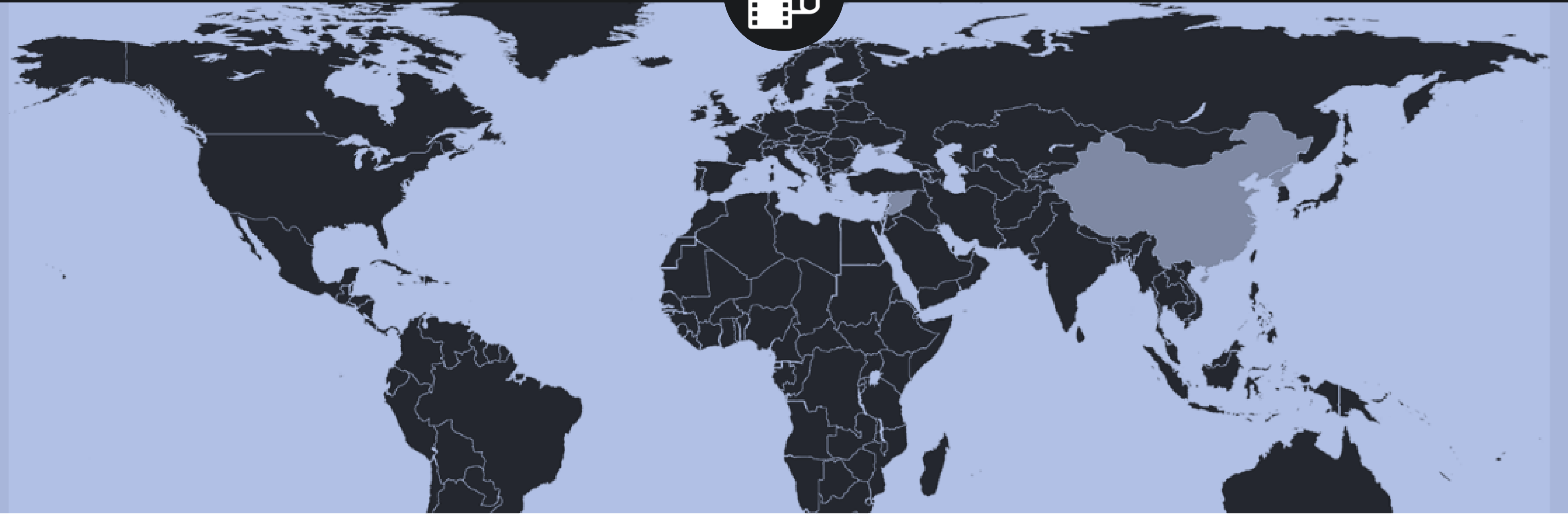
HESHAM SHAABAN, CFA

HEDGEYE



NFLX | RUNWAY GETTING SHORTER

NFLX | 2017 BEAR CASE

DEC 6TH, 2016

DISCLAIMER

DISCLAIMER

Hedgeye Risk Management is a registered investment advisor, registered with the State of Connecticut. Hedgeye Risk Management is not a broker dealer and does not provide investment advice for individuals. This research does not constitute an offer to sell, or a solicitation of an offer to buy any security. This research is presented without regard to individual investment preferences or risk parameters; it is general information and does not constitute specific investment advice. This presentation is based on information from sources believed to be reliable. Hedgeye Risk Management is not responsible for errors, inaccuracies or omissions of information. The opinions and conclusions contained in this report are those of Hedgeye Risk Management, and are intended solely for the use of Hedgeye Risk Management's clients and subscribers. In reaching these opinions and conclusions, Hedgeye Risk Management and its employees have relied upon research conducted by Hedgeye Risk Management's employees, which is based upon sources considered credible and reliable within the industry. Hedgeye Risk Management is not responsible for the validity or authenticity of the information upon which it has relied.

TERMS OF USE

This report is intended solely for the use of its recipient. Re-distribution or republication of this report and its contents are prohibited. For more details please refer to the appropriate sections of the Hedgeye Services Agreement and the Terms of Use at www.hedgeye.com

PLEASE SUBMIT QUESTIONS* TO

QA@HEDGEYE.COM

*ANSWERED AT THE END OF THE CALL

NFLX | BEAR CASE SUMMARY

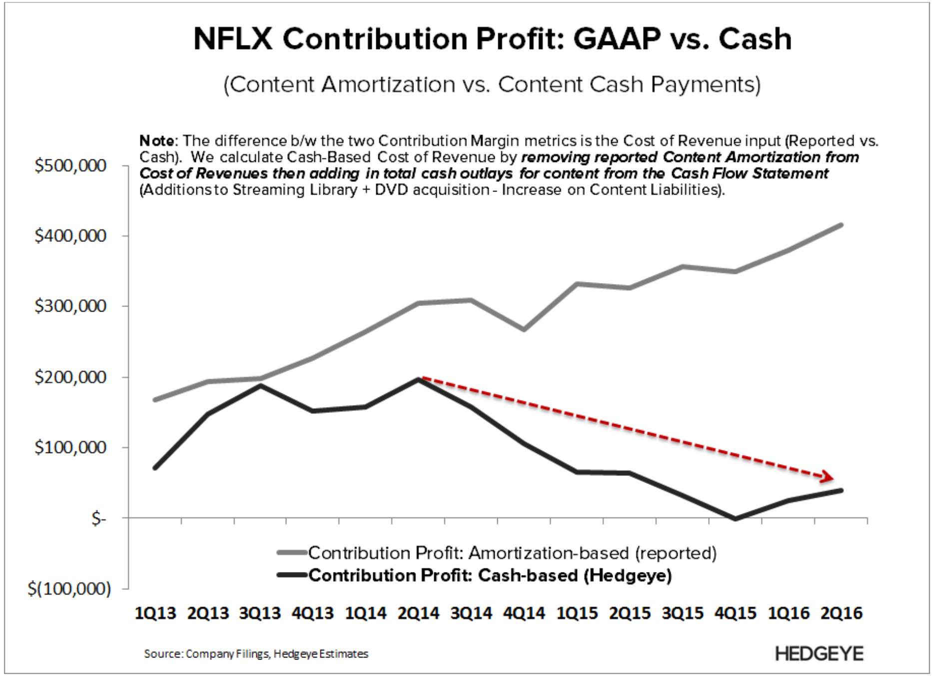
1. **<u>Business Model</u>**: Content Distributor/Producer. The viability of its model is dependent on driving enough revenue/sub growth to cover its content costs

2. **<u>Analysis</u>:** NFLX's stated contractual obligations are essentially minimum recurring cost of running its business, making the burden for user growth much greater than many assume

3. **<u>Outlook</u>:** Sub growth likely to disappoint given shorter runway and increasing churn pressure. NFLX may not have the marketing budget to offset.

4. **<u>Setup</u>**: Mgmt preemptively sandbagged the 1Q sub guide, so potential short-term squeeze risk on less than terrible guide.

5. **<u>Timing</u>**: Entry point ahead of 1Q17 print, maybe sooner



BULLS RUNNING OUT OF REASONS TO BELIEVE

The bull/bear debate is on Point 1 above. The bulls have been winning since int'l has been compensating for waning US sub metrics. However, we expect net sub adds to disappoint across the board next year.

NFLX | KEY POINTS

1

CONTENT = HAMSTER WHEEL

NFLX's content expenditures are a much bigger hurdle than its income statement/contractual obligations would suggest. NFLX's content profiles more as recurring expense than it does asset, and its obligations are an understated view of the ongoing cost of running that model.

2

RUNWAY GETTING SHORTER (SUBSCRIBERS)

We expect that the bull/bear debate is coming to a head in 2017 with net sub adds in both segments facing mounting pressure with the emergence of two big headwinds in each market. Consensus is positioned for improving trends through 2017.

3

2017 = NOT ENOUGH CAPITAL?

NFLX could conceivably counteract its 2017 sub-add headwinds by considerably ramping up its marketing spend, but we doubt it will have the budget to do so given our expectation for surging SAC and that the bulk of that budget is committed/earmarked for content outlays.

NFLX | KEY POINTS

1

CONTENT = HAMSTER WHEEL

NFLX's content expenditures are a much bigger hurdle than its income statement/contractual obligations would suggest. NFLX's content profiles more as recurring expense than it does asset, and its obligations are an understated view of the ongoing cost of running that model.

2

RUNWAY GETTING SHORTER (SUBSCRIBERS)

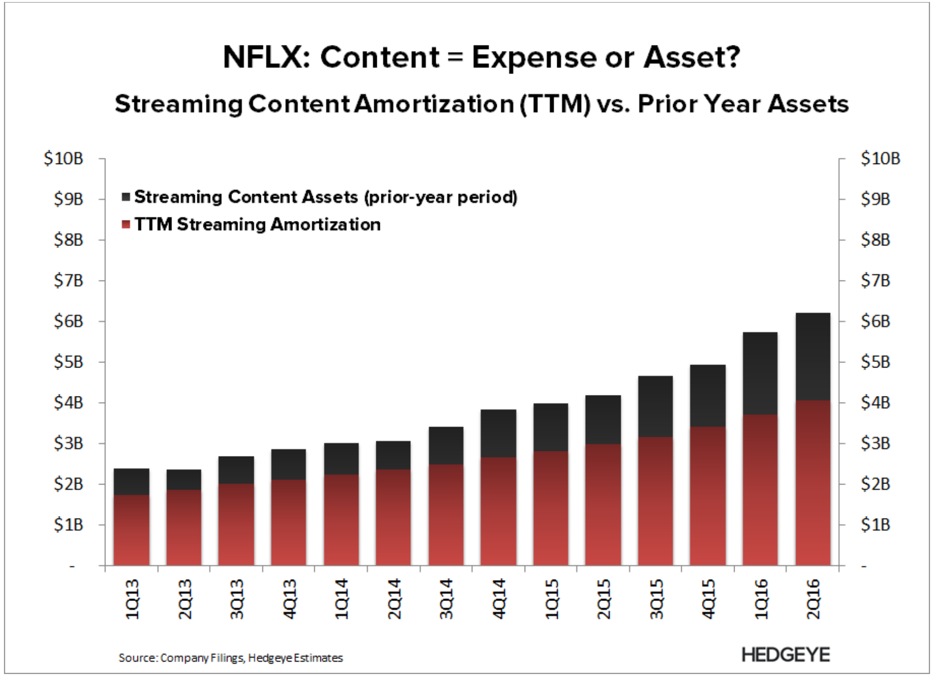
We expect that the bull/bear debate is coming to a head in 2017 with net sub adds in both segments facing mounting pressure with the emergence of two big headwinds in each market. Consensus is positioned for improving trends through 2017.

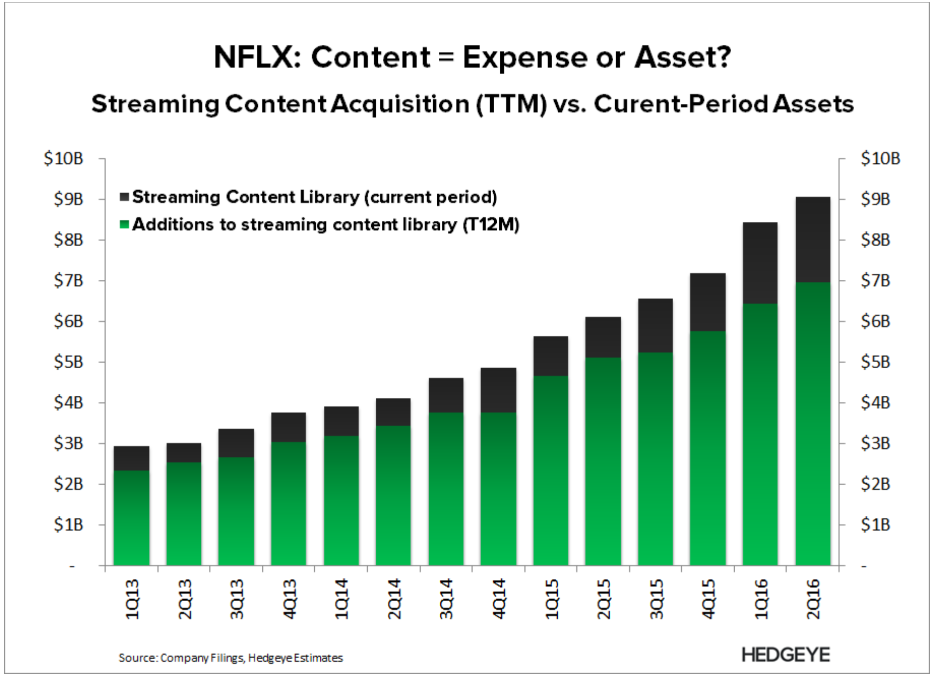
3

2017 = NOT ENOUGH CAPITAL?

NFLX could conceivably counteract its 2017 sub-add headwinds by considerably ramping up its marketing spend, but we doubt it will have the budget to do so given our expectation for surging SAC and that the bulk of that budget is committed/earmarked for content outlays.

