NETFLIX

CLIENT REPORT

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Contents

Executive Summary

Netflix hired Sontag Solutions to advise on growing strategies that enable the company to maintain its leading stance in the competitive and fast changing industry. To come up with those strategies, Sontag Solutions conducted a financial analysis of Netflix for the fiscal year 2014, analyzing the stock performance, cash flow, and revenue streams. Sontag Solutions also looked closely at the video streaming industry to look for growth opportunities and study the actions of its major competitors.

We recommend Netflix to reaffirm its brand as a multi-channel platform providing high-quality movies and TV shows that could not be seen elsewhere. Netflix should continue investing in well-made original contents, and leverage its already successful series as well as its network with Hollywood top producers to disrupt the international markets, especially the market in China. Furthermore, Netflix should innovate on its product features to retain existing customers, optimize the contents to license based on how many customers that video could retain or attract customers, and partner with movie theaters, cable companies, or airlines to diversify its streaming channels.

Company Background

Netflix is the world's leading Internet television network with over 57 million members in over 50 countries. Netflix offers more than two billion hours of TV shows and movies per month, from original series, to documentaries and feature films. Netflix members could watch all contents anytime cross-devices without commercials or commitments.[1]

History

In 1997, Marc Randolph and Reed Hastings, who worked together at Pure Software, founded Netflix. The Netflix website was launched on August 29, 1997, which had only 925 works available for rent through a traditional pay-per-rental model. It started to adopt the monthly subscription concept in September 1999, and hence dropped the single-rental model in early 2000. Netflix then built its reputation on the business model of flat-fee unlimited rentals without due dates, late fees, shipping and handling fees, or per-title rental fees. On May 29, 2002, Netflix initiated an IPO, selling 5.5 million shares of common stock at US$15.00 per share. In 2005, there were 35,000 different film titles available, and 1 million DVDs got delivered out every day via Netflix.

Netflix started to transition from a DVD rentals provider to a streaming video provider in 2007, since which time the DVD sales began to fall. By 2010, Netflix's streaming business had grown dramatically, turning it into the biggest source of Internet traffic in North America.

In March 2011, Netflix started acquiring original content for its subscription streaming services. Netflix launched its first original drama, the hour-long political drama *House of Cards* in February 2013, which received nine Primetime Emmy Award nominations,

[1]http://ir.netflix.com/releases.cfm009B44B6F64C/Netflix_to_Announce_First_Quarter_2015_Financial_Results.pdf

making it the first original online-only web television series to receive major Emmy nominations. Netflix scheduled to launch over 30 original movies or series in 2015, including then new Series of *Orange is the New Black*, *Crouching Tiger, Hidden Dragon II: The Green Legend* and the already-launched *House of Cards Season 3*.

Competition

In April 2014, Netflix possessed 50 million global subscribers with a 32.3% video streaming market share in the United States. Amazon Instant Video and Hulu are among the major competitors of Netflix in the video streaming industry.

Financial Analysis

Overview

Valuation Measures[2]	**Netflix, Inc.**
Market Cap:	26.70B
Enterprise Value (Apr 8, 2015):	24.94B
Trailing P/E (ttm, intraday):	102.16
Forward P/E (fye Dec 31, 2016):	80.69
PEG Ratio (5 yr expected):	5.23
Price/Sales (ttm):	4.65
EPS:	4.32
Enterprise Value/Revenue (ttm):	4.53
Enterprise Value/EBITDA (ttm):	54.61

Netflix's financials show that it is a strong, booming company at a growing industry with lots of potentials. As a market leader in the video streaming business, Netflix has market

[2] http://finance.yahoo.com/q/ks?s=NFLX+Key+Statistics

cap of $26.70 Billion dollars. As of April 8th, 2015, Netflix trades at $441.35, a 36% increase compared to its price ($323.76) per share in January 15th, 2015, mostly due to the release of its better-than-expected quarterly results.

Netflix continued to generate growing revenue, in both international video streaming and domestic video streaming, while operating with sufficient cash in hand. However, Netflix has a substantially higher P/E ratio (102.16), enormous compared to its peers in technology such as Google (26) and Facebook (79).

