

Netflix, Inc. (NFLX): Short @ \$96.00

Short Thesis: We reiterate our Sell rating but we are raising our Price Target from \$80.00 to \$96.00. We believe that at current valuation levels (\$138.60 as of Jan. 20), Netflix is priced to perfection. We believe the Risk/Reward is to the downside as any hint of a slowdown in subscriber net adds will cause the stock to be viewed negatively. Management’s 1Q17 subscriber guidance already points to a deceleration in subscriber growth momentum. Although Netflix’s Original Content Shows were a big hit in 2016, management may not be able to replicate the same success this year and the competition (i.e., Amazon *Prime Video* and Hulu) is not that far behind.

TABLE 1: Netflix 4Q16 Results

4Q16 Results			1Q17 Guidance			4Q16 Results			1Q17 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
0.15	0.13	beat	0.37	0.18	beat	2.478B	2.468B	in-line	2.516B	2.608B	miss

Source: Netflix, Inc. and Estimize.com

I. Tepid Subscriber Growth Despite Overall Beat

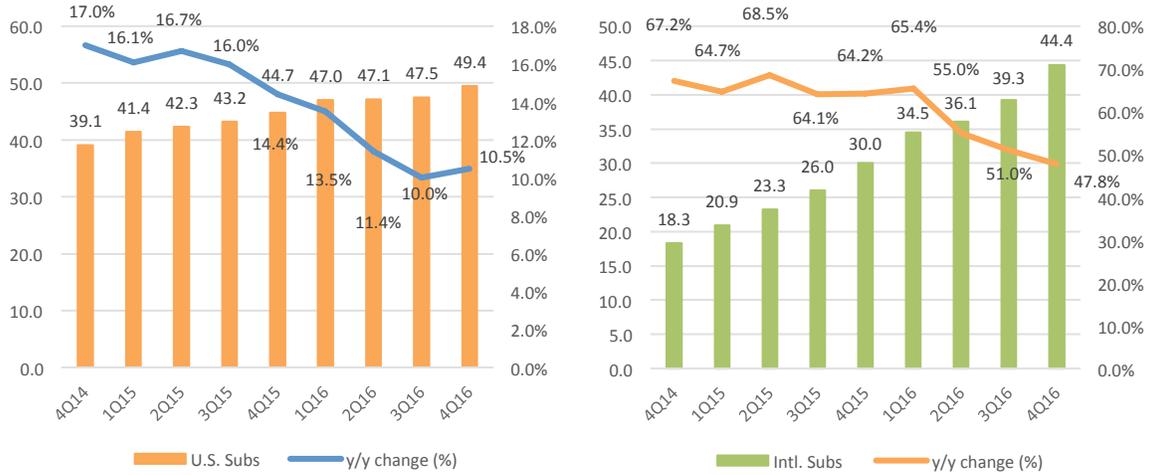
Netflix reported 4Q16 subscriber net add numbers that beat both Street estimates as well as its own guidance. The only miss was 1Q17 U.S. subscriber growth guidance which came in below Street estimates:

- 4Q16 U.S. subscriber growth (net additions): 1.93M vs. Street forecast of 1.38M and Netflix’s own guidance of 1.45M
- 4Q16 international subscriber growth (net additions): 5.12M vs. Street forecast of 3.78M and Netflix’s own guidance of 3.75M
- 1Q17 U.S. subscriber growth guidance: 1.5M vs. Street forecast of 1.72M
- 1Q17 international subscriber growth guidance: 3.7M vs. Street forecast of 3.5M

Netflix credited the success of last quarter’s total subscriber growth to the popularity of its original content programming and stated that it planned on spending \$6B on content in 2017, up from \$5B in 2016. Moreover, the company also stated that it will continue to invest in local content programming with a focus on local content that travels pan-regionally or across multiple territories, such as Japanese anime and Turkish dramas. One such example was the success of “3%,” the Brazilian post-apocalyptic sci-fi series which played well throughout Latin America as well as in the U.S. where millions of domestic members watched the show dubbed and subtitled in English.

Despite the overall beat in 4Q16 subscriber growth numbers for both U.S. and international, Netflix’s y/y subscriber growth continues to remain tepid (see Figure 1).

FIGURE 1: Subscriber Growth: U.S. (left) vs. International (right) – both Million, % Growth



Source: Netflix, Inc.

Netflix added 1.9M new U.S. subs for 4Q16 growing its domestic subscriber base from 47.5M in 3Q16 to 49.4M subscribers in 4Q16 (see Figure 1 left). Sequentially, that amounted to a marginal 50 bps increase from 3Q16 to 4Q16, which is not enough to stem the slowdown in quarterly growth since 4Q14. Netflix’s next quarter forecast for U.S. sub growth in 1Q17 is ~50.93M, an increase of ~8.4% y/y which points to further deceleration in domestic subscriber growth momentum.

