

Netflix, Inc. (NFLX)

Strong Quarter. International Driving Upside.

INVESTMENT HIGHLIGHTS: Netflix tripled 3Q13 EPS to \$0.52, overdelivered subscriber growth (especially offshore), and raised guidance for 4Q13. We retain our BUY and \$425 target price. We believe the market is valuing Netflix at 17x US OIBDA + \$260 per international subscriber lifetime value, which suggests upside.

3Q13. The 3 most important take-aways (our view) from 3Q13 earnings call included:

- 4Q13 EPS guidance was raised to \$0.47-0.73, well above the \$0.46 consensus. We raise our estimate to \$0.62 (from \$0.55).
- International subs were 8% above estimates, which suggests faster breakeven and higher RICs than previously anticipated, since programming costs are fixed.
- Margins hit guidance, up 400% y/y, even after an extra \$27mm of extra amortization costs, suggesting margin expansion is ahead of schedule.

Thesis: We believe three key attributes of the Netflix story are undervalued:

- International markets will reach breakeven faster, have higher marginal ROICs, and will represent a visible growth driver, in our view. In 3Q13, NFLX hit 9.2mm international subs, 8% above our estimate. Since content costs are fixed, faster international adoption implies faster breakeven and higher marginal ROICs than prior estimates.
- We believe Netflix is the best way to play global broadband growth. According to Cisco & the OECD, broadband penetrations and internet video demand should grow 30-90% annually through 2017, and Netflix should be a key beneficiary.
- In the US, we estimate that Netflix is the super-low-cost provider at ½ to 1/5 the cost of the linear TV, implying pricing power upside potential of over 100%, through tiering, advertising revenue, add-on services, etc.

Valuation. We believe that the market is valuing Netflix at a 17x multiple of its FY14E US profitability plus the lifetime value of its international subscribers. Our analysis of Netflix's aged international markets shows that each international subscriber has a lifetime value of \$450. Discounting this back to today at Netflix's WACC of 9.5% implies a PV of lifetime value of each international subscriber of \$260.

	FY 12/31/2012		FY 12/31/2013		FY 12/31/2014	
	Actual	Old	New	Old	New	
Rev. (MM)	3,609.3A	4,352.3E	4,366.8E	5,116.9E	5,116.9E	
Growth			21.0%		17.2%	
EPS: 1Q	(0.08)A	0.04A	0.04A			
EPS: 2Q	0.11A	0.49A	0.49A			
EPS: 3Q	0.13A	0.71E	0.52A			
EPS: 4Q	<u>0.13A</u>	<u>0.55E</u>	<u>0.62E</u>			
EPS: Year	0.29A	1.79E	1.68E	3.96E	3.96E	
Growth			479.3%		135.7%	
P/E Ratio	NM	NM	NM	89.6x	89.6x	

ESTIMATE CHANGE

Stock Rating	BUY
	Unchanged
Price Target	\$425.00

Entertainment & Internet

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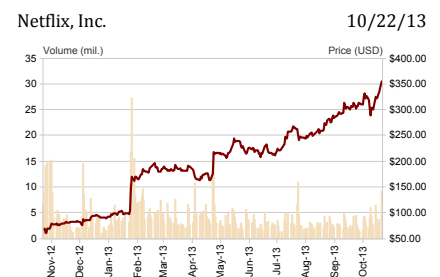
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Stock Price Performance**Market Data**

Price (10/21/2013)	\$354.99
52-Week Range	\$355.42 - \$57.40
Shares Out. (MM)	58.9
Market Cap. (MM)	\$20,908.9
Avg. Daily Volume	3,136,164.0
Cash & ST INV/Share	\$13.46
Total Debt/Cap.	21.17%

Earnings Overview and Summary

Figure A includes our estimates compared with consensus.

FYE 12/31:	3Q13A	4Q13E	2013E	2014E
Rev Current (\$m)	\$1,106	\$1,167	\$4,367	\$5,117
Previous (\$m)	\$1,105	\$1,154	\$4,352	\$5,117
Consensus (\$mm)	\$1,100	\$1,140	\$4,340	\$5,080
EPS -GAAP	\$0.52	\$0.62	\$1.68	\$3.96
Previous	\$0.71	\$0.55	\$1.79	\$3.96
Consensus	\$0.49	\$0.46	\$1.53	\$3.46
P/E Current			211.9	89.7
Source: Yahoo Finance, Needham & Company estimates				

3Q13 Discussion & Analysis

NFLX reported 3Q13 revenue of \$1.106B (up 22% y/y and in line with our estimates), Operating Income of \$57.1M (up 254% y/y and 26% below our estimates), Net Income of \$31.8M (up over 3Q12 Net Income of \$7.7M and 27% below our estimates), and GAAP EPS of \$0.52 (up over 3Q12 EPS of \$0.13 and 27% below our estimates). Segment information for NFLX was as follows:

- **Domestic Streaming.** Total member growth in 3Q13 was 1.29M (up 11% y/y and 11% below our estimates), and NFLX ended the quarter with 31.09MK (up 24% y/y and 1% below our estimates). Paid member growth in 3Q13 was 1.3M (up 17% y/y and approximately in line with our estimates), and NFLX ended the quarter with 29.925M (up 26% y/y and approximately in line with our estimates). Revenue for this segment was \$701.08M (up 26% y/y and approximately in line with our estimates), and Contribution Profit was \$166.5M (up 74% y/y and 7% below our estimates).
- **International Streaming.** Total member growth in 3Q13 was 1.44M (up 110% y/y and 49% above our estimates), and NFLX ended the quarter with 9.188M (up 113% y/y and 8% above our estimates). Paid member growth in 3Q13 was 1.07M (up 61% y/y and 28% above our estimates), and NFLX ended the quarter with 8.084M (up 119% y/y and 4% above our estimates). Revenue for this segment was \$183.1M (up 135% y/y and approximately in line with our estimates), and Contribution Profit (Loss) was (\$74.3M (up 20% y/y and 15% below our estimates)).
- **Domestic DVD.** Total member loss in 3Q13 was 360K (better than a loss of 634K in 3Q12 and approximately in line with our estimates), and NFLX ended the quarter with 7.1M (down 17% y/y and approximately in line with our estimates). Paid member Loss in 3Q13 was 355K (better than a loss of 680K in 3Q12 and in line with our estimates), and NFLX ended the quarter with 7.014M (down 17% y/y and in line with our estimates). Revenue for this segment was \$221.9M (down 18% y/y and 1% above our estimates), and Contribution Profit was \$106.7M (down 18% y/y and 6% above our estimates).

Figure 1A 3Q13A vs 3Q12A vs 3Q13E					
<i>\$ and shares in millions, except per share data</i>	3Q12A	3Q13A	Change	3Q13E	Act/Est
Revenue	\$905.1	\$1,106.0	22%	\$1,105.4	0%
Cost of Revenue	\$662.6	\$791.0	19%	\$765.0	3%
Marketing	\$108.4	\$116.1	7%	\$125.0	-7%
Technology and Development	\$82.5	\$95.5	16%	\$95.0	1%
General and Administrative	<u>\$35.3</u>	<u>\$46.2</u>	31%	<u>\$43.0</u>	7%
Operating Income	\$16.1	\$57.1	254%	\$77.4	-26%
Other Income (Expense):					
Interest Expense	(\$5.0)	(\$7.4)	49%	(\$7.5)	-1%
Interest and Other Income (Expense)	\$0.8	(\$0.2)	-124%	\$0.0	
Loss on Extinguishment of Debt	<u>\$0.0</u>	<u>\$0.0</u>		<u>\$0.0</u>	
Income Before Taxes and Extraordinary	\$11.9	\$49.5	314%	\$69.9	-29%
Provision (benefit) for Income Taxes	<u>\$4.3</u>	<u>\$17.7</u>	314%	<u>\$26.6</u>	-34%
Net Income	\$7.7	\$31.8	315%	\$43.4	-27%
EPS-GAAP	\$0.13	\$0.52	299%	\$0.71	-27%
Weighted Avg. Diluted Shares	58.7	61.0	4%	61.0	0%
Calculation of Adjusted EBITDA					
Operating Income	\$16.1	\$57.1	254%	\$77.4	-26%
SBC	\$18.5	\$18.0	-3%	\$18.0	0%
Adjusted Operating Income	\$34.6	\$75.1	117%	\$95.4	-21%
Depreciation and Amortization	\$11.1	\$12.0	8%	\$12.0	0%
Adjusted EBITDA	\$45.7	\$87.1	90%	\$107.4	-19%
<i>Sources: Company reports, Needham & Company LLC research.</i>					