Income Statements

Income Statement, FY2014	
Revenue (ttm):	5.50B
Revenue Per Share (ttm):	91.63
Quarterly Revenue Growth (yoy):	26.30%
Gross Profit (ttm):	1.75B
EBITDA (ttm):	456.68M
Net Income:	266.80M
Diluted EPS (ttm):	4.32
Quarterly Earnings Growth (yoy):	72.20%

Netflix reported annual revenue of 5.5B in FY2014, a 25.83% growth in revenue compared to FY2013. 86.10% of the Netflix revenue came from video streaming in FY2014, while domestic DVD rental generated only 13.9% of the total revenue. Within the video streaming segment, domestic streaming was the major driver to profit, bringing in 0.936B of contribution profit (27.3% contribution margin), while the fast-growing international streaming segment rendered negative contribution profit of 159.79 Million (-12.2% contribution margin)[3].

Compared to FY2013, revenue from international streaming increased by 84% in FY2014, exceeding that generated from DVD rentals as a substantial revenue driver. On the other had, revenue from domestic DVD rentals continued to fall, by another 16% compared to that of the prior financial year.

Balance Sheets

Balance Sheet, FY2014	
Total Cash (mrq):	1.61B
Total Cash Per Share (mrq):	26.59
Total Debt (mrq):	929.60M
Total Debt/Equity (mrq):	50.04
Current Ratio (mrq):	1.48
Book Value Per Share (mrq):	30.75

Netflix continued to see substantial total asset growth in FY2014 (7.056B), compared to that in the prior year (5.42B). Netflix obtained $1 Billion dollar increase in current asset from FY2013 to FY2014, due to significant increases in cash and content ownership.

On the liability side, Netflix saw an increase of $1.2 Billion dollars in total liabilities, making it $5.2 Billion dollars in total. In addition to $2.2 Billion dollars in current content liabilities, Netflix also had a long-term debt of $900 Million dollars (up $400 Million dollars compared to prior year).

3 http://ir.netflix.com/financials.cfm?CategoryID=282

Total shareholder's equity reached $1.86 Billion, a 39.3% increase than the year before. The $300 Million value increase in common stock contributed the most to such increase, while the increased retained earnings contributed the rest.

Cash Flow Statements

[4]

Cash Flow Statement, FY2014	
Operating Cash Flow (ttm):	16.48M
Levered Free Cash Flow (ttm):	3.01B

Netflix generated $266.8 Million dollars in net income in FY2014 and saw $508.64 Million dollars increase in net change in cash from the prior year. Netflix received $16.48 Million dollars in Cash from Operating Activities. With an operating cash flow of $16.48

[4]https://www.google.com/finance?q=NASDAQ%3ANFLX&fstype=ii&ei=PfIlVfjvIafSiAK384Fw

Million dollars and a levered free cash flow of $3.01 Billion dollars, Netflix has abundant free cash to pursue investment opportunities and obtain original contents.

Competitive Analysis

Threat of New Entrants

The threat of new entrants is low in the video streaming market. To succeed, a new entrant needs to have abundant selections of movies and shows to offer, a number of well-produced original series to entice and retain customers, as well as a stable infrastructure and technology to ensure a smooth video streaming experiences, all of which require huge amount of capital and mature technology.

It takes large capital to obtain licensing rights for movies and shows, and Netflix spent $2 Billion dollars primarily on licensing movies and TV shows.[5] To produce high-quality original contents, network with Hollywood directors and actors as well as a sufficient budget for production and marketing are required. It cost Netflix $100 Million to produce two 13-episode of *House of Cards*[6], an enormous amount of capital that could deter many new entrants from producing their own original contents and joining the competitions.

Threat of Substitutes

Due to the abundant number of entertainment service providers, and the variety of products offered, the threat of substitutes is high in Netflix's case.

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[5] http://techcrunch.com/2013/04/24/netflix-spends-2b-per-year-on-content-primarily-on-licensing-movies-and-tv-shows/

[6] http://www.thewire.com/technology/2013/02/economics-netflixs-100-million-new-show/61692/

From a narrower prospective, providers of movies and TV shows in other means could substitute what Netflix could offer. For example, other than using Netflix to watch movies, people could go to movie theaters, buy DVD, or watch on TV. Though a ticket for one movie may cost $10, the same amount Netflix charged for unlimited access to movies and shows for an entire month, movie theaters show the latest movies with the most popular stars, while contents licensed to Netflix could be more obsolete and less popular.