International subscriber base has seen rapid growth since 4Q14. For 2015, international subscriber base grew an average of 65.4% y/y. For 2016, international subscribers grew an average of 54.8% y/y. However, the growth curve has peaked at 65.4% y/y in 1Q16 and has since been decelerating steadily (see Figure 1 right). For next quarter, Netflix is projecting international subscribers to reach 48.07M, an increase of 39.2% y/y but down sequentially by 860 bps from 4Q16 growth rate of 47.8% y/y.

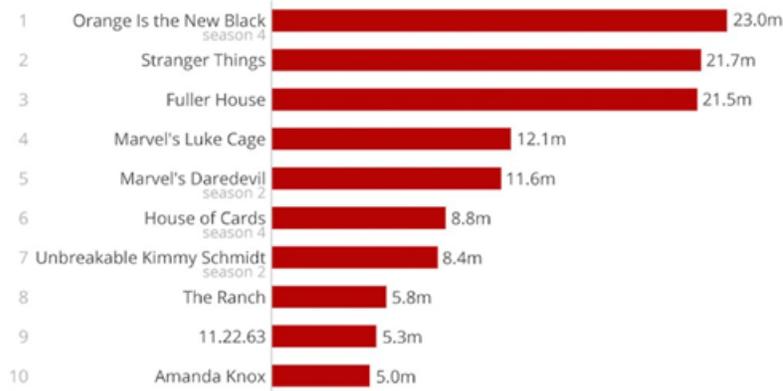
II. Netflix’s Original Content Shows Dominated in 2016; but Competition (i.e., Amazon) is Not Far Behind

Netflix pointed to the popularity of its original content programming as the driver for new subscriber growth in 4Q16. The company announced that it is set to release 1,000 hours of original TV shows and movies in 2017, which equals to ~41 straight days of TV binge-watching for the avid Netflix viewer.

Although Netflix, Amazon and Hulu do not release viewership numbers for individual shows, new data from *Symphony Advanced Media* (which uses its own independent technology to track viewership), indicates that Netflix’s original shows took nine out of the Top 10 spots for the most watched streaming shows in 2016 (see Figure 2). *SymphonyAM’s* data is based on engagement during the first 35 days of the show’s release in the U.S. Based on Figure 2, Hulu’s “11.22.63” was the only non-Netflix show in the Top 10 Category.

Netflix has stated that it can use its data and algorithms to make better programming decisions. Which means that it already knows a viewer would like “Stranger Things” before he or she watched the show, based on all the ‘80s nostalgia stored in their viewing behavior.

FIGURE 2: Most Popular Original Streaming Shows of 2016 (Million Viewers)

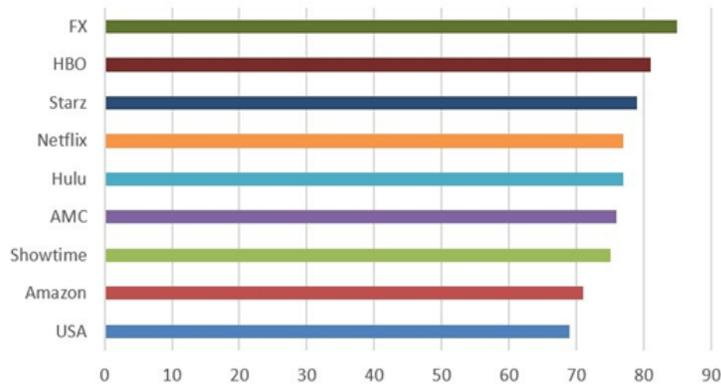


Furthermore, Netflix's original shows have also won critical acclaim from the TV industry. It recently won two of the best drama series Golden Globe nominations for "The Crown" and "Stranger Things" along with six nominations overall.

Source: Symphony Advanced Media and Business Insider 1/10/17

But how do other networks and content providers stack up against Netflix in terms of the quality of their own original content programming? Figure 3 below shows the average ratings of original series by content provider based on the data collected by streaming blog *Cut Cable Today*. The chart shows which cable networks and streaming service provider produced the best original shows based on ratings from *Metacritic* and *Rotten Tomatoes*.

FIGURE 3: Average Ratings of Original Series by Content Provider



On average, FX and HBO came ahead of Netflix (with a score of 85 and 81 respectively), roughly in line with this year's Golden Globe awards. Starz came in third with a score of 79 and Netflix came in fourth with a score of 77 (see Figure 3). Hulu also scored a 77 but this may not be accurate since half of their original shows were not rated by *Rotten Tomatoes* or *Metacritic*. Amazon also did well with a score of 71.

Source: Cut Cable Today (Streaming blog) and Business Insider 12/15/16

The key takeaway in Figure 3 is that despite Netflix's claim of overall success with original content programming in 2016, it does not have a competitive edge in this category. Figure 3 shows that other networks and content providers are also capable of producing the same high quality original content hit shows that Netflix produces. We consider Amazon as a major threat to Netflix, given that Amazon *Prime Video's* business model and price points are comparable to Netflix. Moreover, Amazon is not far behind Netflix in terms of average rating of original content.

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