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The APTV Battle Line. Netflix Versus Disney S1 E1

Opportunity Derived from Strategy, Data and Precision

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Forward

APTV Battle Line is a white paper series discussing media opportunities. To be clear. I have a short position (Puts) in Netflix shares and will benefit if the price declines. I intend to hold part if not all the position until the options expire in September. On any given day, I have limit orders to expand or cut my position. If the stock declines >10% in the very near-term readers should assume I will cut my risk by as much as 75%. While I think Netflix shares decline from these high valuation levels, I have the upmost respect for Netflix's management and the Enterprise's ability to provide a loved trilling service at a price the average person can afford.

Personally, I do not like short research attempting to impair management or organizations. Managers make decisions for many different reasons and there is no computer known to humankind that can predict the future with clarity. I assume managers make decision to maximize the benefit to long term stakeholders. However, every decision an enterprise makes has risks and rewards. Sometimes even if good research is wrong it has value and contributes to the overall fact set available to investors.

Analysts and Investors are not reporters, we forecast the future based on the facts we have today. In some cases, like a Government Bond the fundamentals are known and the cash flows are certain. In the case of a "Steady Eddie" business many of the fundamentals are known and the cash flows can be forecasted in a narrow range. In the case of high growth disruptive consumer direct enterprises, all investors can know is these businesses are miss priced -defined as an asset with greater or lower risk than its return would imply. These assets can have A) little relative risk and low returns, B) high risk and high returns, C) low relative risk and high returns or D) excessive risk and low returns. The challenge is we do not know of a Company like Netflix is under or overpriced. Thus, good rational analysts could derive a $300 price target or a $60 target and each could have pure and valid reasons for their diverse conclusions.

The purpose of this white paper and follow on white papers is to provide insights on the APTV Market and the recent developments between industry competitors such as The Walt Disney Company, AMC Networks, Time Warner, CBS and Netflix which represent different Strategies in the marketing and distribution of APTV content.

APTV: or AP TV is catch all term TenXResearch uses to describe digital video content distributed as A La Carte OTT, SVOD Subscriptions, TVE Aps, Skinny Bundles, AD ONs, Digital Download, and VMPVD services. While HULU TV is different than HBO Now the nuance in inconsequential, TV even if it's an Ap on a Mobile Device is TV to the consumer.
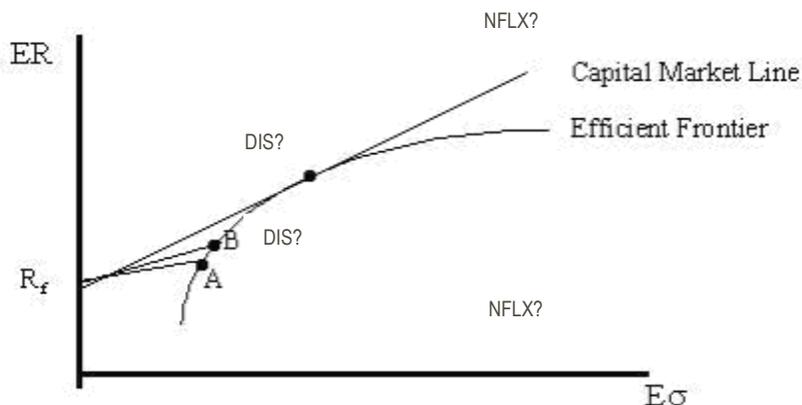

Image Source: CF Institute, The question; given the level of volatility of returns is Netflix less efficient today than other investments. If so do investors benefit from the inefficiency?

Introduction

On August 8, 2017 after the market close The Walt Disney Company CEO (DIS, NC) cancelled its deal to provide Disney first window exclusive content and movies to Netflix (NFLX UW). CEO Bob Iger's reason for announcing and pulling its content is a planned new service being launched in 2018/19.

We think it is important to note that the relationship between DIS and NFLX is complex and covers more than the content discussed on the earnings call. Several box office franchises are covered by the announcement such as Toy Story, Frozen and Lion King. Each of these franchises has generated over $1 billion in aggregate revenue from rights and box office for DIS. At the time, the original deal was announced in 2012 the deal covered theatrical movies, direct released movies and TV content. Over time the relationship expanded to include more Pixar, Marvel, and LucasFilms content which are also controlled by The Walt Disney Company. In addition to the traditional content syndication deals Disney also produces Marvel Comics based Original series for Netflix including Luke Cage, Dare Devil, Iron Fist and Jessica Jones. In separate agreements, other Disney platforms such as ABC and ESPN also sell content to Netflix in North America and International Markets.

Deal Assumptions

- Today we assume all theatrical Disney and Pixar content is not available in the first window after December 2018.
- The NY Post and other media outlets have reported that 30% of Netflix viewership is Disney content. The estimate sounds high and with an 80% probability the percentage is likely over 20%.
- The cancelled content does not include: Marvel Produced Netflix Originals, Marvel Theatrical Content, ABC, and ESPN, and Lucasfilms Theatrical and TV content including live action, animated and documentary content.
- Netflix and Disney are in negotiations to extend the non-Disney Pixar relationship including the rights for additional seasons for Marvel and Lucasfilms content.
- According to Disney's SEC filings the total content catalog includes approximately 1,400 active produced and acquired titles, including 1,000 live-action titles and 400 animated titles, in the domestic home entertainment marketplace and approximately 2,500 active produced and acquired titles, including 1,900 live-action titles and 600 animated titles, in the international marketplace, roughly 4000 titles.
- We estimate roughly 90% of the catalog is covered in the Netflix Disney/Pixar deal.
- According to all AlFlix Netflix had over 8000 movies and shows available to subscribers on the service in 2014, today the estimate is roughly 4000.
- Not all of Disney's content is on Netflix contemporaneously, we estimate that at any given time 5% to 10% of the titles on Netflix are licensed from Disney and a lower percentage is covered under the deal.
- We assign a 60% probability Disney will seek to cancel Marvel Theatrical Content on Netflix
- We assign an 80% probability Disney will see to cancel Lucasfilms theatrical content on Netflix.
- We assign a 20% probability Disney will seek to cancel Marvel Original Series on Netflix.
- We assign an 80% probability Netflix will seek to cancel first window ABC TV content on Netflix.

    So, from our perspective the Netflix deal covers about 400 hours of content, total Disney content (including Marvel and Lucasfilms) costs Netflix about $600 million annually. We assume the Disney is "take and pay" and Netflix spends between $300 and $400 million annually on the Disney/Pixar deal.

    Thus about 10% of Netflix content spend is on Disney content and roughly 8% is on the deal we know is getting cancelled.

Disney Licensing and Netflix

Unless stated otherwise most if not all content in the Netflix deal is second run and covered under the 2nd Run example below. If Disney or Netflix also pull Netflix Originals in addition to 2Nd Run Disney Deal content, the ramifications make the Disney versus Netflix battle lines more complex.

In a worst case, the lost Disney top line sales from Netflix expands by roughly 50% to about $600 million from $400 million, Netflix losses rights to content potentially on a global basis. Both Companies would have to write down content investments and it is likely Netflix writes down Disney Marvel content if Marvel series are cancelled. Marvel has a limited streaming history as compared to the 50-year-old syndicated TV market and given the small sample set auditor estimates could be volatile. Netflix has more than 80 licensed Originals, Documentaries and Comedy Shows and all could also face expanded scrutiny in a worst case.

Examples.

Type of content	Netflix Originals		2nd Run movies & TV shows
	Self-produced	Licensed	Licensed
Examples	*Stranger Things, The OA, Dave Chappelle, Ingobernable, Ridiculous 6, Santa Clarita Diet, 3%, A Series of Unfortunate Events*	*House of Cards* (MRC), *Orange is the New Black* (Lionsgate), *Iron Fist* (Marvel), *Narcos* (Gaumont), *Bloodline* (Sony)	*Shameless* (Showtime), *How to Get Away with Murder* (ABC), *Friends* (Warner Bros.), *Captain America: Civil War* (Disney)

We do not have specifics on the Disney Deal but we do have estimates.

