The Ugly Truth About Netflix: Investors Beware

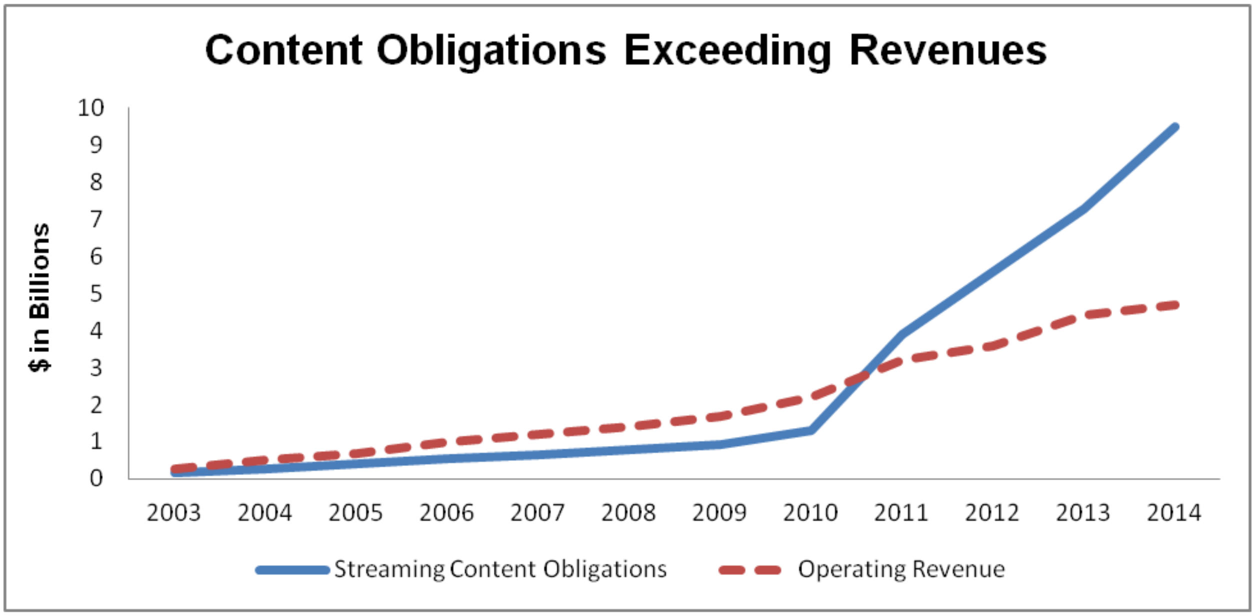
It is almost becoming an expected event every quarter: Netflix (NFLX $436/share) releases quarterly earnings amid much speculation about its future, and the price soars. We're not talking about Netflix' stock price though — Netflix's streaming content obligations continue to soar year in and year out. We've previously written about the many issues with Netflix, and with each quarterly report, our thesis gets stronger. The company's 4Q14 earnings reveal that our thesis is stronger than ever: as costs continue to rise faster than revenues, the profit expectations in the stock price are unrealistically high. Investors who own this stock are playing a dangerous game with momentum. When the music stops on Netflix, the stock will likely get crushed.

Rising Content Costs Undermine Value of Revenue Growth

We first highlighted Netflix's [content cost problem in April 2014.] As Netflix continues to increase its streaming content library, it must also pay licensing fees to host and distribute this content to its customers. However, the growth in spending on this content far outpaces the company's revenue growth. Versus 2013, Netflix's 2014 streaming content obligations increased 30% to $9.5 billion dollars while revenue only increased 7%. This trend began in 2010 when streaming content costs first accelerated.

Figure 1 shows that Netflix is spending more and more to increase its content library, but those costs have not been matched by enough of an increase in revenue. How long can Netflix pay for more content without more rapidly increasing its revenue growth?

Figure 1: Streaming Content Obligations Grow Much Faster Than Revenues



Sources: New Constructs, LLC and company filings

Beware Subscriber Growth That is Slowing and Not Profitable

It seems that the only number that many Netflix investors care about is subscriber growth. Overall subscriber growth was up in 2014, but issues with that stat persist under the surface. We mentioned Netflix's slowing subscriber growth in October 2014, and that trend continues through 4Q14. Netflix added only 1.9 million subscribers to its U.S. streaming segment, down from 2.3 million the prior year. This segment's contribution margin declined to 28%, down from 29% the prior quarter. Netflix has continued to expand internationally, and the company added 2.4 million members over 1.7 million the year before. However, the international segment's contribution margin plummeted to -20% from -9% the prior quarter. Netflix has grand plans to expand internationally, but as of late, those plans have only cost the company more money.