Figure 1B Netflix Key Stats: 3Q13A Actuals vs Estimates

<i>\$ and shares in millions, except per share data</i>	3Q12A	3Q13A	Change	3Q13E	Act/Est
Domestic Streaming					
Total Members End of Period	25.1	31.1	24%	31.3	-1%
Paid Members End of Period	23.8	29.9	26%	30.0	0%
Revenue	\$556.0	\$701.1	26%	\$704.0	0%
Cost of Revenues	\$399.1	\$470.6	18%	\$454.1	4%
Marketing	\$61.2	\$64.0	5%	\$70.0	-9%
Contribution Profits	\$95.7	\$166.5	74%	\$179.9	-7%
International Streaming					
Total Members End of Period	4.3	9.2	113%	8.5	8%
Paid Members End of Period	3.7	8.1	119%	7.8	4%
Revenue	\$77.7	\$183.1	135%	\$182.8	0%
Cost of Revenues	\$124.4	\$208.0	67%	\$195.0	7%
Marketing	\$45.7	\$49.4	8%	\$52.5	-6%
Contribution Profits	(\$92.4)	(\$74.3)	20%	(\$64.7)	-15%
Total Streaming					
Total Members End of Period	29.4	40.3	37%	39.8	1%
Paid Members End of Period	27.5	38.0	38%	37.8	1%
Revenue	\$633.8	\$884.1	40%	\$886.8	0%
Cost of Revenues	\$523.5	\$678.6	30%	\$649.1	5%
Marketing	\$106.9	\$113.3	6%	\$122.5	-7%
Contribution Profits	\$3.3	\$92.2	2669%	\$115.2	-20%
Domestic DVD					
Total Members End of Period	8.6	7.1	-17%	7.1	0%
Paid Members End of Period	8.5	7.0	-17%	7.0	0%
Revenue	\$271.3	\$221.9	-18%	\$218.6	1%
Cost of Revenues	\$139.1	\$112.4	-19%	\$115.9	-3%
Marketing	\$1.5	\$2.8	84%	\$2.5	11%
Contribution Profits	\$130.7	\$106.7	-18%	\$100.2	6%
Consolidated					
Revenue	\$905.1	\$1,106.0	22%	\$1,105.4	0%
Cost of Revenues	\$662.6	\$791.0	19%	\$765.0	3%
Marketing	<u>\$108.4</u>	<u>\$116.1</u>	<u>7%</u>	<u>\$125.0</u>	<u>-7%</u>
Contribution Profits	\$134.0	\$198.9	48%	\$215.4	-8%
	15%	18%		19%	
Other Operating Expenses	<u>\$117.9</u>	<u>\$141.8</u>	<u>20%</u>	<u>\$138.0</u>	<u>3%</u>
Operating Income	\$16.1	\$57.1	254%	\$77.4	-26%
Other Income (Expenses)	(\$4.2)	(\$7.6)	82%	(\$10.0)	
Provision (benefit) for Income Taxes	\$4.3	\$17.7	314%	\$23.6	
Net Income (Loss)	7.7	\$31.8	315%	\$43.8	
EPS-GAAP	\$0.13	\$0.52	299%	\$0.71	

Sources: Company reports, Needham & Company LLC research.

Risks to Target Price

Risks to our Target Price include competition from well capitalized and experienced competitors, new services like video on demand, and new technologies. Low barriers to exit for NFLX users is another risk as there are no annual contracts so users can cancel anytime. Rising content costs are a third key risk.

12-Month Target Price of \$425

Our target price of \$425 is based on a DCF valuation. We use a WACC of 9.5% for NFLX and a long-term nominal GDP growth rate of 1%. The standard DCF is widely used on Wall Street because it is a rigorous bottom-up valuation of the enterprise based on discounting its long-term cash flows and removing the impact of non-cash accounting conventions. Positives and negatives of this valuation methodology are highlighted beside the calculation in Figure 5.

Our \$425 target price embeds a 10-year EBITDA growth rate of 21.9% annually beginning in FY14 and represents a 39.1x multiple of forward year (2015E) EBITDA.

Valuation and FY13 Estimate Revisions

We believe the market is valuing Netflix as a multiple of its US profit contribution plus the lifetime value of its international subscribers, as calculated in Figure B.

Figure B Netflix Valuation Analysis					
	FY14E	Multiple	Value	% of Total	
Calculation of Current US Value, FY14E (\$000)					
Contribution from US Steaming, FY14E	\$ 831	20	\$ 16,625	67%	
Contribution from DVDs, FY14E	\$ 335	14	\$ 4,692	19%	
Total US Value Contribution	\$ 1,166	17	\$ 21,317	86%	
Calculation of Current Intl Value					
Each Intl sub is worth at maturity (see figure H)	\$450				
Discounted back at 9.5% (WACC) for 6 periods	\$260				
Paying Intl Subs at 12/31/14E	13.6		\$ 3,539	14%	
Total Netflix Value			\$ 24,856	100%	
Less: Marketing	-535	3	\$ (1,604)		
Less; R&D - Tech & Development	-420	3	\$ (1,260)		
Less: Corp Overhead	-160	3	\$ (480)		
Total Implied Netflix Value			\$ 21,513		
Current Netflix Trading Value (\$392/share)			\$ 20,900		
Variance			\$ 613		

Source: Company data, Needham estimates.

Our BUY rating is based on several forms of valuation, summarized in Figure 2:
Netflix, Inc.

Figure 2 Netflix: Valuation Summary & Conclusions

2014E Valuation Multiples		Embedded Expectations Metrics	
1	EV/Sales	4.5	
2	EV/OIBDA	41.7	
3	P/E	89.7	
4	FCF/Share	\$5.58	
5	EV/FCF	65.4	
6	FCF Yield	2%	
		9	Breakeven DCF (Calculated as the 10-Yr EBITDA CAGR required to justify current share price) 13.9%

Source: Needham & Company estimates.

- The “**Breakeven DCF**” valuation methodology uses the current share price to calculate the market’s growth expectations for the enterprise, including capital efficiency trends. This valuation methodology concludes that NFLX must achieve a 10-year OIBDA compound annual growth rate of approximately 13.9% to justify its current share price. (Please see Figure 6.)
- In Figures 7 and 8 we summarize several **valuation multiples** for Sales, OIBDA, P/E and Free Cash flow. NFLX’s EV/OIBDA trading multiple is approximately 41.7x 2014E OIBDA and has a 2% free cash flow yield.
- In Figure 9, we present our **Comparative Industry** valuation metrics.