In 2014, WikiLeaks Twitter Furor was not about Donald Trump and the Russians. It was about North Korea and Sony Pictures, like OJ they never found the real hackers to our knowledge. *Personally, I believe the Sony hack was initiated by two disgruntled SNAP Inc. engineers who were fired weeks before the hack, the reason – one of the oldest, revenge- the Sony Pictures CEO has a vested interest in SNAP INC.*

Thousands and thousands of documents were hacked and posted on Wikileaks. Moreover, the hack is searchable if you know what you are looking for in the database. *When I come across sensitive information or reason to believe systems are vulnerable due to this "North Korean" hack I notify the principles and the authorities. I am looking for unique public information that can help with investment insights due to the Wikileaks transparency.* Note several of the principles in the SONY hack do show up in the "Russia Elections Hack" so to speculate: Putin hacked Sony to subvert Seth Rogan's career and put his thumb on the scale for Jonah Hill (Satire).

What does hacking have to do with Netflix and Disney Content? Available on Wikileaks are Slide Decks used to support meetings between SONY executives (who at the time were negotiating a similar output deal as DISNEY with Netflix). In the decks Sony and Netflix employ an unnamed sell side analyst/s to model the Disney Deal.

Source: Sony Pictures

Sony Hack Slide below:

Since 2013 Netflix has outperformed internal projections on a subscriber basis but has underperformed the SONY/Netflix Model on a pricing basis under some assumptions. Overall, excluding content spending on other deals and Netflix Originals Netflix is ahead of the projections below. Including the new spending, high stock price and international, TenXresearch thinks Netflix is in a different position (operating from market leadership) than it was in 2013. The financial position at Netflix is less risky than Sony Modeled but more complex as the Netflix Balance sheet is at greater scale in 2017 than forecasted. In 2013, Netflix's content spend and liabilities were $600 million and $4 billion respectively versus $6 billion and $16 billion today.

Netflix will need to continue to either grow faster than US Broadband households due to Word of Mouth, more/better/exclusive content available, better user experience etc. or increase its monthly price per subscriber, or some combination of both. SPE's preliminary view is in agreement with equity research analysts that Netflix will need to pull a combination of levers in order to meet its content payment obligations. The growth assumptions do not appear out-of-reach but carry a significant risk

- Per the analysis below, at $7.99, paid US subs need to grow at a CAGR of 12.4% from $25.1mm for 2012E to 45.0mm in 2017E. This would imply an increase in U.S. Broadband Households penetration from 28.6% in 2012E to 42.5% in 2017E

Sensitivity: Break Even Analyses at $7.99 Constant Price and Varying Subs Growth

2017E Incremental EBIT Required to Break Even — 2013E - 2017E Sub Growth

		0.0%	2.0%	4.0%	6.0%	8.0%	10.0%
2017E Disney Deal	$300.0	($1,611.3)	($1,361.3)	($1,090.9)	($798.8)	($483.8)	($144.7)
	$325.0	($1,636.3)	($1,386.3)	($1,115.9)	($823.8)	($508.8)	($169.7)
	$350.0	($1,661.3)	($1,411.3)	($1,140.9)	($848.8)	($533.8)	($194.7)
2017E Disney & SPE Deals	$575.0	($1,886.3)	($1,636.3)	($1,365.9)	($1,073.8)	($758.8)	($419.7)
	$600.0	($1,911.3)	($1,661.3)	($1,390.9)	($1,098.8)	($783.8)	($444.7)
	$625.0	($1,936.3)	($1,686.3)	($1,415.9)	($1,123.8)	($808.8)	($469.7)
	$650.0	($1,961.3)	($1,711.3)	($1,440.9)	($1,148.8)	($833.8)	($494.7)

2017E Incremental Subs Required to Break Even — 2013E - 2017E Sub Growth

		0%	2.0%	4.0%	6.0%	8.0%	10.0%
2017E Disney Deal	$300.0	16.8	14.2	11.4	8.3	5.0	1.5
	$325.0	17.1	14.5	11.6	8.6	5.3	1.8
	$350.0	17.3	14.7	11.9	8.9	5.6	2.0
2017E Disney & SPE Deals	$575.0	19.7	17.1	14.2	11.2	7.9	4.4
	$600.0	19.9	17.3	14.5	11.5	8.2	4.6
	$625.0	20.2	17.6	14.8	11.7	8.4	4.9
	$650.0	20.5	17.8	15.0	12.0	8.7	5.2

2017E Additional Subs vs. Today (25.1mm subs)

		Subs
2017E Disney Deal	$300.0	16.8
	$325.0	17.1
	$350.0	17.3
2017E Disney & SPE Deals	$575.0	19.7
	$600.0	19.9
	$625.0	20.2
	$650.0	20.5

2017E Total Subs

		Subs
2017E Disney Deal	$300.0	41.9
	$325.0	42.1
	$350.0	42.4
2017E Disney & SPE Deals	$575.0	44.7
	$600.0	45.0
	$625.0	45.3
	$650.0	45.5

2012E-2017E Expected CAGR of Total Subs to Break Even

		Subs
2017E Disney Deal	$300.0	10.8%
	$325.0	10.9%
	$350.0	11.1%
2017E Disney & SPE Deals	$575.0	12.3%
	$600.0	12.4%
	$625.0	12.5%
	$650.0	12.7%

2017E Broadband Household Penetration

		Subs
2017E Disney Deal	$300.0	39.6%
	$325.0	39.8%
	$350.0	40.0%
2017E Disney & SPE Deals	$575.0	42.3%
	$600.0	42.5%
	$625.0	42.8%
	$650.0	43.0%

- Per the analysis below, if subs remain flat at 25.1mm over the projection period, price points of $12.57 per US sub per month in 2016E and $14.35 in 2017E would be needed to break even

- If subs grow at 4.0% CAGR in line with analyst projections for increases in U.S. broadband households, a price point of $11.79 in 2017E would be needed to break even

2017E Incremental (over $7.99) Monthly Fee per Sub Required to Break Even — 2013E - 2017E Sub Growth

		0%	2.0%	4.0%	6.0%	8.0%	10.0%
2017E Disney Deal	$300.0	$5.36	$4.10	$2.98	$1.99	$1.10	$0.30
	$325.0	$5.44	$4.18	$3.05	$2.05	$1.15	$0.35
	$350.0	$5.53	$4.25	$3.12	$2.11	$1.21	$0.40
2017E Disney & SPE Deals	$575.0	$6.27	$4.93	$3.73	$2.67	$1.72	$0.87
	$600.0	$6.36	$5.00	$3.80	$2.73	$1.77	$0.92
	$625.0	$6.44	$5.08	$3.87	$2.79	$1.83	$0.97
	$650.0	$6.52	$5.16	$3.94	$2.86	$1.89	$1.02

2017E Total Monthly Fee per Sub Required to Break Even — 2013E - 2017E Sub Growth

		0%	2.0%	4.0%	6.0%	8.0%	10.0%
2017E Disney Deal	$300.0	$13.35	$12.09	$10.97	$9.98	$9.09	$8.29
	$325.0	$13.43	$12.17	$11.04	$10.04	$9.14	$8.34
	$350.0	$13.52	$12.24	$11.11	$10.10	$9.20	$8.39
2017E Disney & SPE Deals	$575.0	$14.26	$12.92	$11.72	$10.66	$9.71	$8.86
	$600.0	$14.35	$12.99	$11.79	$10.72	$9.76	$8.91
	$625.0	$14.43	$13.07	$11.86	$10.78	$9.82	$8.96
	$650.0	$14.51	$13.15	$11.93	$10.85	$9.88	$9.01

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Source: Company Reports and Wikileaks

Sony's 2013 opinion of Netflix Disney Risk

Investors should asses the motives behind Disney cancelling the Netflix deal and the many possible reasons. We rank our scenarios from most likely to less likely. 1) Disney seeks to maximize the value of its catalog and following the Bam Tech acquisition the content has greater value if Disney goes direct to the consumer. 2) The cable ecosystem has collapsed under its own weight and faulty industrial logic. 3) The Golden Age of TV is a bubble. After the burst, movies on APTV will have more value per hour than TV Originals thus an output deal structured as a loss leader to sell Originals to Netflix makes no sense if Netflix is cancelling expensive Licensed Originals and favoring Netflix Owned content over Marvel Content (see MillarWorld transaction) and 5) Its 2017 and now Disney is concerned about getting paid.