CONTENT ISN'T REALLY AN ASSET…

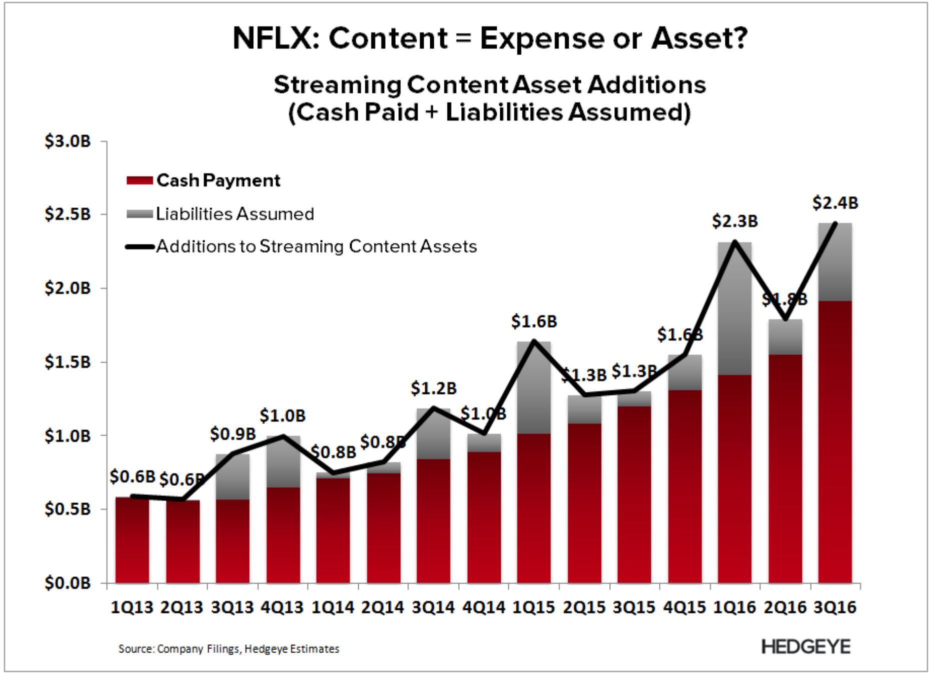


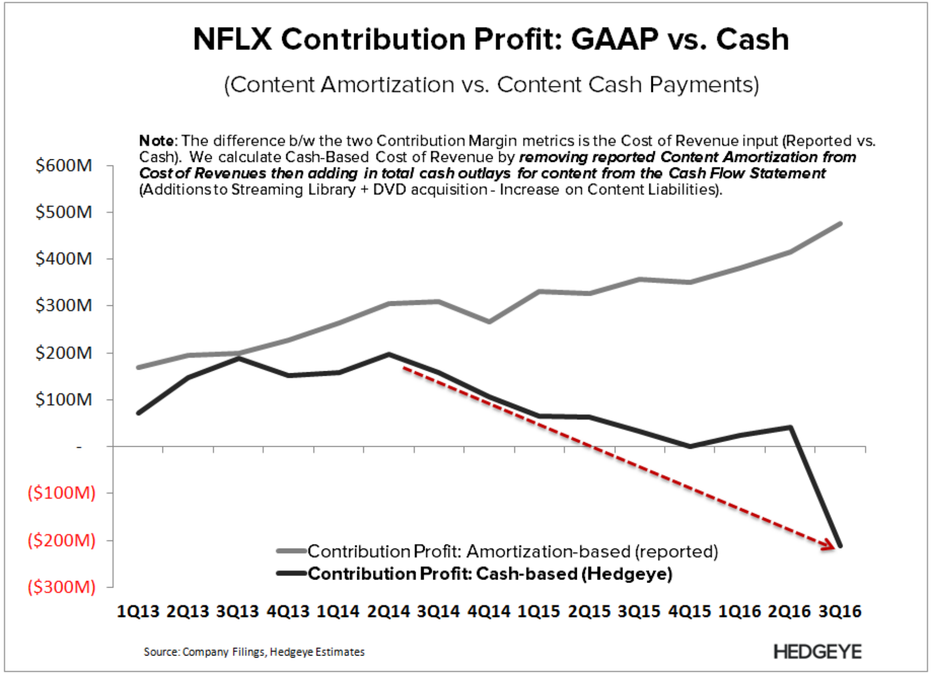


CONTENT PROFILES MORE AS A RECURRING OPERATING EXPENSE

NFLX's content assets are generally comprised of content NFLX acquired in the TTM since the bulk of its library is amortized within a year. The relatively short life of its content suggests it is more expense than asset

SO GAAP MODEL LESS RELEVANT

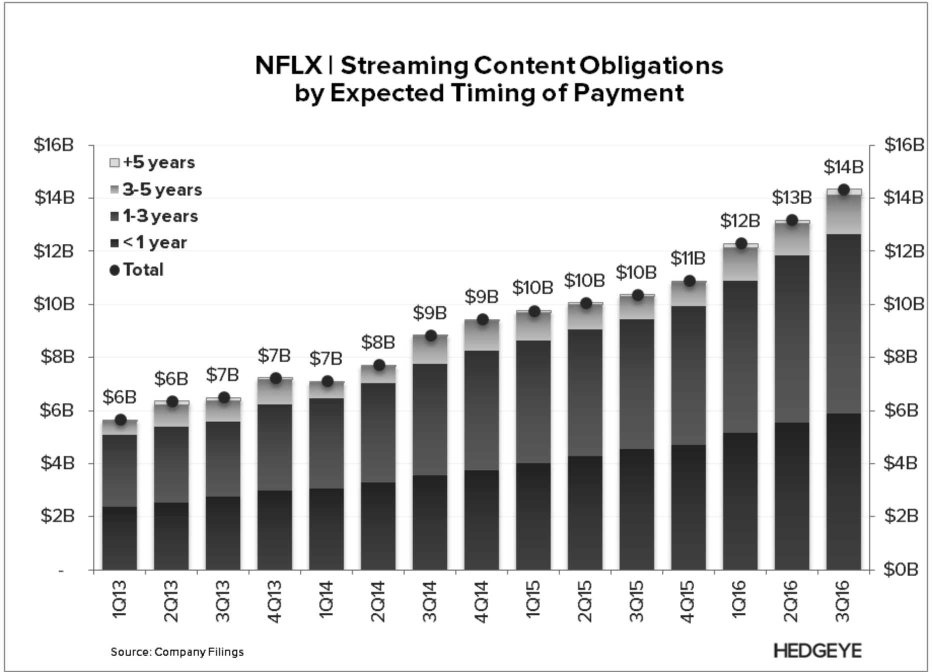


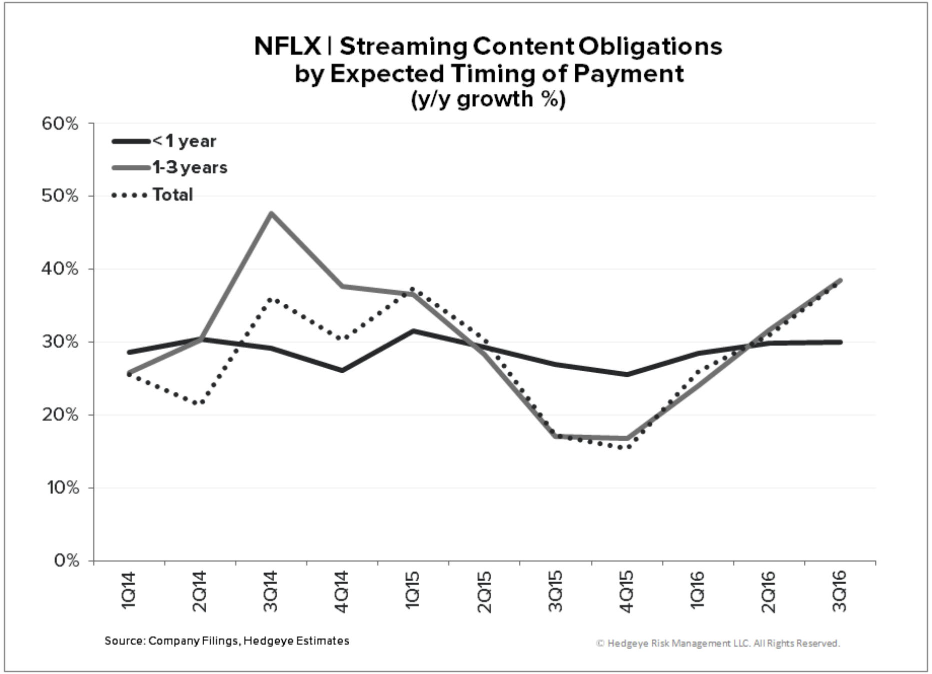


CASH MODEL IS A BETTER REFLECTION OF ITS OPERATING RESULTS

GAAP (amortization-based) basically a reflection of the prior year's cash content outlays. Current cash outlays are the true operating expense since they're recurring in nature, and most of those assets were acquired in the LTM.

CONTENT COSTS = NO END IN SIGHT

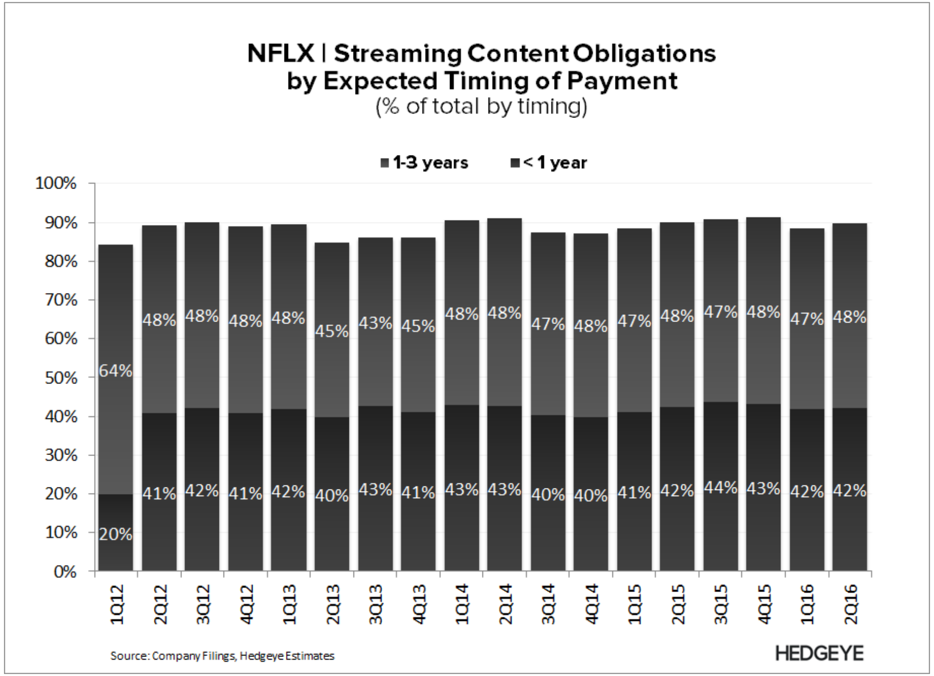




STEADILY CLIMBING AND YET TO SLOW DOWN

NFLX's contractual obligations have risen almost every quarter as far back as we can track the data. Further, the growth rate hasn't abated much either, particularly it's current obligations (more detail in slide 11)

OBLIGATIONS ≈ BARE MINIMUM

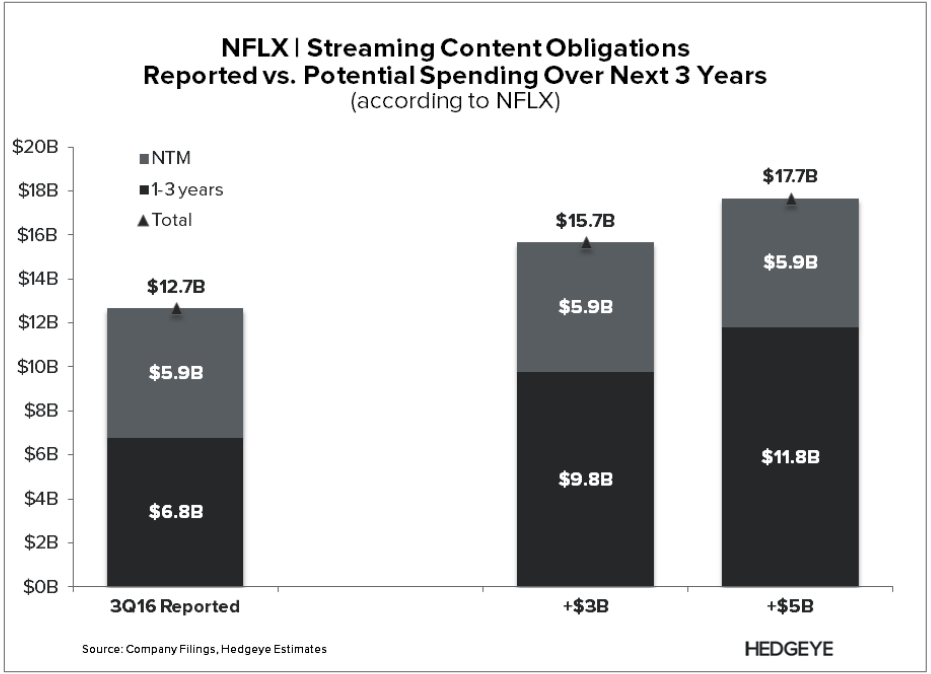


NFLX 10-Q: Streaming content obligations include amounts related to the acquisition, licensing and production of streaming content. An obligation for the production of content includes non-cancelable commitments under creative talent and employment agreements. An obligation for the acquisition and licensing of content is incurred at the time we enter into an agreement to obtain future titles. Once a title becomes available, a content liability is recorded on the Consolidated Balance Sheets. **Certain agreements include the obligation to license rights for unknown future titles, the ultimate quantity and/or fees for which are not yet determinable as of the reporting date.** Traditional film output deals, like the U.S. output deal with Disney, or certain TV series license agreements where the number of seasons to be aired is unknown, are examples of these types of agreements.

NFLX REALLY DOESN'T KNOW WHAT IT WILL HAVE TO SPEND

NFLX's reported streaming content obligations are only the amounts that it can currently identify. The reason why obligations over the NTM and the 2-yr period thereafter appear equivalent is that the later is tougher to estimate.