More broadly speaking, Netflix is competing against other entertainment service providers on people's leisure time, the time they spend watching movies in movie theaters, playing video games, listening music with their mobile phone, or even browsing their Facebook or Twitter.

Bargaining power of customers

Since Netflix charges customers on a monthly basis, the switching cost to get out of Netflix and choose another streaming provider is very low. Customers have a lot of freedom in choosing which service to buy from that perspective. However, with Netflix's flat-rate monthly model, buyers themselves don't seem to have lots of power in negotiating the price of Netflix's services. Over the past years we saw little change in the rate of video streaming and DVD rental of Netflix, so the bargaining power of customers is relatively low in terms of price.

Bargaining power of suppliers

The quality of the contents provided in Netflix is the key to its success, so Netflix would want to obtain high-quality contents that could attract and retain customers. Hence, the bargaining power of suppliers is high.

For the DVD rental services, Netflix could just ensure that they have enough DVDs to rent out without worrying too much about supplier power. However, for video streaming, suppliers have lots of power in deciding when to provide the contents to Netflix. Lots of new or popular movies are not available in Netflix's video streaming as most of them still count on selling DVDs or through iTunes store on a per view basis to generate more profits. Therefore, to obtain the most up-to-date or popular contents, Netflix would be pressured by sellers to a greater extent.

Intensity of competitive rivalry[7]

Both in video streaming industry and original contents access, Netflix receives very fierce competition from its aggressive and powerful competitors.

Within the context of video streaming, competitors such as Amazon Prime Video and Hulu are expanding aggressively in the field. The number of streams delivered for Amazon Prime Instant Video service nearly tripled in 2014, surpassing Netflix and iTunes. Amazon charges $99 for an entire year of Amazon prime memberships, whose

[7] http://www.investopedia.com/articles/personal-finance/121714/hulu-netflix-and-amazon-instant-video-comparison.asp

price includes not only unlimited video streaming similar to Netflix, but also unlimited space for photo storage, free Amazon music access, as well as unlimited free 2-day delivery.

Currently, Netflix still leads the video streaming business: Netflix represented 57.5% of the video-streaming market in March 2014, Amazon takes 3% share, YouTube 16.9%, and Hulu climbed from 1.5% to 2.8%.

In terms of original contents, HBO stands strong as a provider of high-quality movies and TV shows and a "long-term primary competitor"[8] of Netflix. Its famous series such as *Game Of Thrones* and *Sex And The City* drew just as much attention as *House of Cards*, if not more. It recently launched its video streaming service, HBO-Now, which includes "every episode of every season of the best of HBO's award-winning original programming" and charges a monthly price of $14.99[9].

SWOT Analysis

Strengths:	Weaknesses:
• Large market share • Strong core technologies and talents • Strong innovative brands • High-quality original content • Versatile cross-device access	• Raising subscription price is hard • Declining DVD Membership • Capital and legal difficulties to expand internationally

[8] http://ir.netflix.com/faq.cfm#Question31075
[9] https://order.hbonow.com/?camp=NowM74

Opportunities:	Threats:
• International Markets • Diversify streaming channels • Raising capital by selling more shares	• Possible legal changes regarding Internet traffic • Aggressive competitions • Potentially increased price to procure high-quality contents

Strengths

1. Large market share

In April 2014, Netflix possessed 53.1 million global subscribers with a 32.3% video streaming market share in the United States. With that scale, Netflix is able to generate $5.5 B revenue in FY2014 and exert lots of power in the video streaming market.

2. Strong core technologies and talents

Netflix has a well-functional recommendation system that could direct users to the right movies they might be interested in. Netflix carried out about 300 A/B tests in the past year to enhance the functionalities of the system. With that, Netflix is able to retain a large number of customers and continue generating high revenues.

