001)</u>	<u>Comment</u>
Assets			
Current assets:			
Cash & equivalents & ST invs	\$798	\$997	Both companies have strong cash positions
Current content library, net	\$920		
Inventories		\$144	
Other current assets	\$113	\$68	
Total current assets	\$1,831	\$1,208	
Non-current content library, net	\$1,047		Netflix is less capital intensive
Property and equipment, net	\$136	\$272	
Other non-current assets	\$55	\$158	
Total assets	\$3,069	\$1,638	Netflix much higher due to its content library
Liabilities and Stockholders' Equity			
Current liabilities:			
Content liabilities	\$935		Netflix has much lower debt levels
Accounts payable	\$87	\$445	
Accrued expenses	\$54	\$305	
Deferred revenue	\$149	\$88	
Current portion of LT debt & other		\$84	
Total current liabilities	\$1,225	\$921	
Non-current content liabilities	\$740		
LT debt (incl. due to related party)	\$400	\$2,156	
Other non-current liabilities	\$62		
Total liabilities	\$2,426	\$3,077	
Stockholders' equity:			
Common stock	\$0	\$4	Netflix has been profitable over time
Additional paid-in capital	\$219	\$1,463	
Accum. other comp. inc. (loss) & other	\$1	-\$46	
Retained earnings	\$423	-\$2,861	
Total stockholders' equity	\$643	-\$1,440	
Total liabilities and stockholders' equity	\$3,069	\$1,637	
Net cash	\$398	-\$1,243	Netflix has a healthy net cash position
Current ratio	1.49	1.31	

Company A is Amazon and Its Stock Has Been a 20-Bagger Since the End of 2001

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Similarities Between Netflix and Amazon

- Both use technology and the internet to deliver an old product in a new way
- Visionary, entrepreneurial CEOs
- A great, convenient service at a very low price
 - Netflix offers a compelling value proposition: it costs 26 cents/day and the average streaming viewer watches 1¼ hours/day = 21 cents/hour of entertainment (pay-per-view is ~10x more expensive)
- Customers can leave at any time without penalty, so both companies must continuously improve to deliver a better customer experience
- Extremely large, global growth opportunities
- Willing to sacrifice short-term profits for long-term growth
- Perceived to have no moat – but actually have substantial competitive advantages
- Both have large, deep-pocketed competitors – that are bureaucratic and slow-moving
- Stocks (Netflix today and Amazon in 2001) are widely hated and shorted

Why Netflix Is a Better Business Than Amazon

- A “lighter” business model that can scale much more quickly and at lower cost
 - Netflix delivers its product electronically, so it has virtually no fulfillment costs, doesn’t have to build warehouses, etc.
- Higher margins, profits, and free cash flow
- Both companies have large international opportunities, but I’d argue that Netflix’s are greater
 - Netflix is just starting to expand overseas; last quarter, international was 7% of sales vs. 43% at Amazon
- Both companies have scale advantages, but I’d argue that Netflix’s are greater
 - More paid subscribers allows Netflix to pay for more, higher-quality content, which in turn attracts more subscribers, etc.

- I don't think it's likely that Netflix is going to be a 20-bagger (like Amazon) in the next decade
- But if there's a 10% chance of a 10-bagger, the expected value of this one scenario justifies the entire price today
- I like investments in which I think my downside is limited and there are numerous multi-bagger upside scenarios
- But there is a wide range of expected outcomes, including ones with a substantial, permanent loss of capital, so this should be sized conservatively (3-4% of my portfolio)