ACTUAL OBLIGATIONS ≈ $16B-$18B



NFLX 10-Q: The contractual obligations table above **does not include any estimated obligation for the unknown future titles**, payment for which could range from less than one year to more than five years. However, these unknown obligations are expected to be significant and **we believe could include approximately $3 billion to $5 billion over the next three years**, with the payments for the **vast majority of such amounts expected to occur after the next twelve months.** The foregoing range is based on considerable management judgments and the actual amounts may differ. Once we know the title that we will receive and the license fees, we include the amount in the contractual obligations table above

Note: The above $3B-$5B estimate is identical to the prior two 10-Qs, when reported content obligations over the next 3 years were $11.9B and $10.9B in 2Q16 and 1Q16, respectively

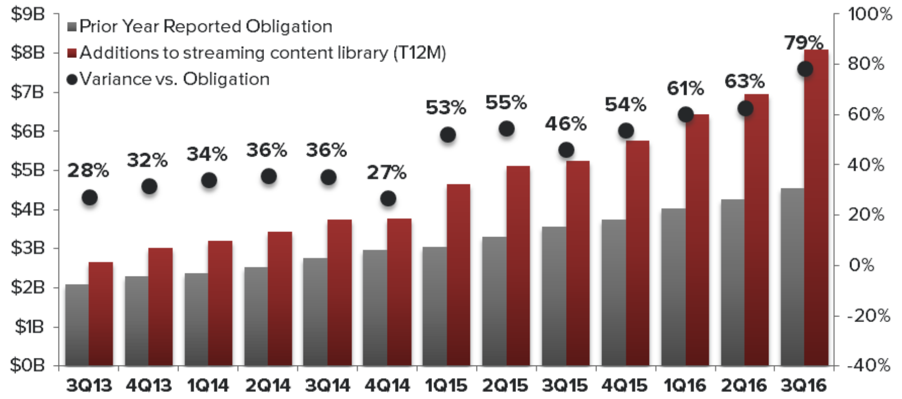
NFLX EXPECTS OBLIGATIONS TO BE 25%-40% HIGHER…COULD BE HIGHER

By NFLX's own admission, its streaming content obligations will be much higher than its current streaming content obligation estimate of $13B. The reason is that it just doesn't know what it's on the hook for yet

HISTORY IS A GOOD GUIDE: CONTENT

NFLX: Content Obligations = Minimum

Streaming Content Additions (T12M) vs. Stated Contractual Obligation (prior year)

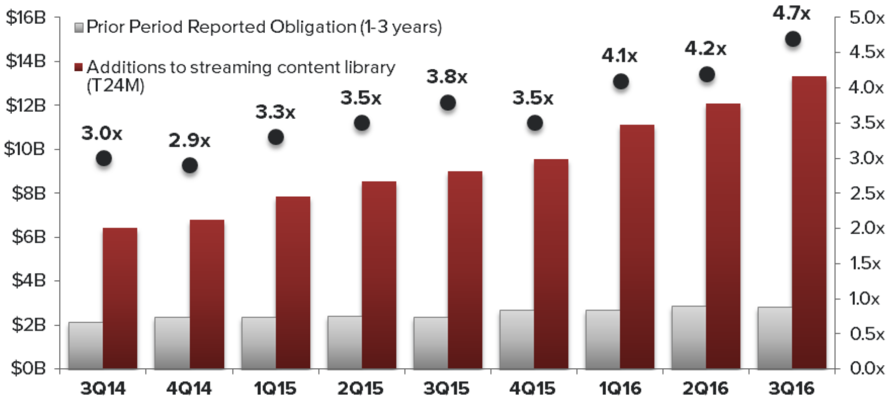


Note: We are comparing NFLX T12M Streaming content additions against its reported current obligations in the year prior. E.g for 4Q15, we are showing what NFLX added in 2015 vs. what is dislcosed as its current ogligations in 4Q14

Source: Company Filings, Hedgeye Estimates

NFLX: Content Obligations = Minimum

Streaming Content Additions (T24M) vs. Stated Contractual Obligation (1-3 yrs)



Note: We are comparing NFLX T24M Content expenditures against what it reported for content obligations 1-3 yrs out. E.g for 4Q15, we are showing what NFLX spent over the prior 2 yrs vs. what it dislcosed in its 4Q12 filings for its content oglibations 1-3 years out (1Q14-4Q15)

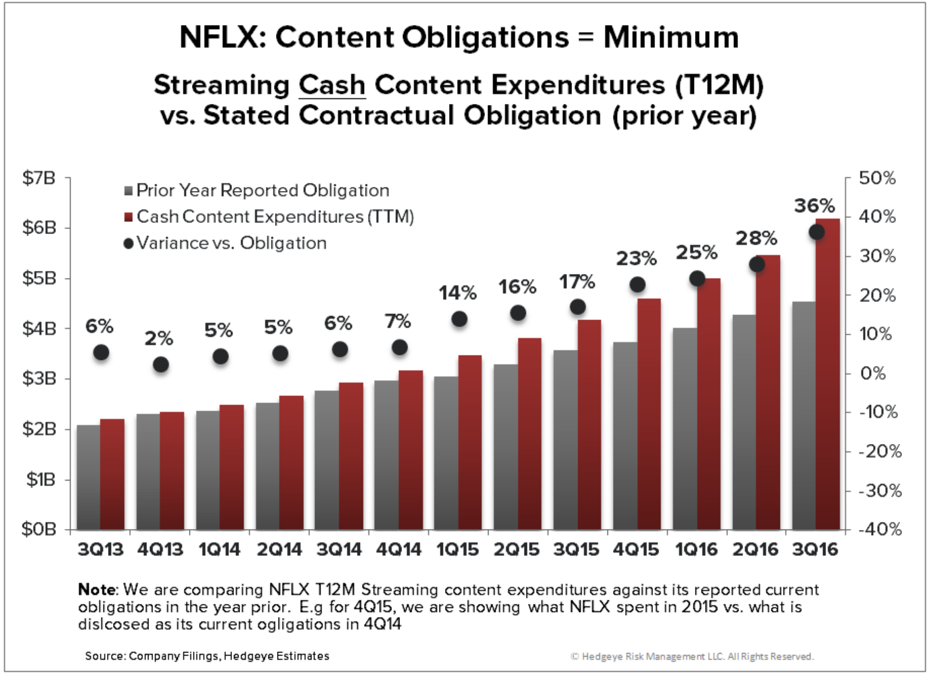
Source: Company Filings, Hedgeye Estimates

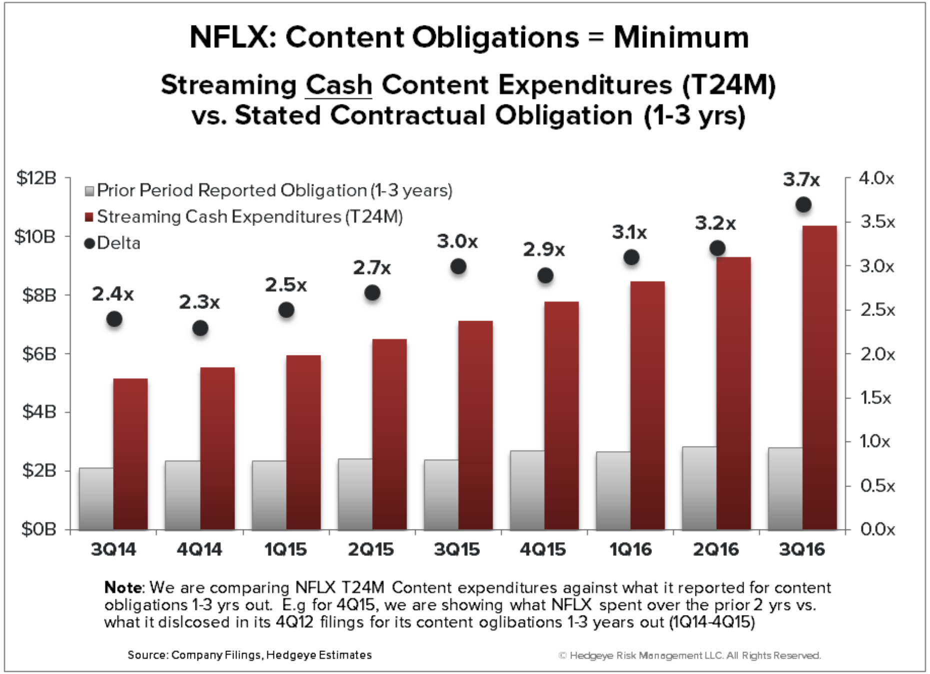
HEDGEYE

GENERALLY ACQUIRES CONSIDERABLY MORE THAN REPORTED OBLIGATIONS

We're comparing actual additions to prior period reported obligations for the associated period. The first chart is additions vs. NTM obligations, the second is the same but vs. stated obligations 1-3 years out

HISTORY IS A GOOD GUIDE: CASH





GENERALLY <u>SPENDS</u> CONSIDERABLY MORE THAN REPORTED OBLIGATIONS

Same as the prior slide, but only looking at cash expenditures (ex liabilities). In short, the 25%-40% excess spend mentioned in slide 11 could wind up being conservative if history repeats itself.

CONTENT = HAMSTER WHEEL

1. Content profiles more as an expense than as an asset

2. Cash Model is better reflection of its operating results (vs. GAAP)

3. Content Obligations continue to grow, at an accelerating rate

4. Reported Content Obligations are just what NFLX can currently identify

5. Actual content expenditures expected to be much higher than obligations

CONTENT IS A BIGGER ISSUE THAN MOST WOULD EXPECT

In the context of the bull-bear debate, those content obligations are not some distant hill that NFLX needs to get over one day, but rather an understated view of the ongoing cost of running that model.

NFLX | KEY POINTS

1

CONTENT = HAMSTER WHEEL

NFLX's content expenditures are a much bigger hurdle than its income statement/contractual obligations would suggest. NFLX's content profiles more as recurring expense than it does asset, and its obligations are an understated view of the ongoing cost of running that model.

2

RUNWAY GETTING SHORTER (SUBSCRIBERS)

We expect that the bull/bear debate is coming to a head in 2017 with net sub adds in both segments facing mounting pressure with the emergence of two big headwinds in each market. Consensus is positioned for improving trends through 2017.

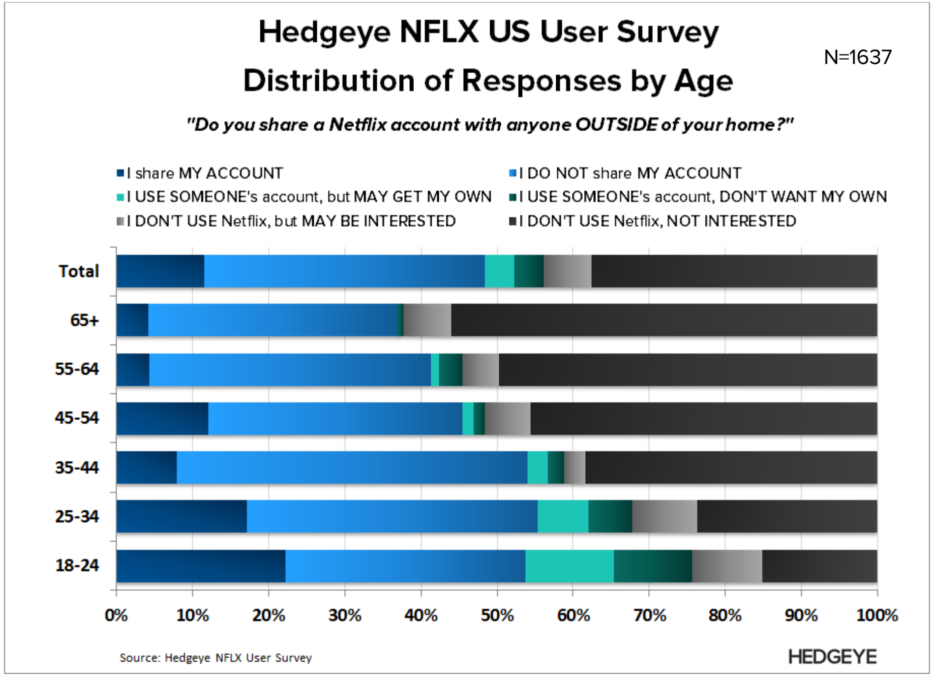
3

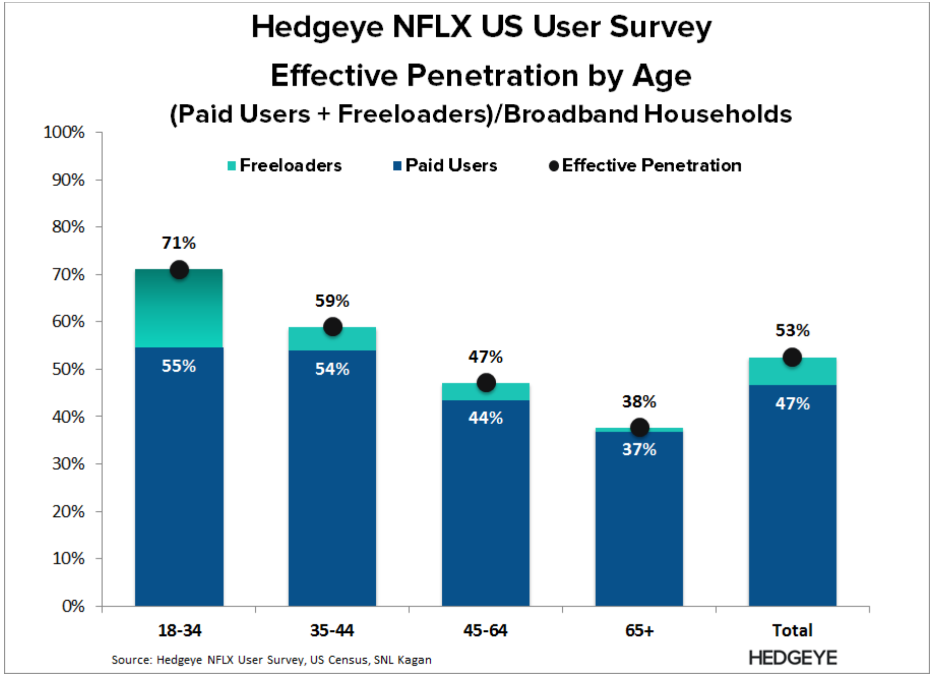
2017 = NOT ENOUGH CAPITAL?

NFLX could conceivably counteract its 2017 sub-add headwinds by considerably ramping up its marketing spend, but we doubt it will have the budget to do so given our expectation for surging SAC and that the bulk of that budget is committed/earmarked for content outlays.

US TOPPING OUT?