FY13 Estimate Change. We change our FY13 estimates to reflect 3Q13 actual results, updated guidance and management comments made on the earnings call. As a result, we now estimate FY13 revenue of \$4.367B (up 21% y/y and 0.3% above our previous estimates), and GAAP EPS of \$1.68 (up over FY12 GAAP EPS of \$0.29, and 6% below our previous estimates).

We maintain our FY14 estimates of revenue of \$5.117B (up 17% y/y), and GAAP EPS of \$3.96 (up 136% y/y).

Figure C below is NFLX’s updated 4Q13 guidance

Figure C Netflix: 4Q13 NFLX Management Guidance

(in millions except per share data)	Q4 2013 Guidance
<u>Domestic Streaming:</u>	
Total members	32.7 to 33.5
Paid members	31.1 to 31.8
Revenue	\$731 to \$741
Contribution Profit	\$165 to \$177
<u>International Streaming:</u>	
Total members	10.1 to 10.9
Paid members	9.1 to 9.7
Revenue	\$210 to \$224
Contribution Profit (Loss)	(\$73) to (\$57)
<u>Domestic DVD:</u>	
Contribution Profit	\$96 to \$110
<u>Consolidated Global:</u>	
Net Income	\$29 to \$45
EPS	\$0.47 to \$0.73

Source: Netflix

Figure 3 Netflix: Quarterly Financial Projections, FY13E

\$ and shares in millions, except per share	3/31/13A	6/30/13A	9/30/13A	12/31/13E	Year
Revenue	\$1,024.0	\$1,069.4	\$1,106.0	\$1,167.4	\$4,366.8
Cost of Revenue	\$726.9	\$753.5	\$791.0	\$826.7	\$3,098.1
Marketing	\$129.2	\$121.8	\$116.1	\$131.5	\$498.5
Technology and Development	\$92.0	\$93.1	\$95.5	\$95.0	\$375.6
General and Administrative	<u>\$44.1</u>	<u>\$43.8</u>	<u>\$46.2</u>	<u>\$45.0</u>	<u>\$179.2</u>
Operating Income	\$31.8	\$57.1	\$57.1	\$69.3	\$215.3
Other Income (Expense)					
Interest Expense	(\$6.7)	(\$7.5)	(\$7.4)	(\$7.5)	(\$29.2)
Interest and Other Income (Expense)	\$1.0	(\$2.9)	(\$0.2)	\$0.0	(\$2.2)
Loss on Extinguishment of Debt	<u>(\$25.1)</u>	<u>\$0.0</u>	<u>\$0.0</u>	<u>\$0.0</u>	<u>(\$25.1)</u>
Income Before Taxes and Extraordinary	\$0.9	\$46.6	\$49.5	\$61.8	\$158.8
Provision (benefit) for Income Taxes	(\$1.8)	\$17.2	\$17.7	\$23.5	\$56.6
Net Income	\$2.7	\$29.5	\$31.8	\$38.3	\$102.3
EPS-GAAP	\$0.04	\$0.49	\$0.52	\$0.62	\$1.68
Weighted Avg. Diluted Shares	60.1	60.6	61.0	61.5	60.8
Operating Income	\$31.8	\$57.1	\$57.1	\$69.3	\$215.3
SBC	<u>\$17.7</u>	<u>\$18.0</u>	<u>\$18.0</u>	<u>\$18.0</u>	<u>\$71.7</u>
Adjusted Operating Income	\$49.6	\$75.1	\$75.1	\$87.3	\$287.0
Depreciation and Amortization	<u>\$12.1</u>	<u>\$12.0</u>	<u>\$12.0</u>	<u>\$12.0</u>	<u>\$48.1</u>
Adjusted EBITDA	\$61.6	\$87.1	\$87.1	\$99.3	\$335.1
Sources: Company reports, Needham & Company estimates.					

Figure 4 Netflix: Annual Income Statement Projections, 2012A-2015E				
\$ and shares in millions, except per share data	2012A	2013E	2014E	2015E
Revenue	\$3,609.3	\$4,366.8	\$5,116.9	\$5,730.9
Cost of Revenue	\$2,625.9	\$3,098.1	\$3,593.3	\$3,839.7
Marketing	\$465.4	\$498.5	\$534.5	\$530.0
Technology and Development	\$329.0	\$375.6	\$420.0	\$420.0
General and Administrative	<u>\$139.0</u>	<u>\$179.2</u>	<u>\$160.0</u>	<u>\$140.0</u>
Operating Income	\$50.0	\$215.3	\$429.1	\$801.2
Other Income (Expense)				
Interest Expense	(\$20.0)	(\$29.2)	(\$30.0)	(\$30.0)
Interest and Other Income (Expense)	\$0.5	(\$2.2)	\$0.0	\$0.0
Loss on Extinguishment of Debt	<u>\$0.0</u>	<u>(\$25.1)</u>	\$0.0	<u>\$0.0</u>
Income Before Taxes and Extraordinary	\$30.5	\$158.8	\$399.1	\$771.2
Provision (benefit) for Income Taxes	\$13.3	\$56.6	\$150.8	\$293.1
Net Income	\$17.2	\$102.3	\$248.2	\$478.1
EPS-GAAP	\$0.29	\$1.68	\$3.96	\$7.59
Weighted Avg. Diluted Shares	58.0	60.8	62.8	63.0
Calculation of OIBDA:				
Operating Income	\$50.0	\$215.3	\$429.1	\$801.2
SBC	\$73.9	\$71.7	\$72.0	\$80.6
Adjusted Operating Income	\$123.9	\$287.0	\$501.1	\$881.8
Depreciation and Amortization	<u>\$45.5</u>	<u>\$48.1</u>	<u>\$48.0</u>	<u>\$50.0</u>
Adjusted OIBDA	\$169.4	\$335.1	\$549.1	\$931.8
Sources: Company reports, Needham & Company estimates.				