Other Considerations

- **Risks:** 1) further increasing content costs, 2) potential new competitors in the company's streaming business, 3) execution challenges and competition potentially limiting growth in new markets, 4) the possibility of ISPs to look to recoup higher rents for Netflix's high bandwidth requirements for streaming, 5) subscriber price inelasticity risk if price hike is to take place, 6) higher than expected churn

- **Opportunities:** 1) content costs rising slower than expected, 2) total subscriber growth is faster than expected, 3) Netflix repairs public image and regains lost customer loyalty, 4) Netflix gets acquired, 5) Netflix develops successful original content and establishes itself as a head-to-head competitor of traditional PayTV networks (5 originals expected to be released in 2013), 6) Netflix has churned off subs of ~17mm in FYE 2011 and is expected to have churn off subs of ~19mm by 4Q13. If these subs are added to the current US subs of 25.1mm, Netflix would have or have already gone through ~ 50% of total US broadband households, a possible but unlikely penetration scenario

- **Additional Financing:** It is unlikely that Netflix will be able to raise a substantial amount of debt or equity in 2017 to finance programming spend given its on and off balance sheet liabilities and assuming similar to the current capital structure
    - If we assume 4% annual subscriber growth and $600mm of additional combined programming spend in 2017 for the Sony and Disney deals, the additional EBIT required to break even of $1.4bn would imply an equity dilution of 22.6%(1) if shortage financed through new equity, a very unlikely scenario
    - Netflix has limited capacity to raise additional debt. Although the company has only $400mm of debt (2.7x Debt/EBITDA), it has significant on and off balance sheet liabilities. Netflix has (i) $4bn of on balance sheet content liabilities and an additional $5bn of off balance sheet liabilities (commitments to studios). As studios will need to get paid prior to debtholders and shareholders in the event of default/liquidation, the $9bn of priority studio commitments makes a significant new debt offering unlikely

(1) Based on $4.8bn current market capitalization

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Source: Company Reports and Wikileaks

What is take and pay?

Take or pay (T/P) covers many media SVOD deals. T/P basically is the business practice of paying a minimum guarantee for content which covers a catalog and new titles when they are available. For example, under the old STARZ deal with Lucasfilms when The Force Awakens was available STARZ had the option of taking the film and paying $19 million (applying the take towards its $230 million annual minimum) or not taking the film and applying the minimum to other titles in the catalog. Many variations will apply to a specific agreement but this is a simple explanation of how it works.

The CFA says "Under a take or pay contract, the purchaser firm commits to a supplier to buy a minimum quantity of an input over a predefined period. In order to properly reflect the nature of these commitments, an analyst should compute the present value of these debt obligations, and this value should be added to the Company's longterm assets and debt values to assess the Company's Debt value" -CFA Institute study materials.

NFLX does not provide a table of its take and pay Disney contracts. However, the Company does provide a table of all its deals with Hollywood. I have stated many times in the past Netflix is highly levered owing to its off-model content liabilities now at roughly $16 billion total. This liability is the reason why despite a 4x expansion in revenue since 2013 Netflix earnings and Free Cash Flow are down. (Yeah Yeah Yeah they are investing……)

To properly value Netflix we think investors should add back the content liabilities to Enterprise Value treating the net liability like debt. Thus, while the NFLX market cap is about $75 Billion its Enterprise Value is $95 billion including debt and content liabilities. In other words, an investor cannot and must not simply look at NFLX shares and apply a takeover premium to the Market CAP or the Enterprise Value as it is normally defined. The would-be acquirer analyzes the off-model liability that is not included in either the EV or MCAP calculation. Thus, a rational strategic partner after conducting due diligence will include a portion of the liability when determining the price paid for Netflix.

Hypothetically, how a deal may look in the board room:

1. Disney looks to acquire Netflix for $100 billion in January of 2017.

2. The deal valued at price is derived after due diligence. Disney concludes it can pay $100 Billion = $73 billion (MCAP)+$16 billion (Content)+$4 billion (Debt)-$2 billion (Cash)+$9 billion (Premium).

3. Thus, investors should not 100% expect a $51 premium in a Netflix takeover as the bulls have suggested. It is a roughly $20 premium if you fair value the company at $100 billion and include the liability in enterprise value according to best practices.

4. If Disney's valued at price is lower (let's say $60 billion) shareholders get hurt. The liability is a constant in the short term and the impact of the liability on fair value is worse. For example, if Disney values Netflix at $60 billion. At a $60 billion deal price DIS pays $93 a share for Netflix in a take under and not $144 dollars in the above scenario in January.

Recently, Reed Hastings the Netflix CEO said "We have a strong financial position because our debt to market cap ratio is favorable." The statement was both correct and incorrect, linking a company's financial position with its ability to tap equity markets is procyclical, Lehman Brothers operated under similar assumptions.

In a Bull Market when revenue growth is robust Mr. Hastings is correct he can raise equity tomorrow with minimal dilution in price or earnings. However, in the long term if revenue flattens or the capital markets are less liquid the market may be closed to Netflix. I am not implying the company is doing anything wrong but investors need to fully understand a risk that until recently has been over looked in Netflix shares. Mr. JP Morgan once said "Never visit your banker with hat in hand." This is the reason why, levered companies cannot raise capital on good terms when they "need" the capital. A metric like a strong Debt to Market Cap only applies if Netflix issues a secondary offering soon.

See Below: According to Netflix:

Streaming content accounting standards.

We use two accounting standards for our streaming content costs. Since we launched streaming in 2007, we have used the guidance of **ASC 920: Entertainment - Broadcasting** because we started the streaming service with content that we license (rather than own).

- We license both Netflix originals (such as *House of Cards* and *Orange is the New Black*) as well as 2nd run titles, such as *Shameless* and *How to Get Away with Murder*

Beginning in 2016, we now apply the guidance of **ASC 926: Entertainment - Films** for the original content that we self-produce and where we own the intellectual property.

- We believe the benefits of self-producing content include lower costs (no studio middle-man), ownership of the intellectual property, which allows us to potentially monetize in different ways (eg, licensing & merchandising) and greater rights flexibility (global rights, exclusivity)

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Basically, what Netflix is saying in the above is it expenses content in two different ways. One way for licensed deals and another way for self-produced Originals. The difference is based on who owns the content, how long the content is controlled and duration of the cash flows generated by a title.

Most Netflix content is controlled for a period exceeding a year and even when 2nd run contracts expire in many cases they are renewed or replaced with deals for Licensed Netflix Originals or cherry-picked content where Netflix has more control over the titles in the deal. Generally, since the old Netflix deals were done when Netflix had less subscribers new content deals have substantial escalations.

Netflixing: Most users and some investors do not fully appreciate Netflix Content suppliers and assume if they never heard of the title it must be a Netflix Original (we call the loss of brand recognition Netflixing and even reporters on TV do it all the time).

Netflixing is less prevalent today as compared to 2015 but in TenXresearch channel checks and focus groups users will still frequently associate a show such as Under the Dome or New Girl as a Netflix Original. These are cases where the content becomes associated with the Netflix brand as opposed to the original broadcaster brand.

In extreme cases, Netflix will overtly revive a popular licensed Original such as Full House or Gilmore Girls to capture audience and associate the entire series with the Netflix brand.

Amortization methodology.

- The amortization schedule for content is based on historical and estimated viewing patterns and reviewed quarterly

- The vast majority of our content library is **amortized on an accelerated basis**

- Content assets are amortized over the shorter of the title's window of availability or maximum useful life (amortization period is 6 months to 5 years on average and never more than 10 years)

- **90%+ of amortization occurs within the first four years** of being available onsite for original TV series and films.

- First run topical programming like talk shows are expensed upon airing

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Expense Capitalization at Netflix

At TenXResearch, we philosophically believe all assets are expenses to be recognized over the long term. For example, when Tesla buys aluminum to make its cars it buys a raw material asset and when it manufactures a Model S the Company the company moves metal from inventory to cost of goods sold and generates an expense plus the associated net income or a loss and cash. When Tesla designs a piece of software (an IP Asset) before the model is produced it creates an amortizable asset and when the car goes into production the asset is then expensed more aggressively.