NFLX US USER SURVEY

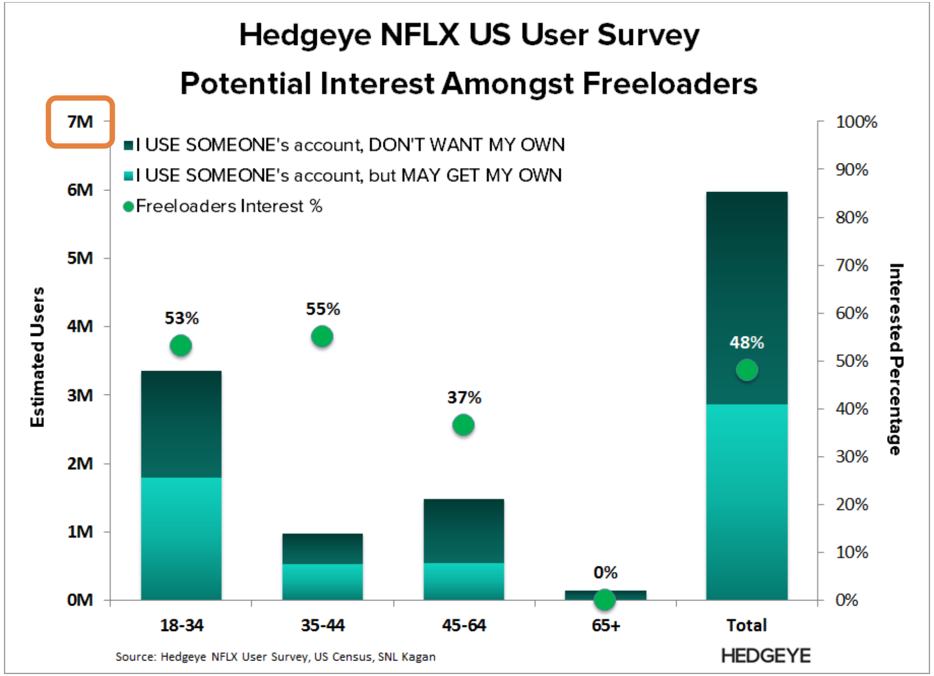


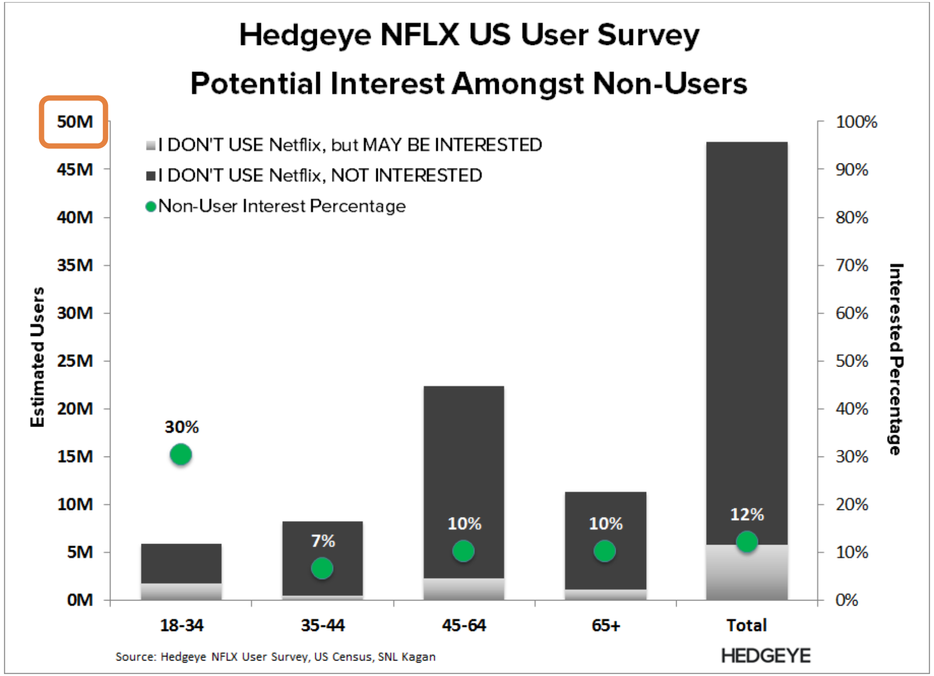


NFLX TAM ESTIMATE IS NOT AN ISSUE, BUT REALIZING IT MAY BE

NFLX US TAM estimate is reasonable (translates to 60%-90% penetration of US Broadband households), but the bigger question is how long it will take to get there given penetration demographics, sharing, & interest levels

LACK OF EXPOSURE MAY BE AN ISSUE

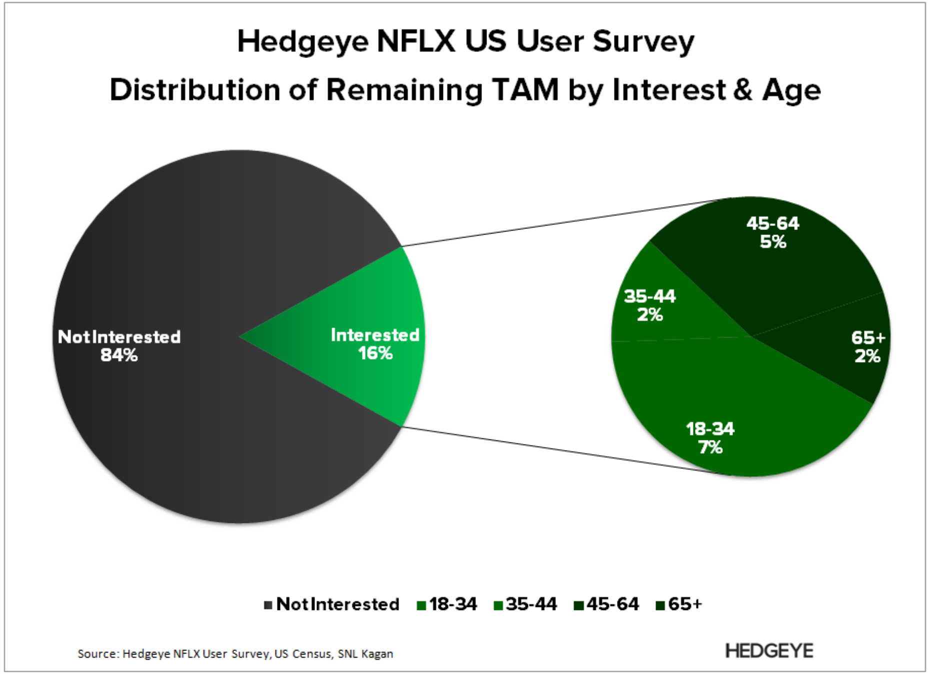


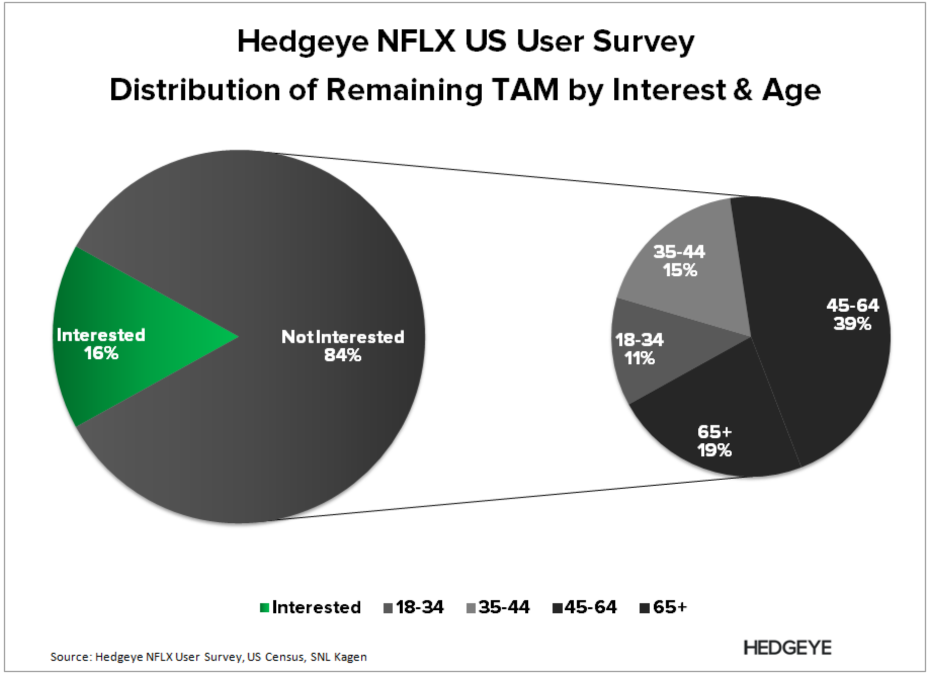


FREELOADERS HAVE HIGH INTEREST, BUT SMALL PERCENTAGE OF TAM

Those freeloaders are effectively trialers. Interest levels amongst freeloaders are 4x that of non users. However, they are much smaller in size (see scale axes)

DEMOGRAPHICS MAY BE BIGGER ISSUE

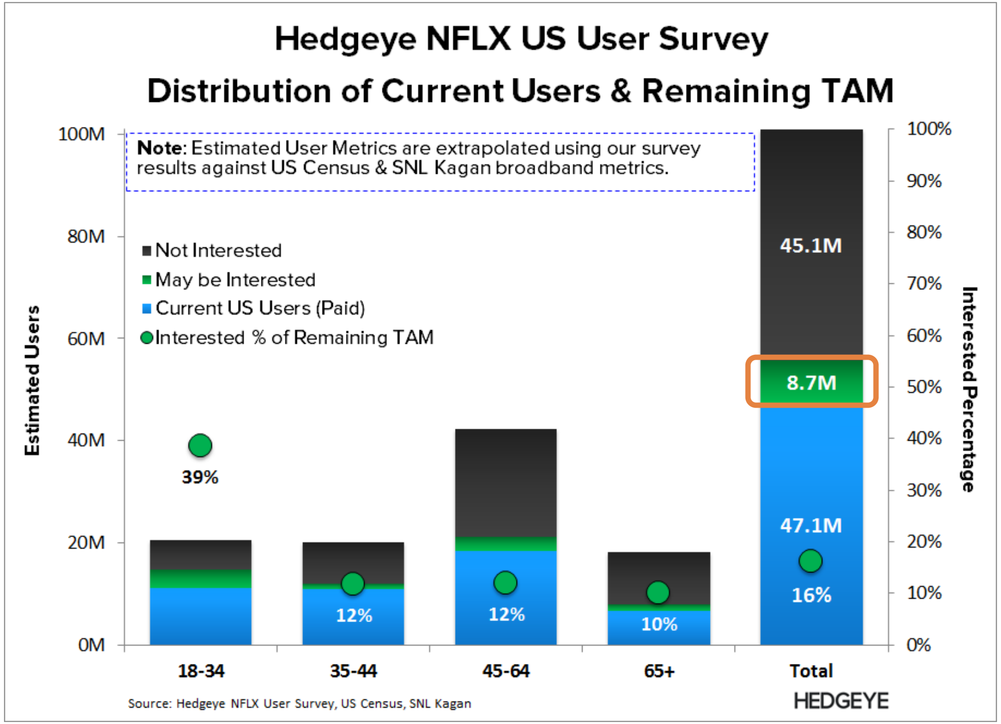




DISTRIBUTION OF REMAINING TAM SKEWS MUCH OLDER

Roughly 85% of NFLX's remaining TAM is interested; of those 2/3 of those are over 45 years old. NFLX's current penetration levels by age (slide 16) suggest those users will be tougher to draw in

NOT MUCH LOW HANGING FRUIT LEFT

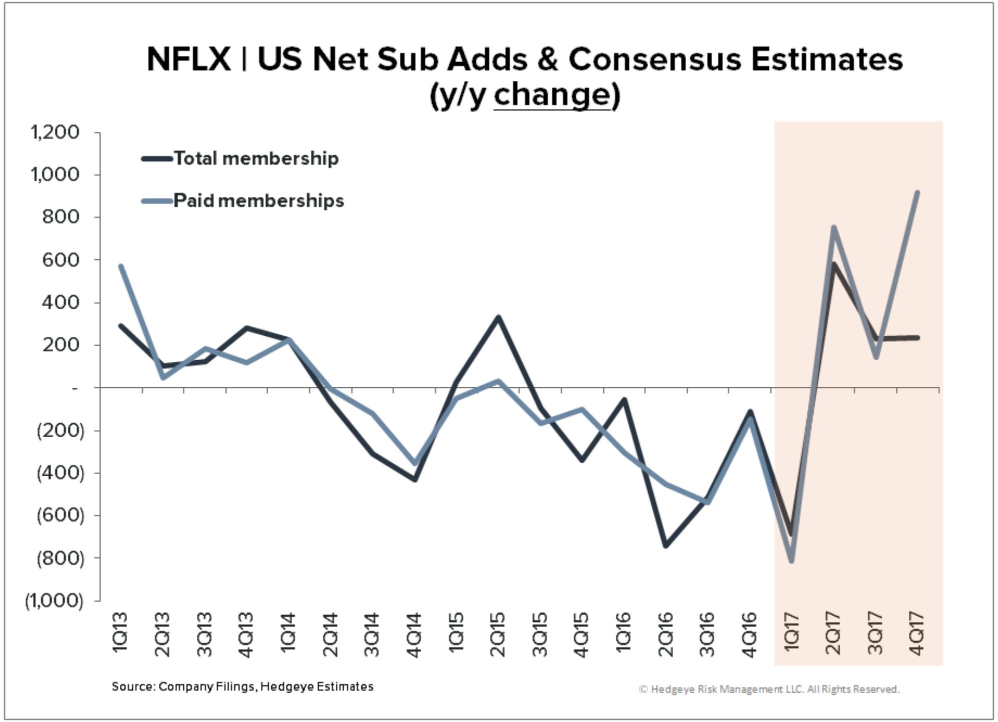


<u>CURRENT</u> TAM MAY BE CLOSER TO 56M (VS. 60M-90M)

We’re not suggesting that 60M-90M is off the table, but that it will probably take a while to get there given muted interest levels amongst the older cohorts, which represent the bulk of its remaining TAM.