Netflix has a stable streaming infrastructure on the Amazon Web Services cloud, which guarantees a smooth and error-free delivery experience for users[10]. In addition, Netflix

[10] https://gigaom.com/2014/11/22/why-technology-and-content-are-inseparable-at-netflix/

has a very capable engineering team, including a Chaos Engineering team that allows it to be better prepared for emergencies[11].

3. Strong innovative brands

After decades of hard work and innovative initiatives, Netflix has built a strong brand, as one of the world's most innovative companies[12]. 46% of US households with 5 or more people subscribe to Netflix[13] is another fact showing that Netflix is the market leader in the video streaming business.

4. High-quality original content

In addition to the abundant libraries of movies and TV shows licensed to Netflix, it provides high-quality original contents that are exclusive in Netflix. The first season of *House of Cards* received nine nominations for the 65th Primetime Emmy Awards in 2013, making it the first original online-only web television series to receive major nomination and the second season received 13 Primetime Emmy Award nominations.

5. Versatile cross-device access

Netflix allows users to access Netflix through many different platforms. The Netflix App has enabled subscribers to stream media on nearly all Internet enabled devices, including PS3, Wii, Xbox, PC, Mac, iOS, Android, and tablet. Users can also have six devices registered to their account, which allows access in different locations for convenience.

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[11] https://gigaom.com/2014/09/11/netflixs-new-chaos-engineering-push-aims-to-hire-staff-to-help-break-its-cloud-based-system/
[12] http://www.rankingthebrands.com/Brand-detail.aspx?brandID=564
[13] http://www.factbrowser.com/facts/15816/

Weaknesses

1. Raising Subscription Prices

Netflix is having a difficult time raising subscription prices. The most recent time they tried to increase the monthly subscription fee left many subscribers upset and in turn led to the Netflix stock taking a tumble.

2. Declining DVD Membership

Netflix's service providing DVD-by-mail rental options has been declining recently as streaming has become popular. It used to be a hybrid plan, but Netflix broke up the two services into separate memberships. This has led to a 50% decrease in DVD-by-mail rental service from 2011-2014.

3. Capital and legal difficulties to expand internationally

Expansion into the European markets has added large expenses without a similar increase in revenue. In 2013 the loss of international streaming totaled $274 million. Changes in European law will soon cause Netflix to pay higher taxes. Expansion in the international market will marginalize overall profitability in the coming years.

Opportunities

1. International Markets

Netflix is aggressively approaching expansion into international markets, currently operating in nearly 50 countries including Canada, Latin America, the Caribbean, and Europe. European expansion is the focus of Netflix at present. Popular series such as *House of Cards* have garnered international attention and the Netflix brand as an innovative and reliable company has become worldwide; both facts could boost Netflix's international expansion efforts.

2. Diversify streaming channels

Since more varied types of electronics are now linked to the Internet, Netflix could potentially attract not only Internet users, but also TV users. Netflix could work with cable companies, airlines or railway companies, as well as movie theaters to offer streaming services of more kinds.

3. Raise capital by selling more shares

Netflix stock is currently trading at over $400 per share. With investors willing to pay this much for Netflix stock, the company might be better off to sell more shares. Even with the dilution of holdings to current shareholders this is an option that remains on the table that could lead to the benefit of the company.

Threats

1. Possible legal changes regarding Internet traffic

Netflix counts for 30% of Internet traffic, which is an extremely high portion. With the potential for net neutrality laws, Netflix may have to start taking on more debt or starting to cut content.

2. Aggressive competitions

Netflix has enjoyed a nice position as the premier streaming service provider, but that reign was surely going to be challenged. Netflix adopts a business model where users can pay $9.99 to enjoy all the contents, but Amazon Prime and YouTube have announced their own original content productions and aim to be direct competitors to Netflix. Amazon has a bigger scale than Netflix in terms of capital, and has already accumulated three times as many videos in their Prime Video libraries. The content competitor HBO also launched its own streaming services HBO-Now. The industry is fast changing and major competitors all possess large capital and profound technologies.

3. Potentially increased price to procure high-quality contents

Netflix was the beneficiary of high-quality contents licensing deals as an early comer in the business. However, with fierce competitions from entrants such as Amazon, which has even more capital to obtain contents, Netflix would need to engage in price competition to get the deals, which might raise the content price up as a result.