Some TV content is evergreen. For example, when Star Trek was first produced in the 1960's the cost per episode was roughly $125K. About 25 years later at the peak in the syndication market, Star Trek generated about $260K per episode even though book value of the assets was nearly zero. Hypothetically, if an episode of Star Trek was sold every year in syndication for $100K the life time revenue of Star Trek's 72 episodes in the syndication market is $2.8 billion. The cost to produce the 72 episodes which generated the $2.8 billion -approximately $9m. For every Star Trek there are dozens of Originals like "The Partners" the show that replaced Star Trek in 1971. (Some people reading this report have parents born around 1971 and Star Trek still makes money).

The decision to amortize content on a straight line or accelerated basis is not really a concern to investors today. In this new APTV world if amortization was very conservative then we would argue the EPS, EBITDA and FCF would not be exactly equal but in the same ballpark reflecting what Netflix calls contribution margin which apparently does not contribute much to Netflix earnings or FCF.

Netflix
Six Months Ending
June 30, 2017

EPS $0.55

($2.31) FCF

($3.97) EBITDA
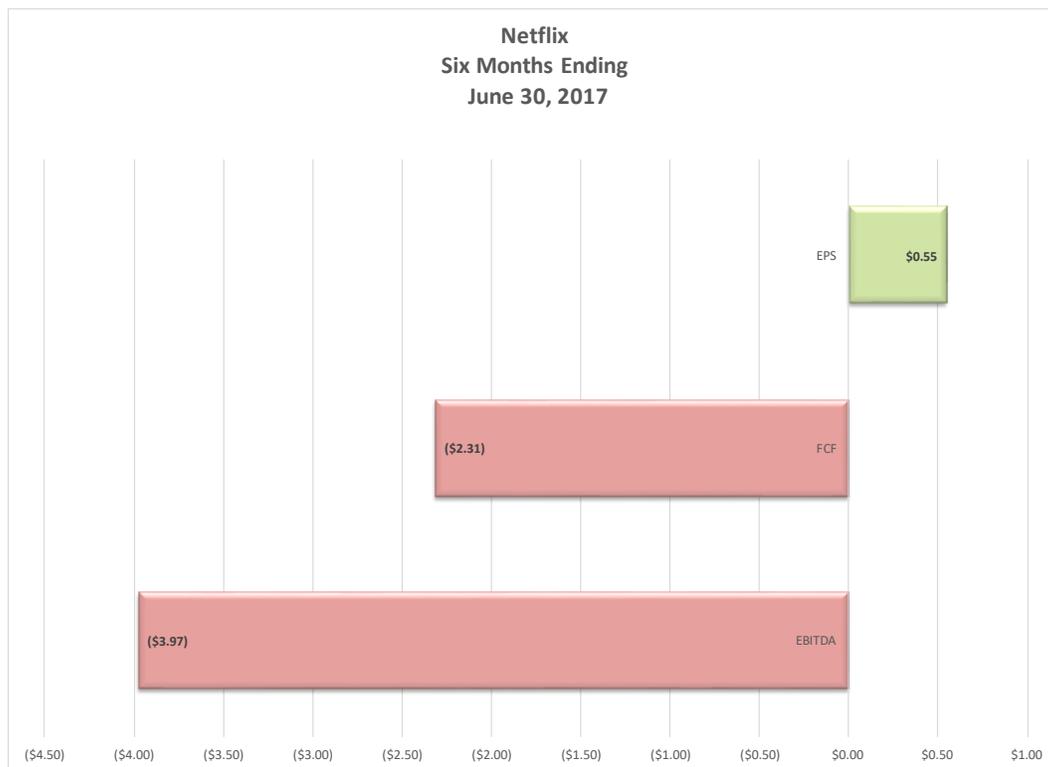
Source: TenXResearch.com and Company Reports

Investor questions about straight line (less conservative and less tax efficient) and accelerated (more tax efficient and conservative) should be secondary. The primary question should be about duration or the period in which content is being amortized. In an environment when the consumer manages her TV schedule and may binge watch 4 seasons (4 years' worth of content in the linear world) in a month duration matters because the subscriber is consuming a cost of goods sold. Several factors are not discussed when it concerns Netflix's Content expenditures and capitalizations. Among the factors are churn, and viewership and Netflix does not provide data but if it amortizes the assets and the consumption pattern is accelerated Netflix may have to adjust its footnotes and financial statements. Consumption versus the linear model goes from years to days. Based on churn, the amortization needs to be accelerated from years to days to match consumption if the Content is not evergreen in on the self-scheduled APTV platform.

If the consumer is not churning out of the Netflix service or if the churned subscribers are replaced by net new cohort subs then the growth of Netflix Content costs in the near term are matching duration with usage growth. However, if the subs churn out or if net additions flatten then the liability and the amortization come into play. The logic is if Netflix does not have to replace the $5 billion in content assets and can match the viewers to the life of the assets. Netflix will be fine and generate EPS, EBITDA and FCF if subs in the US grow.

However, if Netflix over bought and is amortizing costs over 4 years that should be expensed over fewer quarters then Netflix's current FCF, and EBITDA reflect Netflix's long term financial model and losses are secular. In other words, the Netflix Income statement is attractive and Cash Flow Statement Netflix is a disaster. In the first scenario Netflix is buying ever green assets and in the second scenario Netflix is expensing short term costs like long term assets, the liability builds and Enterprise value is transferred from the equity to holder to the debt or liability holders as Netflix needs liquidity to pay its bills.

If investors believe Netflix Content expenses are not evergreen then investors need to model Netflix using a cost waterfall cohort model and not a leverage model. The use of leverage models is one reason why analysts said in 2013 Netflix would make approximately $2.50 to $3.00 a share in 2017 yet TTM earnings are $0.99 per share despite 10 million more US Subs and 50 million more international subs then most analysts modeled in 2013. So far there is no leverage in the Netflix Model and a rational investor could argue the model is past the point of economies of scale.

1H17A	
Operating Income	$384,749
+Content Purchases	(5,013,087)
+Content Amortization	2,856,477
EBITDA	(1,771,861)
EBITDA Per Share	($3.97)
FCF Per Share*	(1,030,967)
FCF per share	($2.31)
EPS	$0.55
*Company Measure	

Source: TenXResearch.com and Company Reports

*FCF is a Company defined measure

TenXResearch calculates EBITDA as Operating Income excluding net additions to streaming content assets, Interest and Tax expenses.

Over a Barrel versus an Operating Leverage Gold Mine

Today Netflix is at an inflection point. Either Netflix cuts costs, generates followup hits to House of Cards, Orange is the New Black, and Narcos or the $10 billion they spent over the last few years is a sunk cost going over Niagara Falls. In a best-case scenario pulling the Disney Deal saves Netflix about $400 million annually or roughly $1 million per programming hour. Replacing the hours will not be cheap, $1 million for Disney content compares to $8 million spent on Sense8, $13 million spent on The Crown and $6 million spent on Orange is the New Black per programming hour. This comparison is one reason why we like CBS and its strategy. https://www.cnbc.com/video/2017/08/07/cbs-beat-revenues-but-still-flat-point-views-david-dietze.html

If Netflix has modeled a conservative case scenario the Disney Deal when the cancellation is recognized should reduce the content liability to by $1.2 to $1.8 billion or a little over 10%. Replacing the content is a big wildcard. Disney content is a known element in the syndication market but new Netflix Originals even with Netflix's big data advantage are no guarantee of success. Netflix may have to spend $2 to $4 billion annually to replace the viewed programming hours it lost owing to Disney. The opportunity for Netflix is getting by without spending the savings. If Netflix's current catalog, supplemented by new follow on programming, does better than cancelled Originals like Sense 8 or Bloodline Netflix has a shot and the content budget is being spent on evergreen assets. If the hit ratio does not improve Netflix fails.

Streaming Content Obligations.

Streaming content obligations include amounts related to the acquisition, licensing and production of streaming content. An obligation for the production of content includes non-cancelable commitments under creative talent and employment agreements. An obligation for the acquisition and licensing of content is incurred at the time we enter into an agreement to obtain future titles. Those that are not reflected on the balance sheet do not yet meet asset recognition criteria (see **slide 9**)

- Either will never meet asset recognition criteria because cost per title unknown or
- Cost per title is known but titles are not yet available for showing
- These obligations reflect content costs that will be recorded to the income statement in the future once the 3 criteria for ASC 920 are met
- ESPN and Fox have similar obligations related to their sports programming commitments

Contractual obligations (in thousands):	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Streaming content obligations (1)	$ 15,290,134	$ 6,599,754	$ 6,939,847	$ 1,562,941	$ 187,592

Payments due by Period

NETFLIX

Netflix and its Direct to Consumer Mojo?