Source: Hedgeye NFLX US User (June 2016)

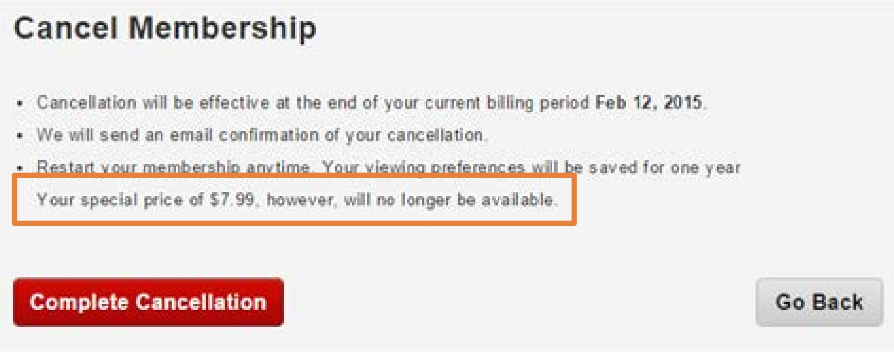
SO NOT SURE WHY THIS MAKES SENSE

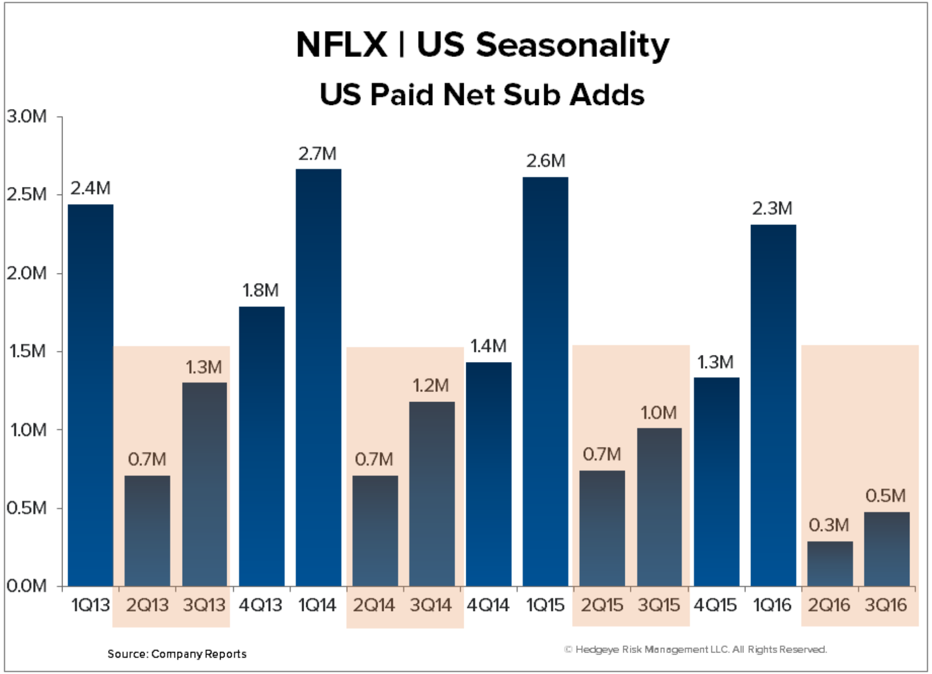


CONSENSUS IS EXPECTING US NET ADDS TO START GROWING AGAIN

Net adds have been declining on a y/y basis pretty much every quarter since 2Q14. Suddenly returning to growth despite higher penetration levels (i.e. lower remaining TAM) is pretty ambitious

ESPECIALLY W/O THE CHURN PENALTY

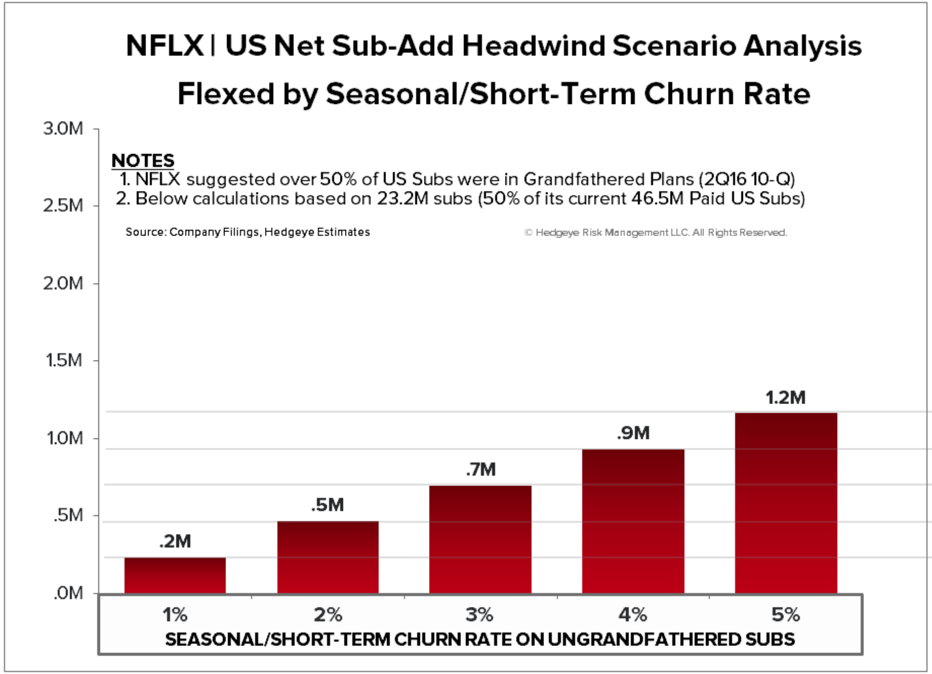


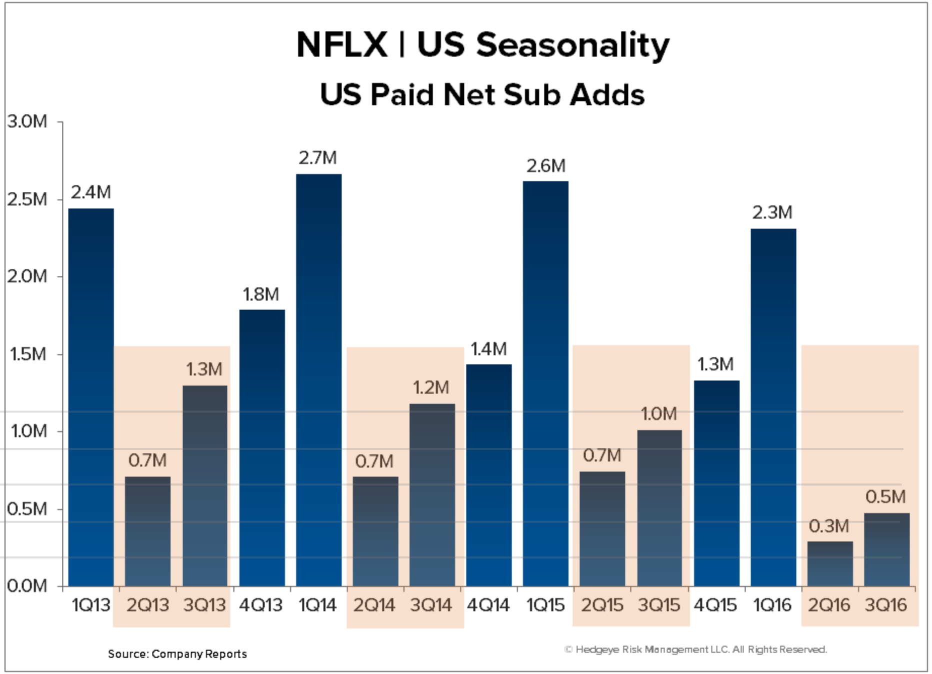


THE RISK ISN'T JUST OUTRIGHT CHURN, BUT INTERMITTENT CHURN AS WELL

First, the outright churn risk isn't confined to subs freaking out and cancelling right away, it carries into 2017. The bigger risk may be subs "pausing" their accounts if they're not using the service as much (e.g. seasonality)

S/T CHURN = BIG DEAL FOR NET SUBS

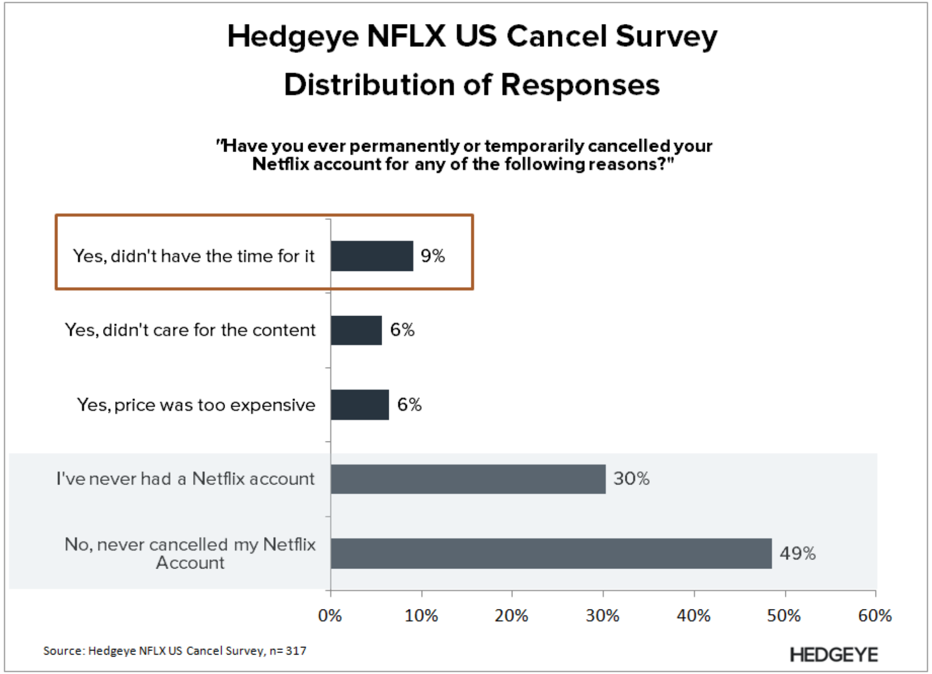


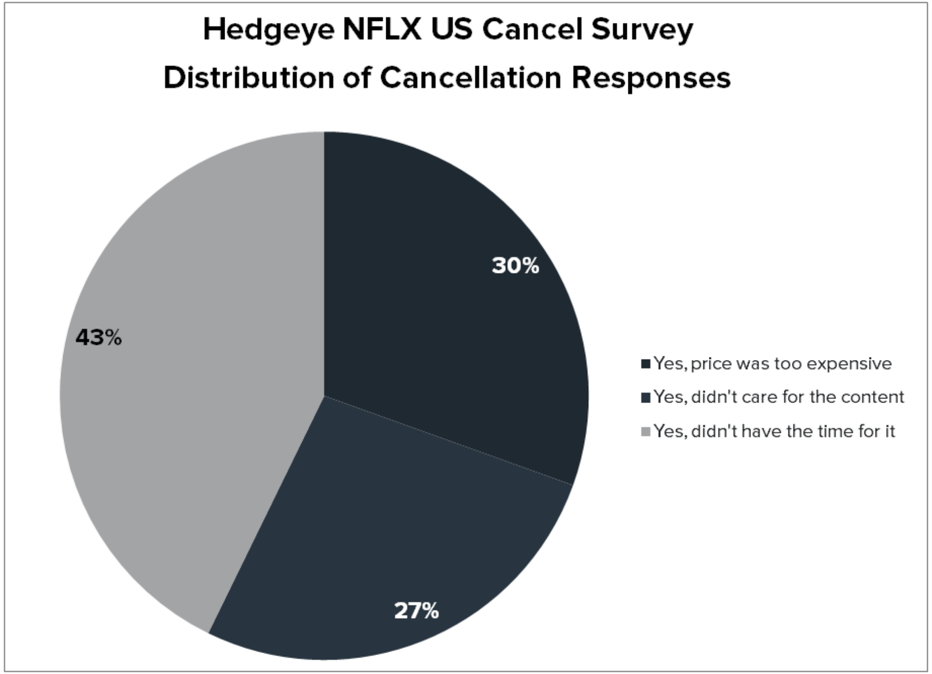


COULD EXACERBATE SEASONAL TRENDS

A few percentage points of incremental churn could possibly wipe out NFLX's US net adds in its seasonally weak 2Q & 3Q, if not lead to actual declines in its US user base. At a minimum, hard to image growth in 2017 net adds

BUT THAT'S NOT WHY SUBS CANCEL!!





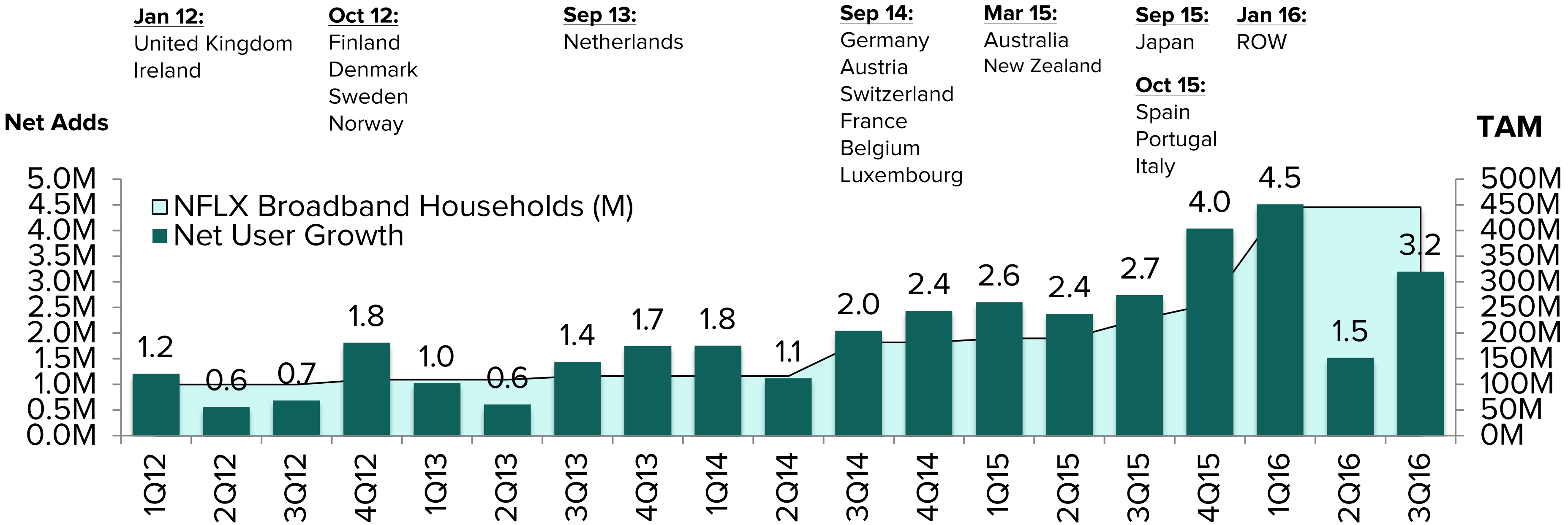
SOMETIMES IT ACTUALLY HAS NOTHING TO DO WITH NETFLIX

Note that these survey results naturally include the time period when subs were grandfathered into plans. Without the monetary churn penalty in place, pausing your account becomes a lot easier next year.