Figure 5 Netflix: Target Price Calculation - Traditional DCF, 2015E-2024E

\$ and shares in millions, except per share data			
Valuation Conclusions		% of Total	
Sum of PV of Free Cash Flow ¹	\$9,724	34%	
PV of Terminal Value Discounted at WACC ¹	\$17,574	62%	
Value of Operations (WACC Method)	\$27,298	96%	
Plus: Excess Cash at 9/30/13	\$1,135		
Plus: NPV of Tax Step Up	\$0		
Plus: Minority Interest	\$0		
Less: Unfunded Retirement Liabilities	\$0		
Enterprise Value	\$28,433	100%	
Less: Debt at 9/30/13	(\$500)		
Less: Lease Obligations	(\$150)		
Less: Preferred Stock Outstanding	\$0		
Less: Value of Options & Restricted Sk, After-tax	(\$1,110)		
Common Equity Value	\$26,673	94%	
Fully Diluted Shares Out, 2014E	63		
DCF Value/Share	\$425.07		
Current Share Price @ 10/21/13	\$354.99		
Upside Potential (DCF-Current Price/Current Price)	20%		

Standard Discounted Cash Flow (DCF) Valuation

Why We Calculate: DCF is a rigorous bottoms-up valuation of the enterprise focusing on cash flows (not accounting)

Strengths

- 1 Focuses on operations. Removes financing
- 2 Focuses on FCF. Removes non-cash accounting
- 3 Explicitly forecasts capital needs (WC & CapX)
- 3 Uses a levered beta (widely available)
- 4 Ent value focus captures entire business model

Weaknesses

- 1 Many assumptions. Valuation can be manipulated
- 2 Terminal value big & based on low visibility projections
- 3 Model assumes constant debt/equity ratio
- 4 Complex to calculate
- 5 Calculates the enterprise value first, then equity value

¹ Calculation of the Value of Operations (WACC Method)

	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E	2024E	CAGR '15-24E
FYE 12/31:												
OIBDA, after sk comp&corp	\$549	\$669	\$815	\$994	\$1,211	\$1,476	\$1,798	\$2,192	\$2,671	\$3,255	\$3,966	21.9%
- Depreciation	(\$48)	(\$60)	(\$75)	(\$75)	(\$75)	(\$75)	(\$75)	(\$75)	(\$75)	(\$75)	(\$75)	
+ Option Exercise Proceeds	\$25	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$30	
+ Int & Inv Income only	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	
EBIT	\$541	\$654	\$785	\$964	\$1,181	\$1,446	\$1,768	\$2,162	\$2,641	\$3,225	\$3,936	
Cash Taxes (at 15%)	(\$81)	(\$98)	(\$118)	(\$145)	(\$177)	(\$217)	(\$265)	(\$324)	(\$396)	(\$484)	(\$590)	
Plus: Depreciation	\$48	\$60	\$75	\$75	\$75	\$75	\$75	\$75	\$75	\$75	\$75	
Plus: Sk Based Comp Exp	\$72	\$75	\$75	\$75	\$75	\$75	\$75	\$75	\$75	\$75	\$75	
Working Capital Change	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	
Less: Capital Spending	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	
FCF from Operations	\$467	\$578	\$705	\$857	\$1,041	\$1,266	\$1,541	\$1,875	\$2,282	\$2,779	\$3,384	21.7%
PV Discounted at WACC ²		\$578	\$644	\$714	\$793	\$881	\$978	\$1,087	\$1,209	\$1,344	\$1,495	
Sum of PV of Free Cash Flow											\$9,724	
Terminal Value of 2024E FCF ³											\$39,787	
PV of Terminal Value at WACC ²											\$17,574	
Discount Period		0	1	2	3	4	5	6	7	8	9	

² Calculation of WACC: (Updated 8/20/11)

10-Year Risk Free Rate ("RFR")	2.0%
Equity Risk Premium (Ibbotson-Arithmetic)	6.0%
Levered Beta	1.53
Target Equity/(Debt + Equity)	80%
Debt Rating	BBB
Debt Spread	2.0%
Marginal Tax Rate ("T")	30.0%
WACC	9.5%
$(RFR + (Equity Risk Premium \times Beta)) \times Equity / Total Capital + ((RFR + Debt Spread) \times (1-T) \times Debt / Total Capital)$.	