I have said this before and I will say it again, Netflix is one of the best brands ever to advertise and market. The Company is on track to do $11 billion in revenue in 2017. The Company sells subscriptions on the Internet when its major competition is Broadcast TV, Ad Supported You Tube, Bundled Amazon Prime, Piracy, and sleep (if you thought Reed Hastings's was serious and is really that arrogant).

We recently conducted a survey of enterprises in the US that have built direct to the consumer models. Like FAANG companies CRI firms sell direct to the consumer, embrace hug technology and have outperformed the stock market and their distributed peers by over 300%. The Index we constructed excludes APPLE, and Alphabet but includes old economy businesses that sell Pizza, Cars and Live Events but use technology to build B to C relationships in an Bought, Earned and Owned marketing business model.

Consumer Relationship Tech Index 5 Year vs. S&P500
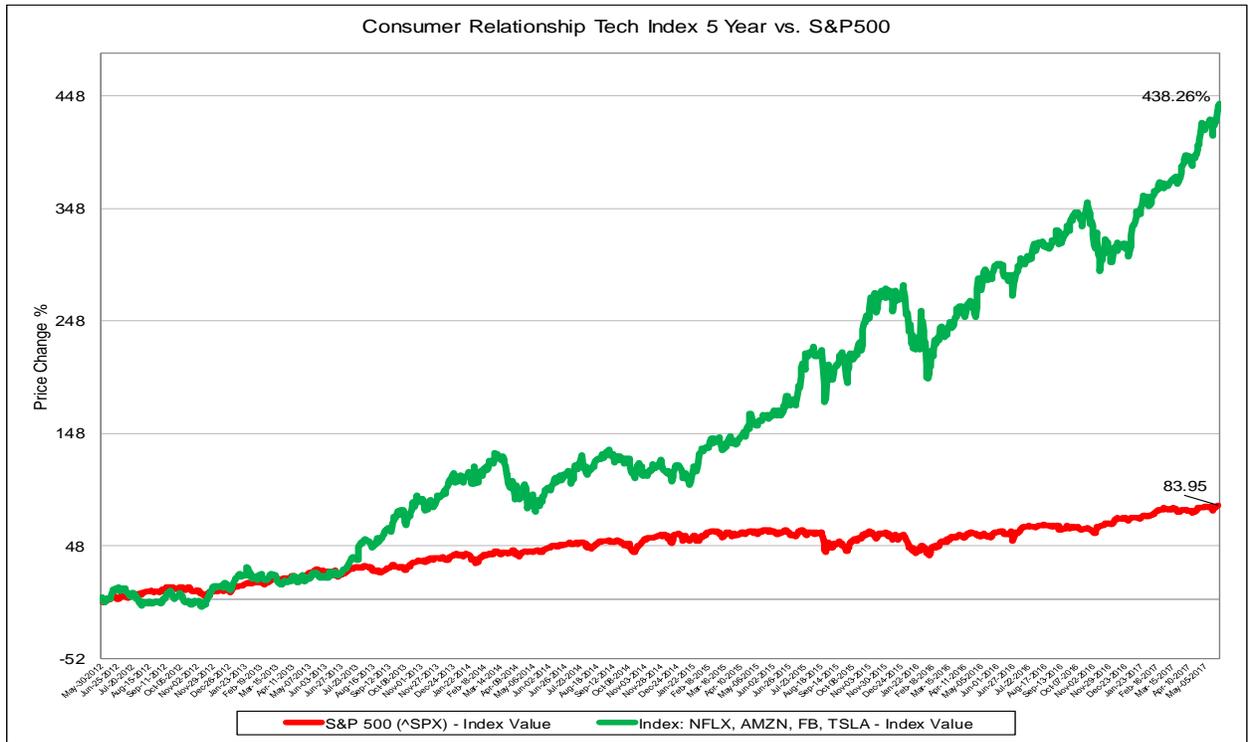
In the chart above we plotted the relative performance of the S&P 500 and our CRI index which is comprised of Facebook (FB), Netflix (NFLX), Criteo (CRTO), Tesla (TSLA), Dominos Pizza (DPX), Live Nation (LYV) and Amazon (AMZN). The performance of equities has trended higher since 2012 however the CRI began to significantly outperform the S&P 500 in 1Q15. One catalyst for the greater price CRI momentum could be the availibility of broad band internet access.Broadband and Mobile Internet speads brought better consumer experiences for On Demand Media, Social Networks and eCommerce.

Return Delta %				
1yr	2yr.	3yr.	4 yr	5 Yr
(2.67)	50.97	103.43	238.54	355.54

In the 5 Year Period, beginning in May of 2012 the CRI index outperformed the S&P 500 by roughly 335%. A proportion of the CRI rally may be due to the "Trump Rally" we think the rally provided momentum to an existing trend as the index was up 238% pre Trump.

CRI enterprises are focused on using technology to serve their customers and this focus is valued on the C Suite and Board Level. Sure AMAZON, and Facebook are perhaps easy examples because these enterprises are defined by their direct link to the market. Others such as Netflix, Tesla or Live Nation could have gone the easy route and inked distribution deals. Surely, GM would like to distribute Tesla Cars, surely LYV could have ceded the secondary ticket market to PayPal's Stub hub, and surely Netflix could be just another SVOD service on Comcast with 60% 40% economics.

However, management and the boards at these companies have decided to sacrifice near term revenue and earnings for longer term revenue growth based on the unique experiences they provide. Executives at these firms in contrast to their DRI (Distributed Relationship Index) peers are compensated based on metrics such as GRUs, Subscription Sales and Ad unit performance. DRI executives are compensated on measures more loosely linked to the consumer and markets such as TV Affiliate Fees, Upfront Ad Revenue, Vehicles sold to dealers. The difference is subtle but critical.

When we contrast Sony and Netflix Sony is making its decisions on what Netflix and not necessarily by Sony's relationship with movie goers or TV audience. As a result, Sony's is to a degree separated from the market and the viewers. Can Sony change its strategic fundamentals with the VUE TV App, it is possible but the board must compensate management for VUE growth and underweight the compensation value of Sony Pictures and Sony TV Production. If there is no change in the status quo management will over allocate resources to the old business model compensating the C Suite and VUE will not develop the consumer branding and mind share it needs to dominate the market in an Amazon or Netflix way.
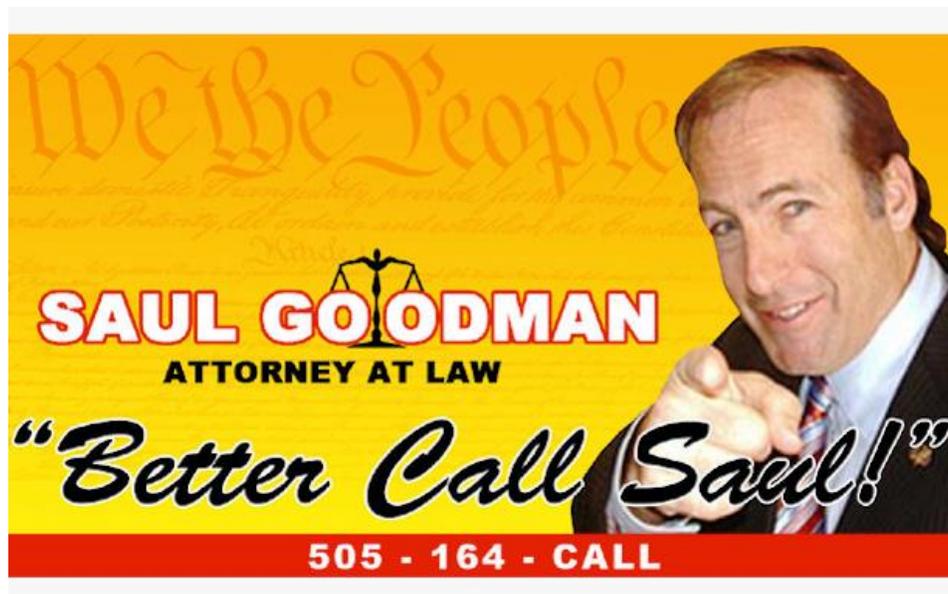
Source: Sony Entertainment

If Sony was dedicated building relationships with the consumer and had the resources and contractual flexibility (which frankly they may not) they should pull OTT and VOD distribution of is content and make it exclusive to VUE. You do not see Netflix in North America distributing House of Cards, or Orange is the New Black to HULU? **(This was Originally published on June 8, 2017, does it not sound like the Disney Announcement?)**

Netflix is now starting to deviate from its CRI Model

TenxResearch observes tactical decisions at Netflix which off its laser focus CRI discipline.