Strategic Recommendations

To maintain continued high growth and satisfactory customer retention, Netflix should continue innovating new product features to increase profitability, building its brand as an innovative platform filled with high-quality contents, obtaining well-produced original contents from more diverse sources, and leveraging its exclusive popular contents for global expansion.

Enter Asian markets by leveraging its high-quality original contents

As Netflix[14] grows slower in the domestic U.S market, it is critical for Netflix to expedite global expansion. At present, Netflix offers services to all of North America (including Cuba), South America and mainly west Europe (Denmark, Ireland, The Netherlands, Norway, Sweden, Finland, United Kingdom, France, Switzerland, Austria, Belgium, Luxembourg and Germany)[15]. In addition to its current plans to move into Australia and New Zealand in 2015[16], Netflix should consider expanding into Asian counties such China and India strategically.

China has the largest number of online-video viewers (around 450m), which makes up of nearly 80% of the internet-connected population. The number is expected to rise to around 700m by 2016, according to iResearch[17]. Though China has a promising market with billions of potential customers, there are already strong incumbents such as Youku or Sohu that offer more up-to-date videos at a cheaper price. Current streaming leader, Youku, charges less than $3 for a monthly membership where users could watch thousands of movies unlimited without ads. Youku members could pay $0.42 for each of the most popular and up-to-date premium movies, and non-members could pay $0.84 for

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[14] http://ir.netflix.com/long-term-view.cfm
[15] http://en.wikipedia.org/wiki/Netflix
[16] http://www.marketwatch.com/story/netflix-steps-up-plan-for-global-expansion-2015-01-21
[17] http://www.economist.com/news/business/21589434-chinas-online-video-market-largest-and-most-innovative-world-it-also-most

the same premium movie[18]. Compared to Youku's more abundant movie selection that also better targets Chinese audience, Netflix doesn't have the same kind of price advantage in China as it has in the U.S. What's worse, pirating is a big problem where Chinese customers could easily download pirated movies for free.

Therefore, Netflix should not brand itself just as paid-for libraries for movies and TV shows. Instead, Netflix should leverage its already popular series in China such as *House of Cards*, along with its existing network with Hollywood and top American producers, to offer exclusive, high-quality original contents that can not be found in other Chinese streaming sites such as Youku or Sohu. For example, Netflix could hire top Hollywood producers and directors to make highly anticipated movies or TV series starring world-famous Hollywood stars and celebrities in China that are only available via Netflix. Chinese customers would have to sign up for Netflix to pay a fixed monthly fee to watch those contents. Netflix should brand itself as a global company that offers premium exclusive contents that are cool and in-trend to target younger generations or upper middle class.

Prioritize qualities over quantities when obtaining contents

According to its investor report, Netflix generally "license content for a fixed fee and a defined time period with payment terms varying by agreement"[19]. Since Netflix license for a fixed cost but generates revenue from monthly fees by head counts, the No.1

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[18] http://vip.youku.com/privilege/film_enclises.html
[19] http://ir.netflix.com/faq.cfm#Question31141

priority is to obtain contents that could retain current customers and entice new customers.

Netflix doesn't offer the most number of videos compared to its competitor such as Amazon Prime or iTunes. The combined total number of movie/file/show/episodes shown in Netflix is 10,209 as in March 2015[20](Amazon has more than 30,000[21]). Since Netflix has less capital and smaller scale compared to Amazon, competing on the number of videos provided might not be the smart move. If an award-winning movie can retain more customers than 10 ordinary movies combined, then licensing the award-winning one is better than the licensing the other 10.

The same logic applies to original contents. Netflix should concentrate on producing high-quality original contents to maintain its competitive edge. Past Netflix series such as *House of Cards, Orange Is the New Black*, and *BoJack Horseman* are well reputed (all have 8.0 or above IMDB rating), and in the future Netflix should continue to do the same.

As quantity is not something that Netflix should boast of compared to its competitors, Netflix should prioritize quality of the original series to the quantities of original series, and reassures its goal of making highly anticipated and well-reputable original contents. Netflix should not be a place where every single movie could be found; it should be a place where all the contents are intriguing and well made.