³ Calculation of Terminal Multiple (WACC Method)

WACC	9.5%
Long-term Nominal GDP Growth	1.0%
WACC-GDP Growth	8.5%
FCF Terminal Multiple [1/(WACC-Growth Rate)]	11.8
EBITDA Terminal Multiple	10.0

Sources: Company Reports, Needham & Company estimates.

Figure 6 Netflix: Breakeven Discounted Cash Flow (DCF) Valuation Calculation, 2015E - 2024E

\$ and shares in millions, except per share data	
Valuation Conclusions	2014E
Sum of PV of Free Cash Flow ¹	\$9,604
PV of Terminal Value Discounted at WACC ¹	\$13,357
Value of Operations (WACC Method)	\$22,961
Plus: Excess Cash at 9/30/13	\$1,135
Plus: NPV of Tax Step Up	\$0
Plus: Minority Interest	\$0
Enterprise Value	\$24,096
Less: Debt at 9/30/13	(\$500)
Less: Lease Obligations	(\$150)
Less: Preferred Stock Outstanding	\$0
Less: Value of Options & Restricted Sk, After-t	(\$1,110)
Common Equity Value	\$22,336
Fully Diluted Shares Out, 2014E	63
Breakeven DCF Value/Share	\$355.95
Current Share Price @ 10/21/13	\$354.99
Discount to DCF Value (DCF-Current Price/D)	0%

Breakeven Discounted Cash Flow Valuation

Why We Calculate: BE DCF uses the current share price to calculate the market's growth expectations for the enterprise.

Strengths

- 1 Makes no assumption about growth for first 10 years
- 2 Prevents over-optimism by working backwards
- 3 Data widely available and model well understood
- 4 Explicitly forecasts capital needs (WC & CapX)
- 5 Uses a levered beta (widely available)

Weaknesses

- 1 Terminal value big & based on low visibility projections
- 2 Model assumes constant debt/equity ratio
- 3 Complex to calculate
- 4 Calculates the enterprise value first, then equity value

¹ Calculation of the Value of Operations (WACC Method)												Required
FYE 12/31:	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E	2024E	LT Growth Rate
Int'l OIBDA	(\$177)	(\$145)	\$221	\$62	\$52	\$181	\$217	\$261	\$313	\$376	\$451	
US OIBDA	\$848	\$1,453	\$840	\$1,147	\$1,326	\$1,388	\$1,571	\$1,776	\$2,007	\$2,268	\$2,561	
OIBDA, after sk comp&corp	\$549	\$932	\$1,062	\$1,209	\$1,378	\$1,569	\$1,788	\$2,037	\$2,320	\$2,643	\$3,011	13.9%
- Depreciat	(\$48)	(\$60)	(\$75)	(\$75)	(\$75)	(\$75)	(\$75)	(\$75)	(\$75)	(\$75)	(\$75)	
+ Option E	\$25	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$30	\$30	
+ Int & Inv	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	
EBIT	\$541	\$917	\$1,032	\$1,179	\$1,348	\$1,539	\$1,758	\$2,007	\$2,290	\$2,613	\$2,981	
Cash Taxes	(\$81)	(\$138)	(\$155)	(\$177)	(\$202)	(\$231)	(\$264)	(\$301)	(\$344)	(\$392)	(\$447)	
Plus: Depre	\$48	\$60	\$75	\$75	\$75	\$75	\$75	\$75	\$75	\$75	\$75	
Plus: Sk Ba	\$72	\$75	\$75	\$75	\$75	\$75	\$75	\$75	\$75	\$75	\$75	
Working C:	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	(\$50)	
Less: Capit:	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	(\$63)	
FCF from C	\$467	\$802	\$914	\$1,040	\$1,183	\$1,346	\$1,532	\$1,743	\$1,984	\$2,259	\$2,572	
PV Discounted at WACC		\$802	\$835	\$867	\$901	\$936	\$973	\$1,011	\$1,051	\$1,093	\$1,136	
Sum of PV of Free Cash Flow											\$9,604	
Terminal Value of 2024E FCF ³											\$30,239	
PV of Terminal Value at WACC ²											\$13,357	
Discount Period		0	1	2	3	4	5	6	7	8	9	

² Calculation of WACC: (Updated 8/20/11)

10-Year Risk Free Rate ("RFR")	2.0%
Equity Risk Premium (Ibbotson-Arithmetic)	6.0%
Levered Beta	1.53
Target Equity/(Debt + Equity)	80%
Debt Rating	BBB
Debt Spread	2.0%
Marginal Tax Rate ("T")	30.0%
WACC	9.5%
$(RFR + (Equity Risk Premium \times Beta)) \times Equity / Total Capital + ((RFR + Debt Spread) \times (1-T) \times Debt / Total Capital)$	

³ Calculation of Terminal Multiple (WACC Method)

WACC	9.5%
Long-term Nominal GDP Growth	1.0%
WACC-GDP Growth	8.5%
FCF Terminal Multiple [1/(WACC-Growth Rate)]	11.8
EBITDA Terminal Multiple	10.0

Sources: Company Reports, Needham & Company estimates.