- Netflix cancelled Sense8 a socially relevant super hero Original after 2 seasons
- Netflix cancelled Bloodline after 3 seasons (Produced by Sony)
- Netflix cancelled Marco Polo after 2 seasons (Produced by The Weinstein Company)
- Netflix cancelled The Get Down after 1 season (Produced by Sony)
- Netflix cancelled Longmier after 2 seasons on Netflix (Produced by TWX)
- Netflix ceded distribution in China to TenCent, to date no additional shows have made it past Chinese censors and some shows were pulled.
- Netflix is distributed in the EU by Altice and Cannel.
- Netflix in the US has entered into agreements with Comcast, Verizon, and Altice. Terms are not disclosed.
- Not working with Disney or any other Content company to sell add ones to Netflix.

TenXResearch thinks cost and viewability were the major factors in the Marco Polo and Get Down cancellations. Marco Polo cost about $11 million per episode and the sex and violence depicted in the Marco Polo is taboo in some International Target markets but that did not hurt viewership. The Get Down cost about $16 million per episode and just did not create the social phenomena Netflix expected. Based on our Google trends analysis Bloodline and Sense8 while not house names like House of Cards or Narcos carried audience.

I think investors should view the cancellations as change in strategy from expensive Licensed Originals to cheaper self-produced content. The problem is some of these shows had loyal audience which when aggregated held Netflix churn low. If Netflix replaces the cancelled with more shows like Stranger Things and Stranger Things holds it sophomore season audience then Netflix will be better than ok. But if not, Netflix has a content, business model and balance sheet problem.

Netflix does not provide user metrics but for years I have compared Netflix programing to other TV events and have extrapolated intent to view from Google Trends and Twitter Trends Data. The idea is if something like the NBA finals has Google Search Footprint and House of Cards is also trending at the same time viewer ship can be extrapolated. The Google Trends comparison could provide an estimate of the Netflix views if an estimate of the NBA views is accurate and correlated. Is it perfect? no, but the extrapolation has been validated in the past.

Thus, I am 80% confident the extrapolation will yield an estimate for Netflix views +/- 2 million, which is a more accurate data point than the one provided by Ted Sarandos. Ted said "Sense 8 was not watched and expensive in 2017 ...it was mind blowing and International in 2015 and was the best 4 hours of anything we have done" (he said).

Source: The Hollywood Reporter

Netflix Viewership

Based on the Google Trends, I suspect Netflix has roughly 6 million unique viewers in the US for House of Cards as compared to 30 million for the NBA finals. This audience has grown by roughly 100% since S1E1 when I estimated the show had 2.5 million unique fans. I would also suggest that Kevin Spacey needs to put Donald Trump on his Christmas card list because based on Google Trends the House of Cards benefitted big league from Trump's Palace intrigues, IMHO. (I digress, that is in another Trend Chart not published here)

NBA Finals Google Trends
versus
House of Cards

NBA Finals: (Worldwide)   House of cards season 5: (Worldwide)
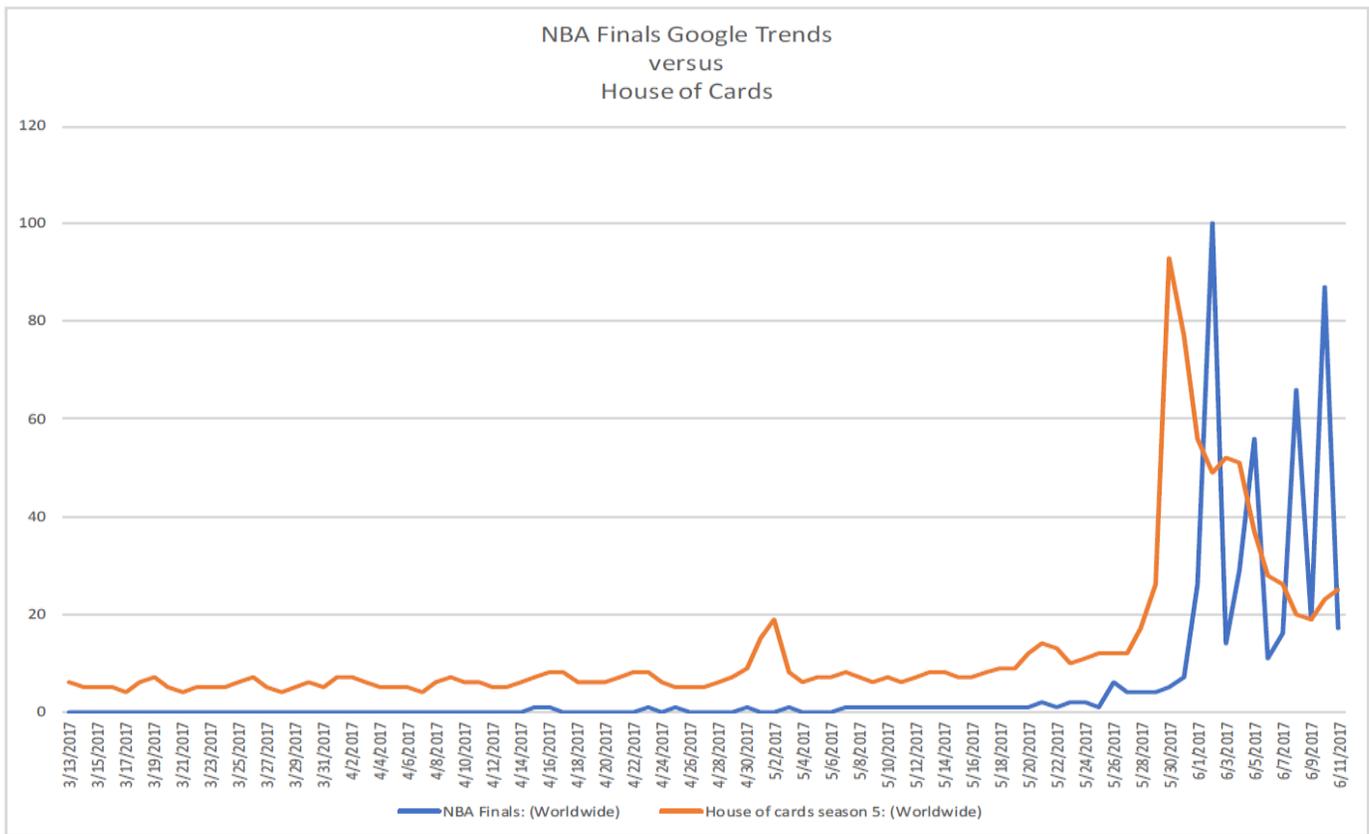
Source: Google Trends and TenXResearch