INTERNATIONAL DECELERATION

INT'L NET SUB ADD HISTORY

NFLX Int'l Net Sub Adds vs. Int'l Expansion Timeline (Broadband TAM)

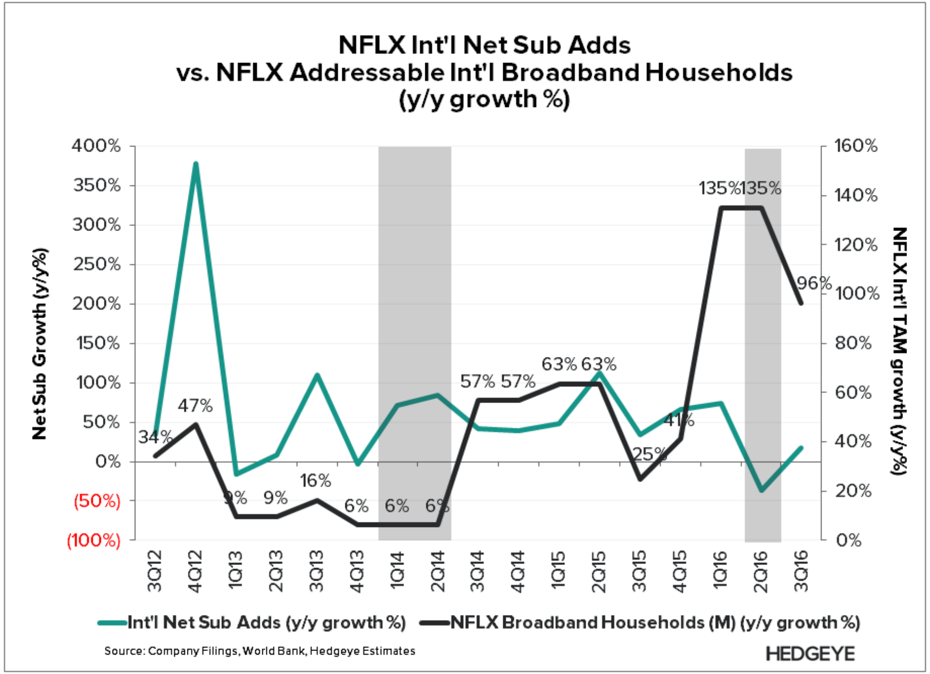


NET ADDS HAVE CLIMBED ALONGSIDE A GROWING TAM

NFLX recent history suggests that an annual run-rate of 12M-13M net new subs would be the norm moving forward since its TAM is much larger post the ROW launch, but the size of its TAM may matter less than…

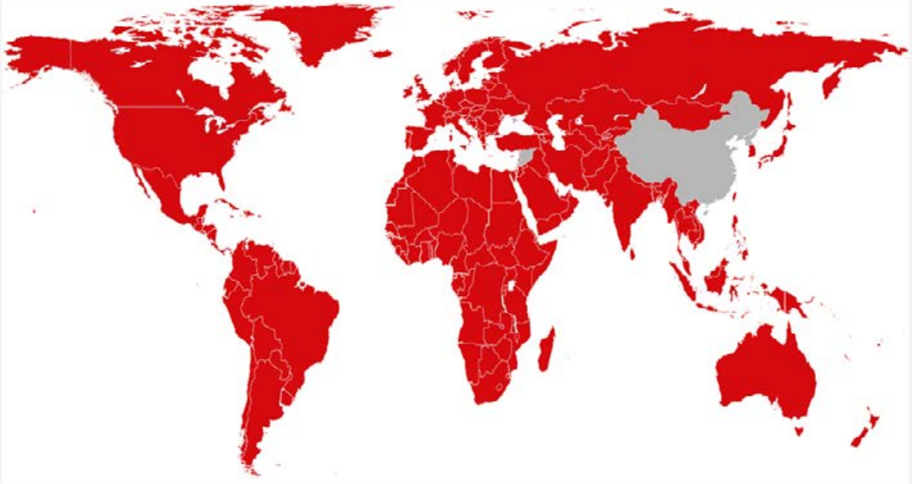
Source: Company Reports, World Bank, Hedgeye Estimates

SUB ADDS MOSTLY LAUNCH DRIVEN



Where is Netflix available?

Members with a streaming only plan will be able to watch instantly through the Netflix service from over 190 countries. The movies and TV shows that are available to stream may vary by location, and will change from time to time.



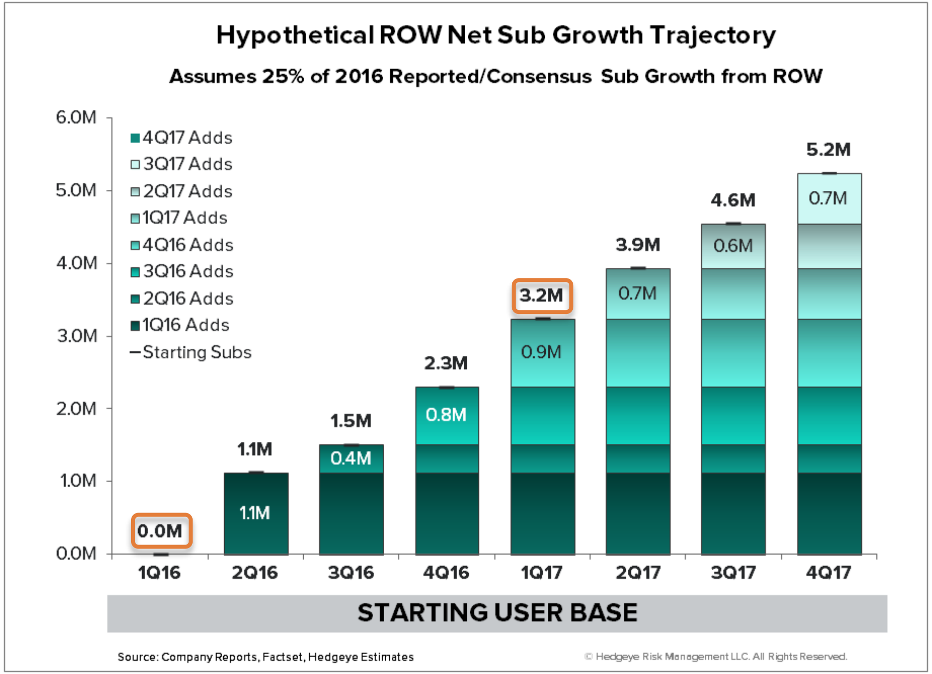
Netflix will not yet be available in China, though the company continues to explore options for providing the service. It also is not available in Crimea, North Korea and Syria due to U.S. government restrictions on American companies.

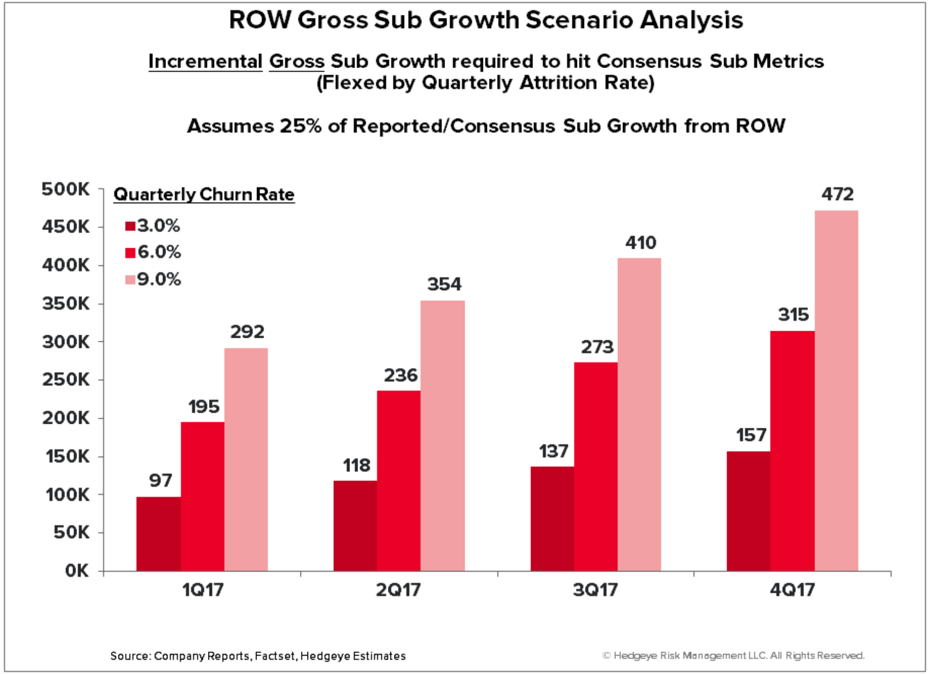
Source: Netflix.com link

AND NFLX HAS NOWHERE ELSE TO EXPAND TO

The trajectory of its TAM matters more than its size. Net sub adds growth tends to follow the growth rate of its TAM, and 2017 will be the first time since at least 2011 that NFLX isn't expanding into a new country

2017 POST-LAUNCH HANGOVER (ROW)

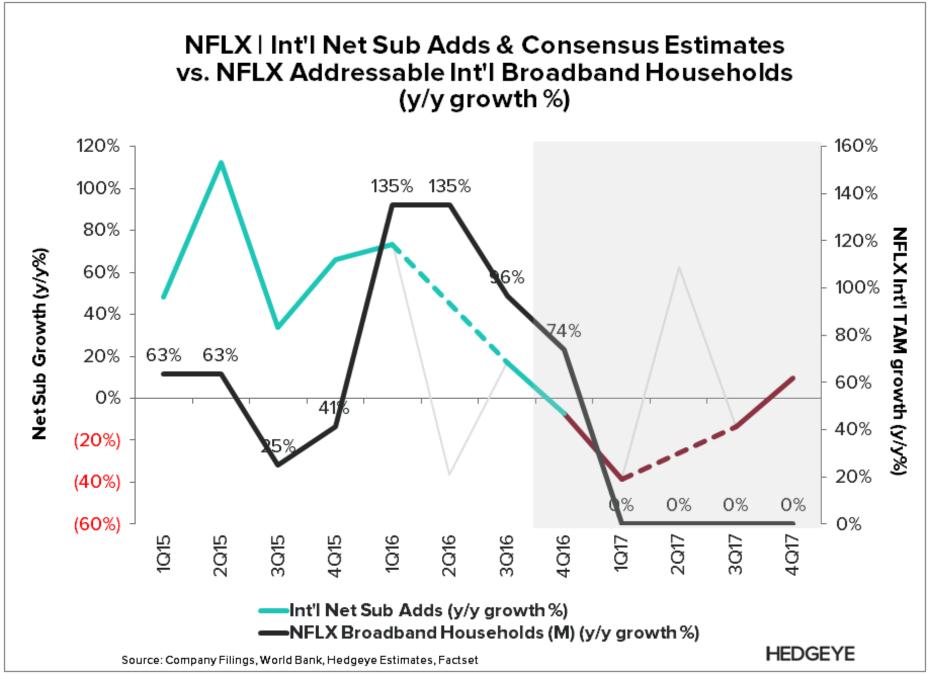


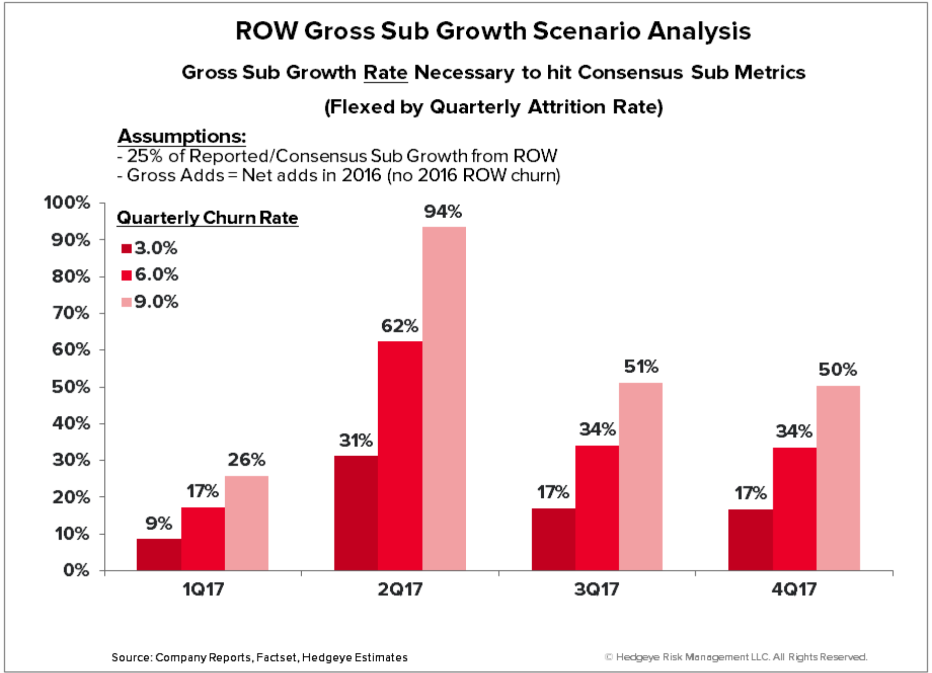


<u>GROSS</u> ADDS HAVE TO INCREASE Y/Y FOR <u>NET</u> ADDS TO STAY FLAT

The operative words are <u>net</u> & <u>add</u> (vs. gross & total). The difference b/w years 1 and 2 is churn since NFLX didn't really have a user base in year 1, but that becomes an escalating headwind in year 2.