Beware top line growth that does not generate profits.

Competition Is Stronger and Limits Pricing Power

At its core, Netflix is merely a content delivery platform — and one of many. From Amazon video services to CBS All Access to HBO Go and Dish Network's new Sling TV, there is no shortage of competition in this space, and none of them stand out as offering anything that is really unique. Netflix is attempting to separate itself by creating original content only available to Netflix subscribers, but it is no longer the only player in that game. Competitor Amazon has established itself as a formidable competitor, recently winning two Golden Globes.

Making matters worse, original content creation is expensive and risky, which is why most movie studios are owned by larger media conglomerates that can afford to take the big risks that making blockbuster movies often takes.

It is hard to see how Netflix can differentiate itself enough from the competition to charge the higher prices it needs to charge to generate the profits already embedded in its stock price.

You May Have Missed This Item That Inflated EPS

Another item of note that artificially inflated Netflix's results was the release of a $39 million benefit from the company's tax reserves. This $39 million, which was recorded as quarterly income, nearly doubled Netflix's reported net income and allowed the company to "beat" quarterly and yearly comps. Without this unusual and nonrecurring tax reserve, Netflix's income before taxes was down 54% from the prior quarter, and 38% from the prior year.

While the aforementioned factors have put the brakes on Netflix's profit growth (the company projects profits to decline in 1Q15), they are hardly new concerns. This makes the momentum run in Netflix's stock even more confusing. Investors are simply ignoring some very transparent truths about the company. Slowing growth, declining margins, and skyrocketing costs are not features of company that is generating meaningful shareholder value.

Valuation is Ridiculous – Even Cramer Agrees

Using different scenarios below, we examine just how much growth in profit margins, subscribers and revenue is implied by Netflix's current stock price. Netflix currently maintains a pre-tax margin around 7.5% and has 57 million subscribers.

Figure 2: Implied Stock Price Scenarios

			Implied By Current Stock Price	
Scenario	Monthly Subscription Price	Profit Margin	Revenue ($mm)	Subscribers (million)
Maintain Status Quo	$8	7.5%	$218,116	2,272
Price 3x & Margin 2x	$24	15%	$35,227	122

Sources: New Constructs, LLC and company filings

Next, we use our discounted cash flow (DCF) model to provide transparency into the growth implications of the current stock price.

Scenario 1 assumes Netflix prices and margins remain the same. The DCF model shows at the current profit margin of 7.5%, the company must grow revenues at 20% compounded annually to justify the current price. That performance means the company would reach over $218 billion in revenue in 20 years. At $8 per month, Netflix would need over 2.2 billion subscribers to generate $218 billion in revenue. The world population is about seven billion. Any questions?

Scenario 2 assumes Netflix can triple its price and double its profit margins. We realize that tripling price and doubling margins at the same time is a stretch. Nevertheless, let's see the impact. The DCF model shows after tripling prices and doubling margins, the company would have to reach over 122 million subscribers, over double their current subscriber base. I wouldn't bet on that happening.

In this scenario it is more likely that Netflix would lose subscribers not double them at $24/month because Amazon Video is $$8.25/month and includes Prime shipping and Hulu Plus is just $7.99. Moreover, at $24/month, Netflix would compete directly with top-tier cable and satellite TV companies such as Comcast and DirecTV, who's TV packages start at $19.99/month for the first year of service.

It is difficult to quantify any more clearly just how much risk is in NFLX.

Stock Price Out of Control

As David Trainer discussed last week, Netflix is one of, if not the most overvalued stock in the market today. To justify its current price of ~$436/share, NFLX would need to grow revenue by 20% compounded annually for the next 22 years. Essentially, Netflix needs to significantly increase its margins, expand its customer base by adding more content, and not pay as much for that content.

Sounds about the opposite of what the company is currently doing doesn't it?

We've seen this movie before: After a huge run up in 2013, Netflix stock dropped 31% early 2014. Then again, after a large run, the stock dropped 26% in October 2014. Don't get caught in Netflix's unfounded momentum again.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any particular stock, sector, or theme.

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