Viewing is now an important metric for NFLX. Netflix may now need to write down content as Netflix is capitalizing content. Under capitalizing and expense rules, if shows are cancelled after 2 or 3 years and they are not well viewed the accountants will make Netflix expense the shows more conservatively to better match the expense and timing of revenue. The write down is also more likely if Netflix is amortizing the shows over a 4 to 6-year period.
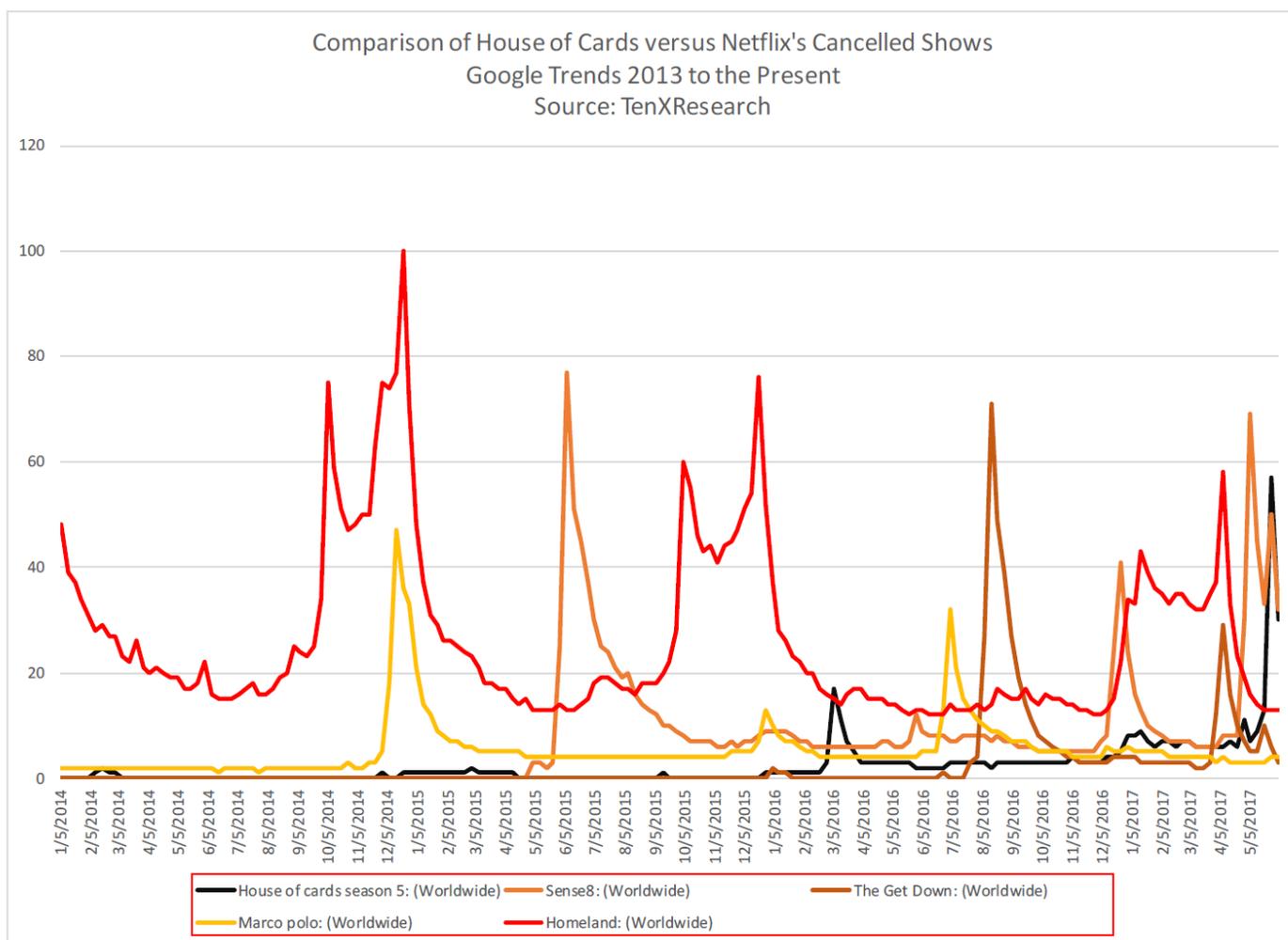
Any content company cannot expense as if the Original is going to last 5 years and get 10 million viewers if it is cancelled after 3 years and gets 3 only million viewers. Moreover, while a write down is noncash, Netflix would certainly have fewer assets, and less equity to support the debt needed to fund remainder of its $16 billion liability. A Company burning cash and taking on liabilities to fund future earnings and FCF is undermined by a write down as the asset is marked down because the Cash Flows did not pass the accounting means test.

House of Cards Clearly outperforms; Netflix's Fallen Stars seem popular according to Google Trends.

As compared to HL and HOC: Sense8, The Get Down, and Marco Polo, three notable cancelled Netflix Shows, appear to have Google Trends in the same ballpark as House of Cards and likely similar viewership. Since HOC is cheaper to produce than some of the cancellations and a key Netflix tentpole the show was not cancelled.
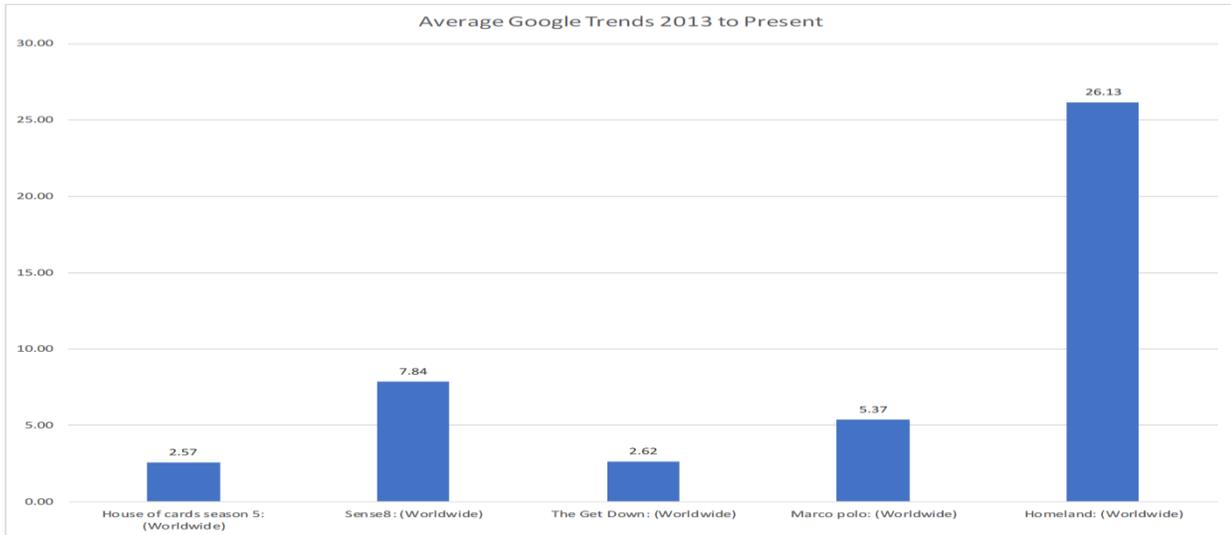
However, if the Netflix model is based on retaining HOC and Orange is the New Black viewers throughout the year, Netflix is going to need to find another way to combat churn and retain subscribers. Maybe the new content is movies but so far Netflix does not have a runaway movie hit that compares to House of Cards, or Orange is the New Black.

In the case study below we used Showtime's Homeland as a bellwether to compare Netflix content.

Comparison of House of Cards versus Netflix's Cancelled Shows
Google Trends 2013 to the Present
Source: TenXResearch