DOESN'T BODE WELL FOR 2017

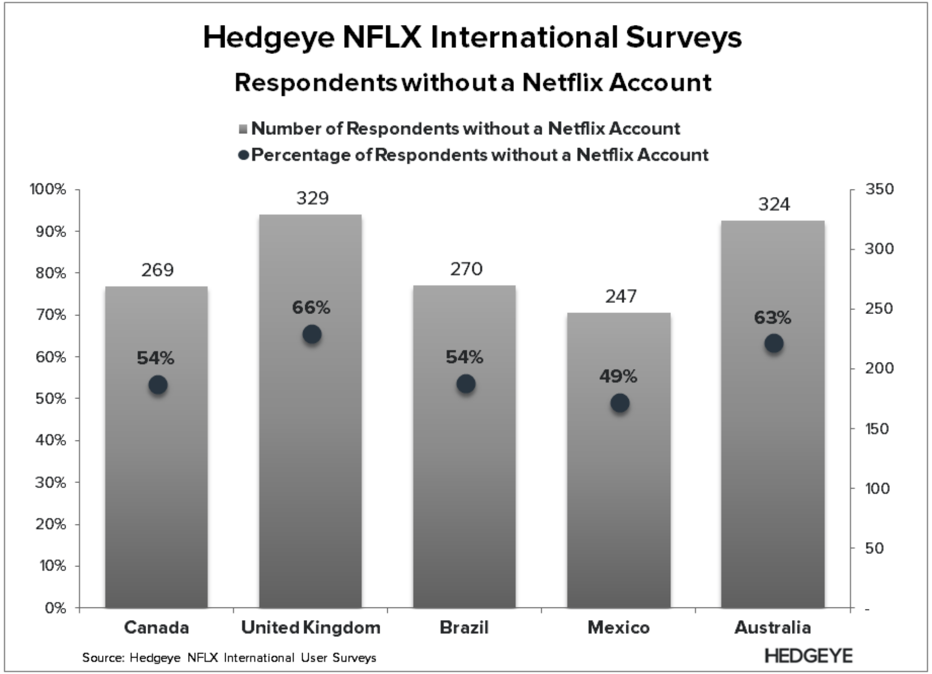


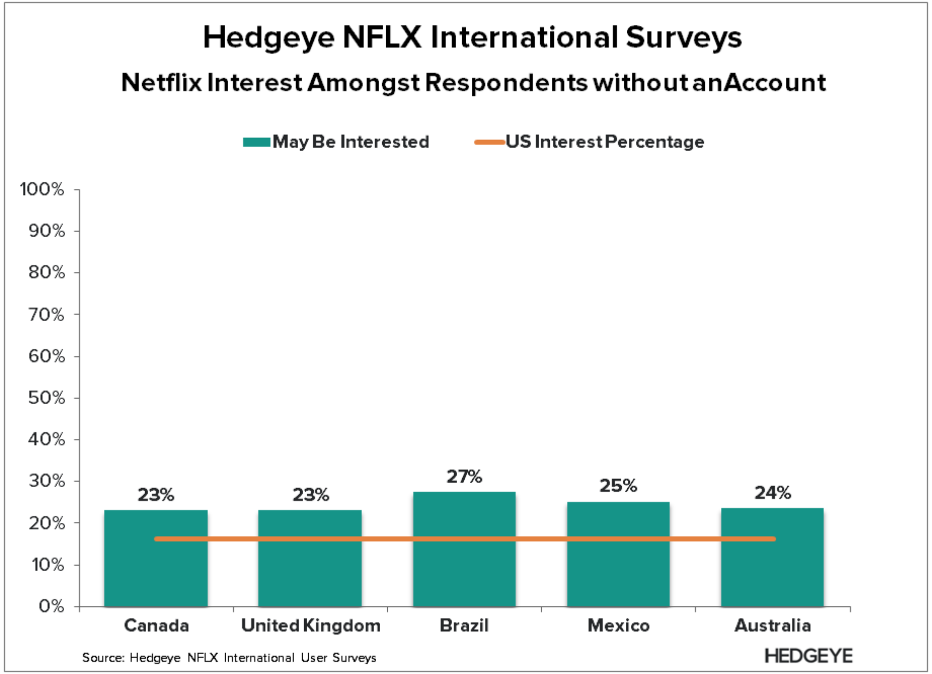


AND CONSENSUS IS LOOKING FOR ACCELERATING TRENDS INTO THAT

We truncated the chart from slide 26 and took out 2Q16/2Q17 results/estimates to smooth out the trend. Consensus is looking for a reacceleration despite increasing churn pressure and no country launch to offset that.

WHAT ABOUT THE PRE-2016 MARKETS?





NFLX MAY HAVE ALREADY CAPTURED MUCH OF THE LOW-HANGING FRUIT

The chart to the left is included just to provide context to the right in terms of sample size, which is limited. But given that we asked these surveys with an affirmative bias, the output is still instructive.

NFLX | KEY POINTS

1

CONTENT = HAMSTER WHEEL

NFLX's content expenditures are a much bigger hurdle than its income statement/contractual obligations would suggest. NFLX's content profiles more as recurring expense than it does asset, and its obligations are an understated view of the ongoing cost of running that model.

2

RUNWAY GETTING SHORTER (SUBSCRIBERS)

We expect that the bull/bear debate is coming to a head in 2017 with net sub adds in both segments facing mounting pressure with the emergence of two big headwinds in each market. Consensus is positioned for improving trends through 2017.

3

2017 = NOT ENOUGH CAPITAL?

NFLX could conceivably counteract its 2017 sub-add headwinds by considerably ramping up its marketing spend, but we doubt it will have the budget to do so given our expectation for surging SAC and that the bulk of that budget is committed/earmarked for content outlays.

2017 = UNCHARTED WATERS

Cancel Membership

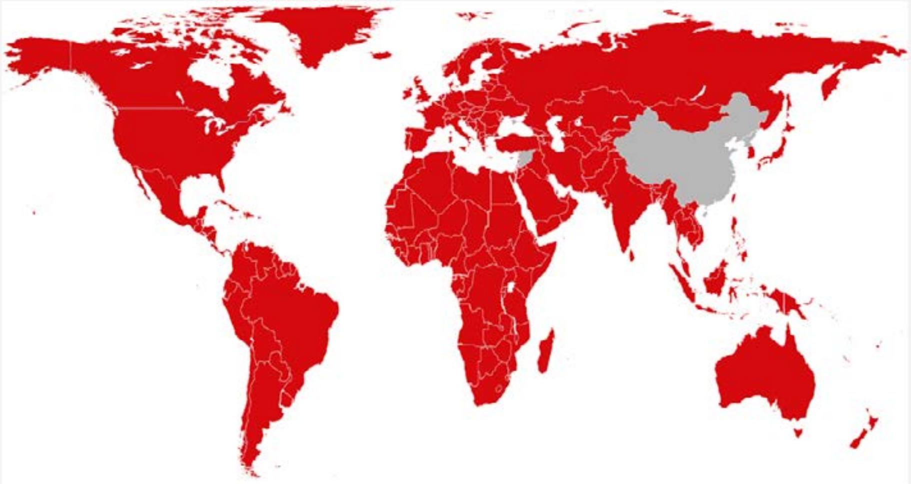
- Cancellation will be effective at the end of your current billing period **Feb 12, 2015**.
- We will send an email confirmation of your cancellation.
- Restart your membership anytime. Your viewing preferences will be saved for one year

Your special price of $7.99, however, will no longer be available.

Complete Cancellation **Go Back**

Where is Netflix available?

Members with a streaming only plan will be able to watch instantly through the Netflix service from over 190 countries. The movies and TV shows that are available to stream may vary by location, and will change from time to time.

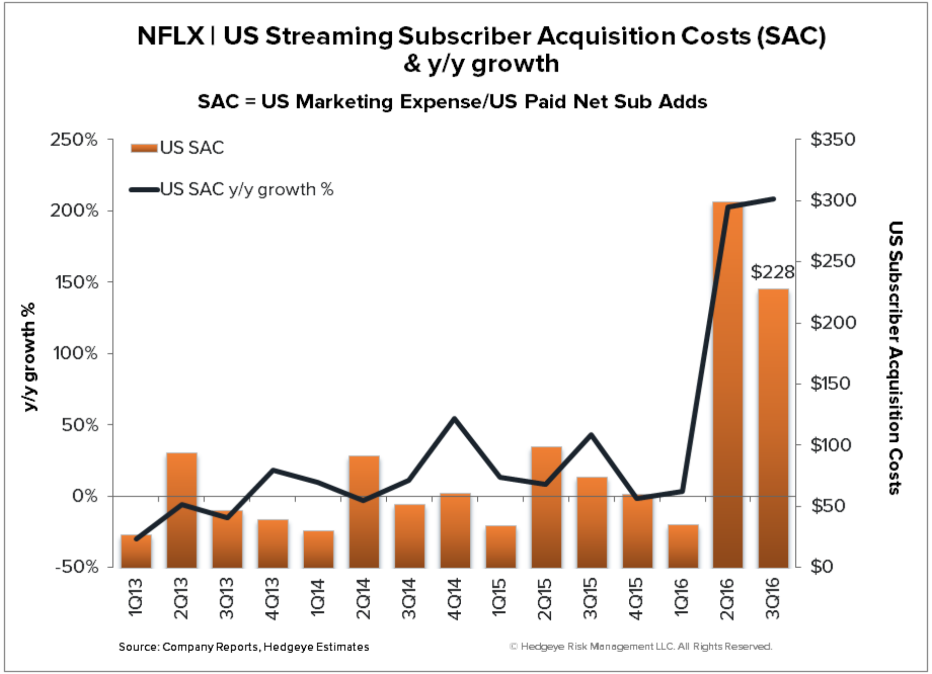


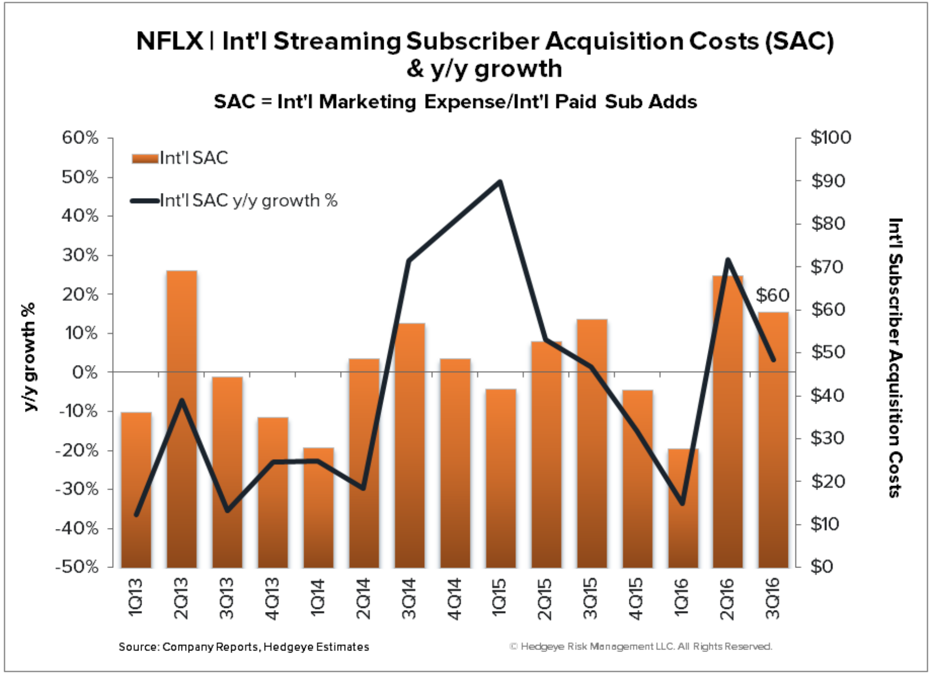
Netflix will not yet be available in China, though the company continues to explore options for providing the service. It also is not available in Crimea, North Korea and Syria due to U.S. government restrictions on American companies.