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[20] http://netflixcanadavsusa.blogspot.com/
[21] http://www.tomsguide.com/us/netflix-amazon-face-off,news-17838.html

Develop new product features that reduce steaming costs[22]

Based on the assumption that each gigabyte costs 3 cents to deliver, Netflix renders a cost of about 6 cents to deliver one SD movie and 9 cents to deliver one HD movie[23]. Since Netflix generates growing revenues simply by attracting more customers or enticing existing customers to upgrade, Netflix could think of ways to reduce the number of movies delivered to increase profitability. Right now Netflix allows one account associated with multiple devices or simultaneous streaming under one account; hence, it's very likely that one user account might have the same video playing multiple times but sent to different devices, each time costing an extra amount for data delivery.

Netflix should innovate on new product features that would encourage users to reduce the number of movies delivered but increase the number of registered users. For example, Netflix could trace three different users' streaming history separately and use machine learning algorithms to recommend movies for the three to watch together. After they watch together, the records will be updated to each account so Netflix could recommend for a different mix of friends next time. For Netflix users, such feature allows multiple users to quickly determine a mutually favorable movie that they could sit together and watch, which is a better experience. On the other hand, now that Netflix only needs to deliver the movie once instead of three times, Netflix spends less for content delivery cost but obtains the same revenue, therefore achieving higher profitability.

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[22] http://www.quora.com/What-do-major-film-studios-charge-for-streaming-licenses-of-their-movies

[23] http://www.streamingmedia.com/Articles/Editorial/Featured-Articles/Stream-This!-Netflixs-Streaming-Costs-65503.aspx

Furthermore, Netflix doesn't have lots of famous movies or contents because the cost to license those is very high. Since Netflix has to license some contents for a fixed period of time[24], Netflix could offer temporary premier contents that are only available for particular months and maybe even charge users more for a "premier" account that could watch those premier contents. Premier users could watch movies from a constantly changing catalog that offers *Wolf of Wall Street* from Jan. to Mar. and *Interstellar* from Oct. to Dec. For premier users, changing contents entice them to remain on the premium list and better signing up now to watch *Wolf of Wall Street* because soon it would not be available anymore. Since Netflix only licenses those popular contents for a shorter period of time, the licensing cost would be lowered. At the same time, users are able to watch more intriguing contents and enjoy a better streaming experience with Netflix.

Diversifying channels and strategizing cost structures

Netflix currently offers services to web users, mobile users (Android, iOS, Windows Phone), as well as some cable users (Chromecast and cable boxes). To increase revenues, Netflix could diversify the channels it offers services.

[24] http://www.quora.com/What-do-major-film-studios-charge-for-streaming-licenses-of-their-movies

Netflix could partner with TV service operators to offer TV channels that could be comparable to that of HBO[25]. With that, users could have a Netflix channel next to their NBC or ESPN.

Netflix could partner with airlines, buses, or trains to offer streaming services for people on the go. For example, a passenger could have a Netflix library of over 10,000 videos to choose from during his flight from LAX to SFO. Netflix could charge that airline for the number of screens that have access to Netflix library, just the same as it charges normal users.

Netflix could also partner with movie theaters to show its original contents on a larger screen for people who prefer to spend some more money for a better watching experience. Customers could only book tickets to watch those movies via Netflix as a Netflix user, so they could now watch *Crouching Tiger, Hidden Dragon II: The Green Legend* on the nearby movie theater in Claremont with its Netflix movie ticket.

Ending notes

Without doubt, Netflix has a strong management team that knows what are the right things to do. Current strategies on global expansion and original content are the smart moves to make Netflix a more attractive company for both shareholders and paid users. Situated in a fast changing industry and competing against very strong companies,

[25] https://gigaom.com/2014/12/10/netflix-wants-to-hook-up-with-your-cable-company-in-2015/

Netflix has to brand itself as the cross-device platform full of high-quality contents and find the right niche in the market. To continue its success, Netflix would need to continue innovating in product features that entice new customers, retain existing customers, and cut down variable costs.