Legend: House of cards season 5: (Worldwide), Sense8: (Worldwide), The Get Down: (Worldwide), Marco polo: (Worldwide), Homeland: (Worldwide)
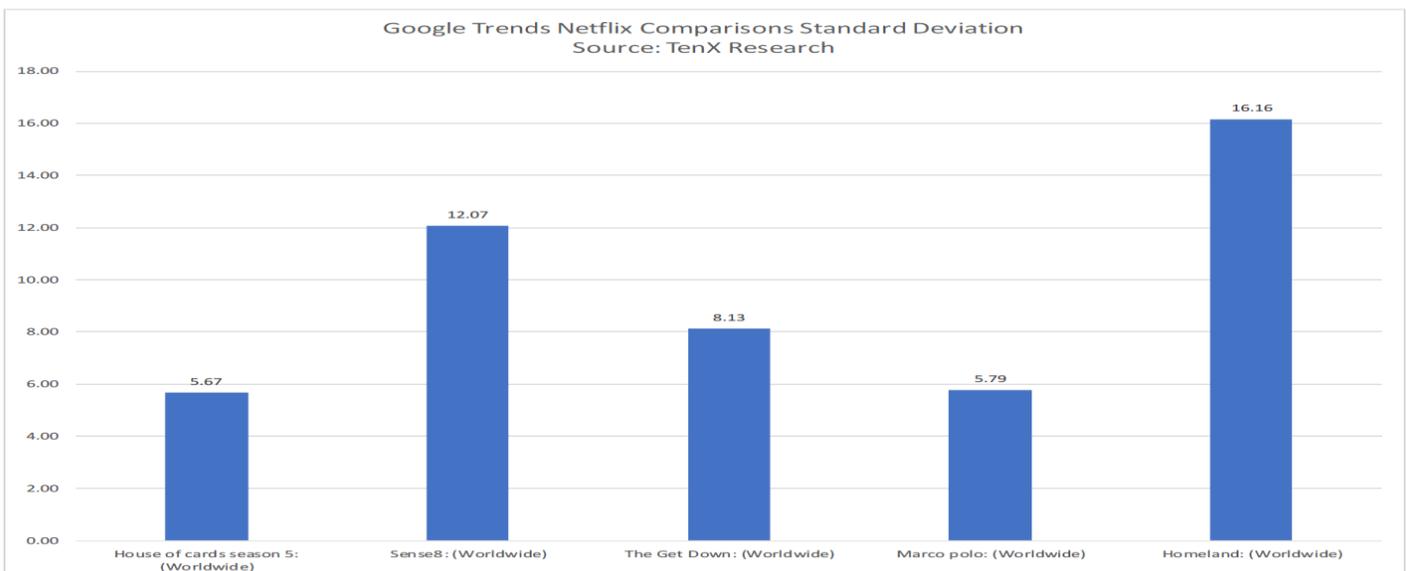
On Average

When we look at the average Google Trends Worldwide of the Netflix programing sample HOC lags the cancelled Originals comparison set. Sense8 and Marco Polo had global Google trends which are roughly double HOC. One explanation for the difference is the cancelled Originals were at some point more popular than HOC but are not more popular today.

Average Google Trends 2013 to Present

Show	Value
House of cards season 5: (Worldwide)	2.57
Sense8: (Worldwide)	7.84
The Get Down: (Worldwide)	2.62
Marco polo: (Worldwide)	5.37
Homeland: (Worldwide)	26.13

Source: Google Trends and TenXResearch

There is more to statistics than an average.

The goal of good content is to retain audiences and limit subscription cancellations. The Standard Deviation may be a good measure of retention for an Original. Netflix, owing to its business model, must essentially renew its subscriber base each month. If Netflix provides popular content every month retention is an easier as compared to blowing up the Internet every month with a spectacular premier. HOC may be less popular at times as compared to the cancelled Netflix shows. However, over time HOC has fewer ups and downs as exemplified by the lower standard deviation on Google Trends. Thus, the HOC audience is more bankable than The Get Down or even Homeland due to the low average variance.

Google Trends Netflix Comparisons Standard Deviation
Source: TenX Research

Show	Value
House of cards season 5: (Worldwide)	5.67
Sense8: (Worldwide)	12.07
The Get Down: (Worldwide)	8.13
Marco polo: (Worldwide)	5.79
Homeland: (Worldwide)	16.16

Conclusion

When compared to Netflix's CRI peers and the S&P 500 the Company is overpriced using several metrics.

- On Price to Sales it is trading at a premium to the peer group 7.6x vs. 5.6x and roughly 2.4x for the S&P 500.
- On EV to EBITDA even with the over statement it trades 112x TTM versus 50x to the peer group and 12x for the S&P 500
- We also note owing to the off-model nature of Netflix's content liability many Netflix Balance sheet and operating ratios are over stated if the business slows.
- Excluding the content liability Netflix Debt to EBITDA ratio is 5.2x functionally its higher but they have favorable working capital.
- Bears should view the company as having downside to the low 100's in the short term if the Disney deal is a harbinger and bulls should view Netflix upside capped at $200 as Netflix has to spend more to offset the Disney Deal Loss as we defined it.
- And we did not even discuss increased competition.

Company Comparable Analysis > CRI (#NFLX) > Trading Multiples

Details

Template:	Capital IQ Default Comps
Currency:	US Dollar
As-Of Date:	May-30-2017

Company Comp Set

Company Name	TEV/Total Revenues LTM - Latest	TEV/EBITDA LTM - Latest	TEV/EBIT LTM - Latest	P/Diluted EPS Before Extra LTM - Latest	P/TangBV LTM - Latest
Amazon.com, Inc. (NasdaqGS:AMZN)	3.3x	39.1x	116.4x	187.7x	26.7x
Netflix, Inc. (NasdaqGS:NFLX)	7.6x	112.2x	123.2x	211.1x	NM
Live Nation Entertainment, Inc. (NYSE:LYV)	0.9x	12.8x	40.4x	NM	NM
Domino's Pizza, Inc. (NYSE:DPZ)	4.8x	24.3x	25.8x	44.6x	NM
Facebook, Inc. (NasdaqGS:FB)	13.5x	25.0x	29.5x	38.7x	10.6x
Tesla, Inc. (NasdaqGS:TSLA)	7.2x	116.6x	NM	NM	12.1x
Criteo S.A. (NasdaqGS:CRTO)	1.8x	18.7x	28.4x	47.1x	11.1x

Summary Statistics

	TEV/Total Revenues LTM - Latest	TEV/EBITDA LTM - Latest	TEV/EBIT LTM - Latest	P/Diluted EPS Before Extra LTM - Latest	P/TangBV LTM - Latest
High	13.5x	116.6x	123.2x	211.1x	26.7x
Low	0.9x	12.8x	25.8x	38.7x	10.6x
Mean	5.6x	49.8x	60.6x	105.8x	15.1x
Median	4.8x	25.0x	34.9x	47.1x	11.6x
S&P 500 (^SPX)	2.4x	12.2x	17.8x	24.2x	8.6x

Displaying 7 Companies.

Excel Comp Set ID: IQ432581714

Values converted at today's spot rate.

S&P Capital IQ

Company Comparable Analysis > CRI (#NFLX) > Operating Statistics

Details

Template:	Capital IQ Default Comps
Currency:	US Dollar
As-Of Date:	########

Company Comp Set

Company Name	LTM Gross Margin %	LTM EBITDA Margin %	LTM Total Revenues, 1 Yr Growth %	LTM EBITDA, 1 Yr Growth %	LTM Net Income, 1 Yr Growth %	LTM Total Debt/EBITDA	5 Year Beta
Amazon.com, Inc. (NasdaqGS:AMZN)	35.6%	8.6%	25.71%	34.49%	121.44%	1.8x	1.48
Netflix, Inc. (NasdaqGS:NFLX)	33.6%	6.8%	32.74%	101.75%	166.38%	5.2x	1.25
Live Nation Entertainment, Inc. (NYSE:LYV)	27.3%	7.2%	16.74%	15.92%	-	3.8x	0.84
Domino's Pizza, Inc. (NYSE:DPZ)	31.1%	19.5%	13.49%	13.68%	20.71%	4.4x	0.63
Facebook, Inc. (NasdaqGS:FB)	86.4%	54.0%	53.23%	75.07%	134.90%	-	0.68
Tesla, Inc. (NasdaqGS:TSLA)	23.6%	6.2%	101.01%	-	-	18.2x	1.18
Criteo S.A. (NasdaqGS:CRTO)	35.7%	9.3%	33.86%	37.73%	21.79%	0.5x	2.71

Summary Statistics

	LTM Gross Margin %	LTM EBITDA Margin %	LTM Total Revenues, 1 Yr Growth %	LTM EBITDA, 1 Yr Growth %	LTM Net Income, 1 Yr Growth %	LTM Total Debt/EBITDA	5 Year Beta
High	86.4%	54.0%	101.01%	101.75%	166.38%	18.2x	2.71
Low	23.6%	6.2%	13.49%	13.68%	20.71%	0.5x	0.63
Mean	39.0%	15.9%	39.54%	46.44%	93.04%	5.6x	1.25
Median	33.6%	8.6%	32.74%	36.11%	121.44%	4.1x	1.18
S&P 500 (^SPX)	32.6%	19.3%	3.70%	3.83%	15.67%	4.1x	-

Displaying 7 Companies.

Excel Comp Set ID: IQ432581714

Values converted at today's spot rate.

Full Disclosure