Figure 7 Netflix: Valuation Multiples

\$ and shares in millions, except per share data	
Valuation Conclusions	2014E
Market-Based Enterprise Value ¹	\$22,901
2014E Sales (From Annual Projections)	\$5,117
EV/Sales	4.5
Market-Based Enterprise Value ¹	\$22,901
2014E OIBDA (From Annual Projections)	\$549
EV/OIBDA	41.7
Target Price	\$425.00
Target Price EV/2015 OIBDA	39.1
Current Price	10/21/13 \$354.99
2014E EPS (From Annual Projections)	\$3.96
P/E Ratio	89.7
¹ Calculation of Market-Based Enterprise Value	
Year End 12/31:	<u>2014E</u>
Current Share Price	10/21/13 \$354.99
Fully Diluted Shares Out	<u>63</u>
Market Capitalization	\$22,276
Less: Excess Cash	(\$1,135)
Plus: Debt at 6/30/13	\$500
Plus: Lease Obligations	\$150
Plus: Preferred Stock Outstanding	\$0
Plus: Options & Restricted Sk Outstanding	<u>\$1,110</u>
Market-Based Enterprise Value	\$22,901
Sources: Company Reports, Needham & Company estimates.	

Figure 8 Netflix: Free Cash Flow Valuation

\$ and shares in millions, except per share data	
Valuation Conclusions	2014E
FCF/Share ²	\$5.58
Current Price	10/21/13 \$354.99
FCF Yield	2%
FCF ²	\$350
2014E OIBDA (From Annual Projections)	\$549
FCF Conversion Rate (FCF/OIBDA)	64%
Market-Based Enterprise Value ¹	\$22,901
FCF ²	\$350
EV/FCF	65.4
Net Debt/OIBDA	(1.2)
Net Debt	(\$635)
Net Debt/Market Cap	-2.9%
² Calculation of Free Cash Flow	
Year End 12/31:	<u>2014E</u>
OIBDA	\$549
Plus: Option Exercise Proceeds	\$25
Less: Cash Interest Expense	(\$30)
Less: Preferred Dividends	\$0
Less: Operating Cash Taxes	(\$81)
Less: Change in Working Capital	(\$50)
Less: Capital Spending	<u>(\$63)</u>
Free Cash Flow	\$350
Less: Dividends	<u>\$0</u>
Free Cash Flow After Dividends	\$350
Shares Outstanding	63
FCF/Share	\$5.58
FCF/Share After Dividends	\$5.58
Sources: Company Reports, Needham & Company estimates.	

Figure 9: Laura Martin & Dan Medina Coverage List - Comparative Valuation Analysis

