Excerpt: Netflix Slides

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

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T2 Accredited Fund, LP
Tilson Offshore Fund, Ltd.
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An Update on Netflix

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Netflix Over the Past Three Years

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Experience Both Short and Long Netflix

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- 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

The Basics

- 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%

Investment Thesis

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- 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

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

Income Statement	**Netflix (2011)**	**Co. A (2001)**	**Comment**
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
Cash Flow Statement			
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)

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- Netflix has a much stronger balance sheet

Balance Sheet	Netflix (2011)	Co. A (2001)	Comment
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		
Property and equipment, net	$136	$272	Netflix is less capital intensive
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		
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**	Netflix has much lower debt levels
Other non-current liabilities	$62		
Total liabilities	$2,426	$3,077	
Stockholders' equity:			
Common stock	$0	$4	
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**	Netflix has been profitable over time
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

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- 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

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- 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.

Netflix Summary

- 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)