\$ and shares in millions, except where noted & per share data

10/18/13

		Market		Cap	Break-even	EV	EV/ '14	EV/ '14		Target	Current	Target/	
		Ticker	Rating	(\$B)	DCF	(\$B)	Sales	EBITDA	2014 P/E	Price	Price	Current	
Online Content													
1	AOL, Inc.	AOL	BUY	\$2.7	-2%	\$3	1.2	6.5	14.8	\$46	\$33.95	35%	
2	Bankrate, Inc.	RATE	BUY	\$2.3	16%	\$2	4.7	16.3	31.5	\$25	\$22.45	11%	
3	Demand Media, Inc.	DMD	HOLD	\$0.5	1%	\$1	1.2	5.7	16.0	NA	\$5.20		
4	Facebook	FB	BUY	\$136.0	16%	\$126	12.7	23.2	53.7	\$37	\$54.22	-32%	
5	Netflix	NFLX	BUY	\$22.3	14%	\$23	4.5	41.7	89.7	\$425	\$354.99	20%	
6	Pandora Media	P	BUY	\$5.9	26%	\$6	7.0	97.9	91.7	\$25	\$28.17	-11%	
7	TripAdvisor, Inc.	TRIP	BUY	\$10.1	9%	\$10	8.7	19.6	32.3	\$75	\$71.87	4%	
8	Yahoo!	YHOO	HOLD	\$34.2	11%	\$19	4.3	11.6	20.1	NA	\$33.43		
Offline Content													
9	CBS	CBS	BUY	\$36.4	7%	\$45	2.7	11.1	17.2	\$65	\$59.20	10%	
10	Discovery Communications	DISCA	HOLD	\$28.9	5%	\$34	5.6	12.5	20.9	NA	\$82.47		
11	Disney	DIS	HOLD	\$119.1	7%	\$129	2.8	10.7	17.9	NA	\$67.15		
12	Madison Square Garden	MSG	BUY	\$4.5	11%	\$5	3.2	12.9	34.1	\$70	\$57.87	21%	
13	21st Century Fox	FOXA	BUY	\$67.2	7%	\$73	2.4	10.4	20.0	\$36	\$34.26	5%	
14	Scripps Networks Interactive	SNI	BUY	\$11.2	5%	\$12	4.5	10.0	18.0	\$88	\$79.15	11%	
15	Time Warner Inc	TWX	HOLD	\$61.2	5%	\$81	2.6	10.0	16.2	NA	\$68.73		
16	Viacom	VIAB	HOLD	\$37.6	5%	\$47	3.2	10.4	15.4	NM	\$83.64		
Content-Adjacent Value Drivers													
17	Nielsen Company BV	NLSN	HOLD	\$14.6	6%	\$20	3.2	10.9	24.4	NA	\$38.44		
18	Synacor	SYNC	HOLD	\$0.1	26%	\$0.1	0.8	27.2	-35.1	NA	\$2.45		
19	Time Warner Cable	TWC	BUY	\$34.0	3%	\$57	2.6	6.7	15.4	\$135	\$118.20	14%	
			Income Statement			Balance Sheet			FCF Data				
		Revenue	EBITDA	EPS	Debt		FCF		FCF	FCF	Dividend/	Conflicts	
		2014E	2014E	2014E	Net Debt	Ratin	g	WACC	FCF	Share	Share	Div. Yield	Disclosure
1	AOL, Inc.	\$2,394	\$456	\$2.30	(\$483)	BBB-	10%	\$366	\$4.57	13%	\$0.00	-	B
2	Bankrate, Inc.	\$518	\$151	\$0.71	\$82	B	12%	\$52	\$0.50	2%	\$0.00	-	B
3	Demand Media, Inc.	\$431	\$99	\$0.33	(\$70)	B	11%	\$64	\$0.69	13%	\$0.00	-	B
4	Facebook	\$9,903	\$5,415	\$1.01	(\$10,252)	BBB	11%	\$4,552	\$1.81	3%	\$0.00	-	B,G
5	Netflix	\$5,117	\$549	\$3.96	(\$635)	BBB	10%	\$350	\$5.58	2%	\$0.00	-	B,G
6	Pandora Media	\$638	\$62	(\$0.24)	(\$69)	BBB-	10%	\$77	\$0.36	1%	\$0.00	-	B
7	TripAdvisor, Inc.	\$1,160	\$514	\$2.22	(\$36)	BBB-	10%	\$421	\$3.01	4%	\$0.00	-	B, G
8	Yahoo!	\$4,637	\$1,633	\$1.66	(\$3,215)	A-	12%	\$756	\$0.74	2%	\$0.00	-	B, G
9	CBS	\$16,656	\$4,071	\$3.45	\$8,041	BBB-	10%	\$2,935	\$4.77	8%	\$0.48	0.8%	B
10	Discovery Communications	\$6,105	\$2,762	\$3.94	\$6,153	BBB	9%	\$1,823	\$5.21	6%	\$0.00	-	B, G
11	Disney	\$47,966	\$12,062	\$3.74	\$11,071	A	9%	\$4,767	\$2.69	4%	\$0.75	1.1%	B
12	Madison Square Garden	\$1,460	\$356	\$1.70	(\$278)	BBB-	9%	(\$72)	(\$0.92)	-2%	\$0.00	-	B, G
13	21st Century Fox	\$30,378	\$7,035	\$1.47	\$11,099	BBB+	10%	\$2,419	\$1.06	3%	\$0.17	0.5%	B, G
14	Scripps Networks Interactive	\$2,683	\$1,213	\$4.39	\$1,087	BBB+	9%	\$696	\$4.93	6%	\$0.60	0.8%	B
15	Time Warner Inc	\$31,191	\$8,141	\$4.24	\$17,383	BBB	9%	\$2,979	\$3.35	5%	\$1.15	1.7%	B
16	Viacom	\$14,404	\$4,493	\$5.44	\$7,769	BBB+	9%	\$2,437	\$5.42	6%	\$1.10	1.3%	B, G
17	Nielsen Company BV	\$6,330	\$1,855	\$0.00	\$5,098	BBB-	10%	\$856	\$2.25	6%	\$0.64	1.7%	B
18	Synacor	\$115	\$3	(\$0.07)	(\$38)	B	11%	(\$5)	(\$0.14)	-6%	\$0.00	-	B,G
19	Time Warner Cable	\$23,217	\$8,548	\$7.68	\$23,494	BBB	10%	\$2,902	\$10.07	9%	\$2.60	2.2%	B

Sources: Needham research, Company documents, FirstCall, Yahoo Finance.

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Valuation (Price Target: \$425.00)

Our \$425 target price embeds a 10-year EBITDA growth rate of 21.9% annually beginning in FY14 and represents a 39.1x multiple of forward year (2015E) EBITDA. We also ran our target price of \$425 through a DCF analysis to double check the reasonableness of our assumptions. We use a WACC of 9.5% for NFLX and a long-term nominal GDP growth rate of 1%.

Potential Upside Drivers

We believe that Netflix is the best way to play global growth of broadband penetration. Broadband penetrations are growing rapidly worldwide. Each of the countries in which Netflix has launched its service are quickly growing broadband penetrations, and Netflix penetration should grow in tandem with higher broadband penetrations. In these markets, as well as in other international markets that Netflix could enter in the future, we expect broadband penetration to grow over the next decade, and Netflix to be a primary beneficiary.

Risks to Target

Risks to our Target Price include: (i) increased competition from well capitalized entrants; (ii) video-on-demand may become a more threatening competitor to Netflix as user interface improves with IP technology; (iii) subscribers ability to cancel Netflix service at any time; (iv) continued slowdown from DVD revenue; and, (v) risks with its pricing strategy.



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Rating Suspended	0	0
Restricted	0	0
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