NO EMBEDDED CHURN DETERRENT + NO WHERE TO EXPAND

These headwinds are occurring <u>simultaneously</u>, making 2017 a bigger challenge than most years with global net adds poised to decline all things being equal. The potential offset <u>could</u> be to ramp up marketing spend

SAC LIKELY TO RAMP IN 2017

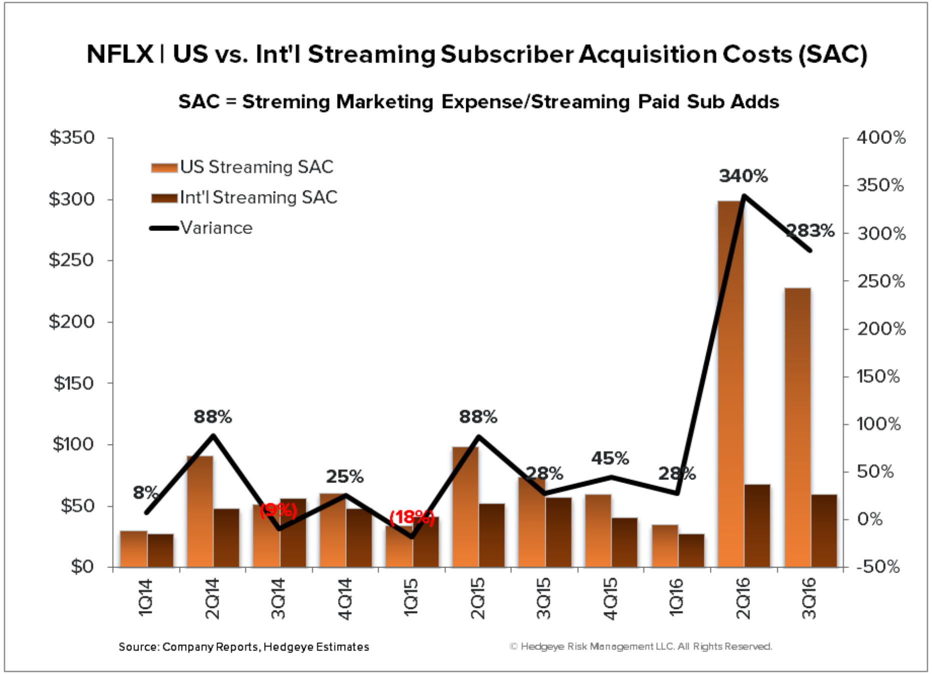


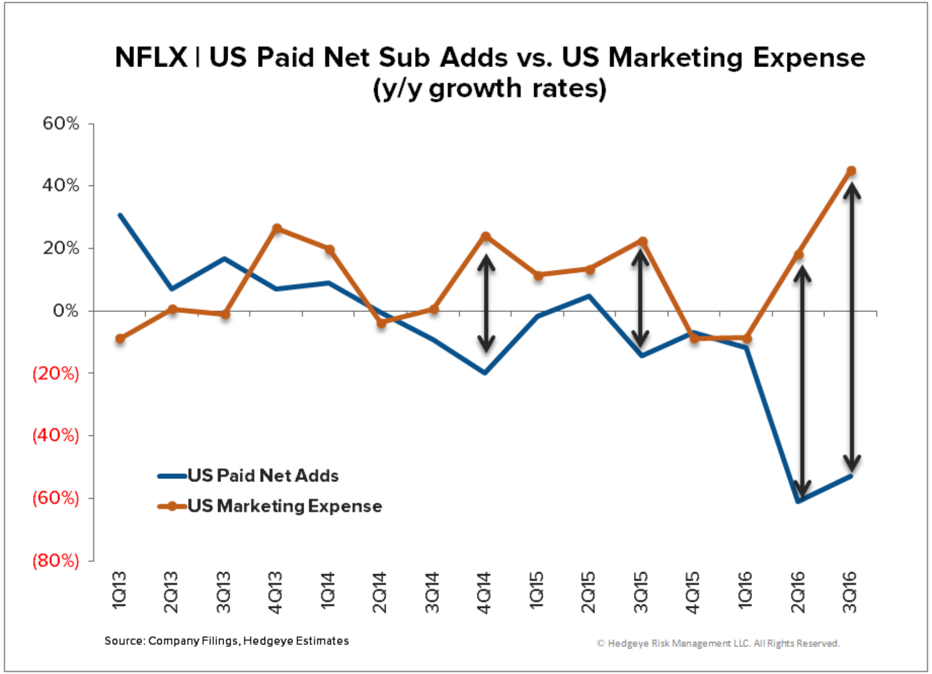


IT'S ALREADY AT/NEAR ALL TIME HIGHS

US SAC hit new highs alongside ungrandfathering, but as we mentioned before those risks will carry in 2017. Int'l SAC is at highest level since 2013, and likely accelerates next year given the ROW post-launch hangover

BUDGET MAY SHIFT TOWARD US

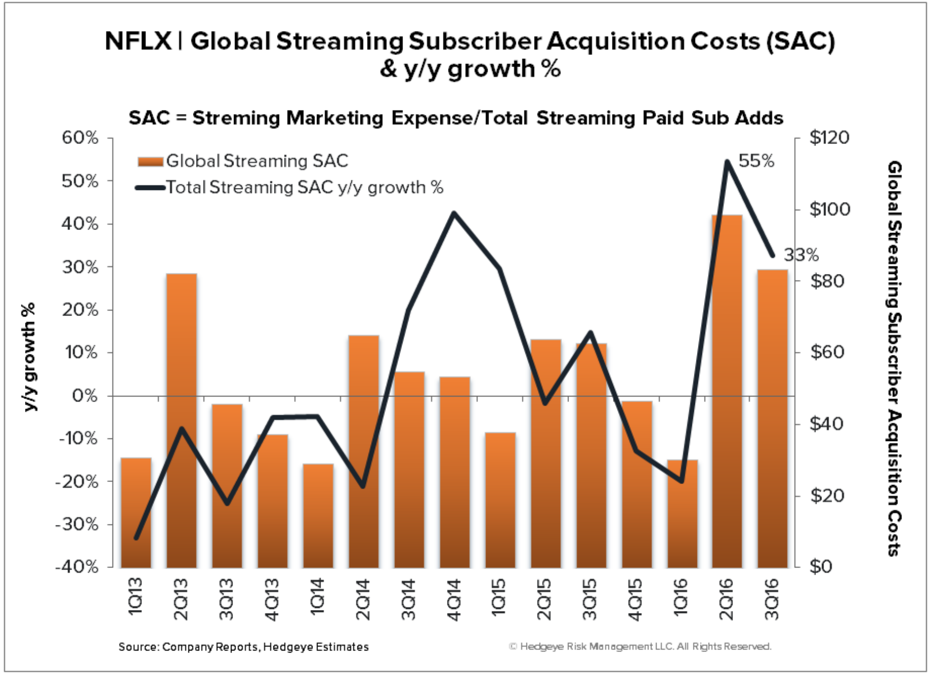


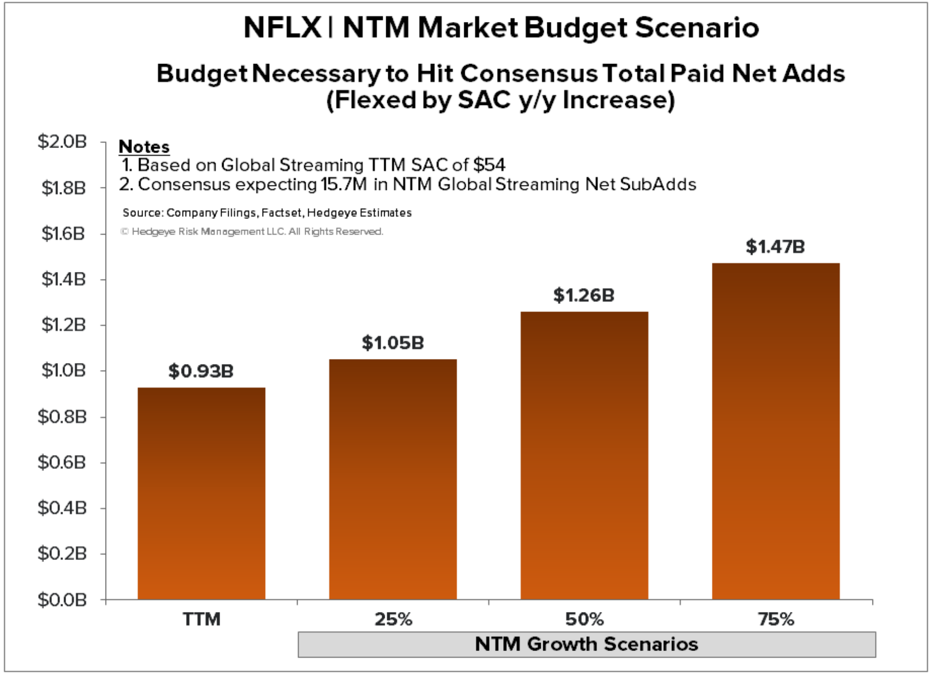


SAC COULD INCREASE ON MIX-SHIFT ALONE AS NFLX DEFENDS ITS HOME TURF

The second chart suggests that NFLX tends to ramp up US marketing spend when it sees pressure on net adds. With the US is in a far more vulnerable position next year, so there may be less budget for the int'l segment

NFLX NEEDS MUCH BIGGER BUDGET

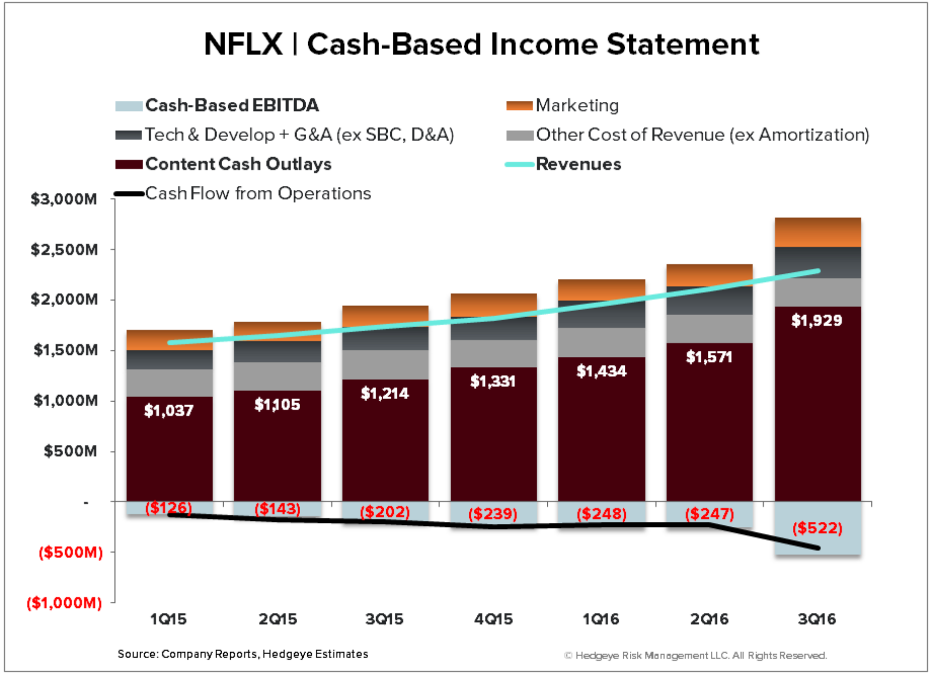


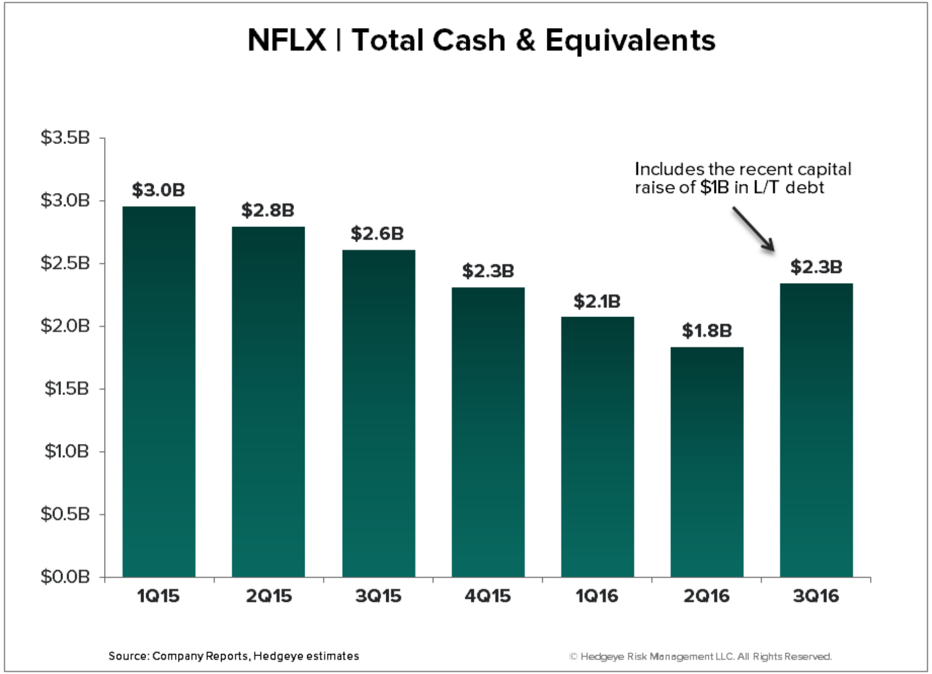


REQUIRED MARKETING BUDGET: $1.0-$1.5B, WHICH MAY BE OPTIMISTIC

It's not really a question of SAC growth, but how much given escalating headwinds across each market and potentially more of that marketing budget shifting into the higher cost US channel

WHAT DOES NFLX HAS TO WORK WITH?

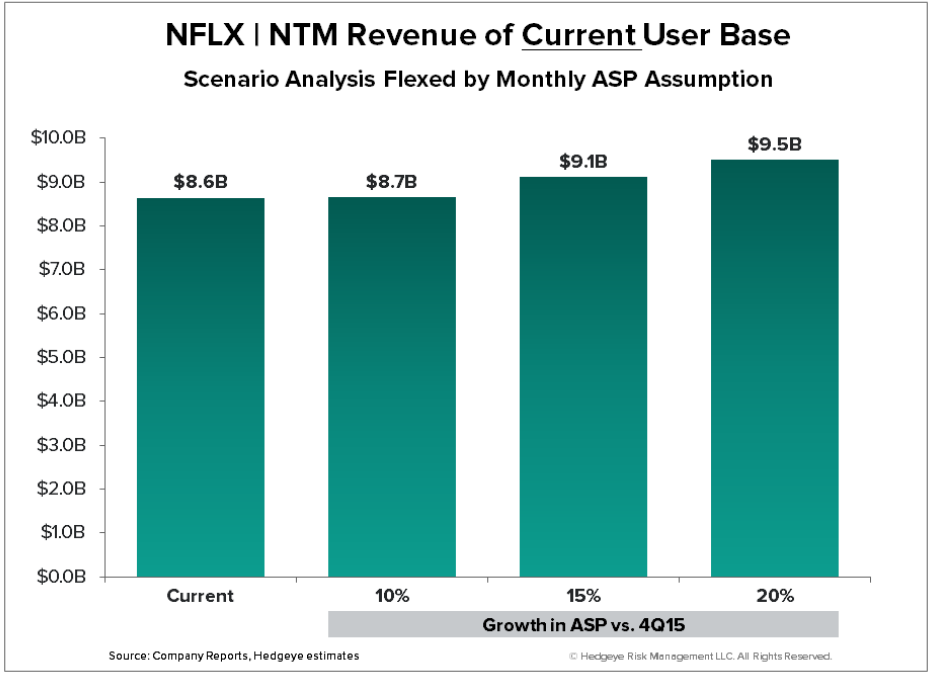


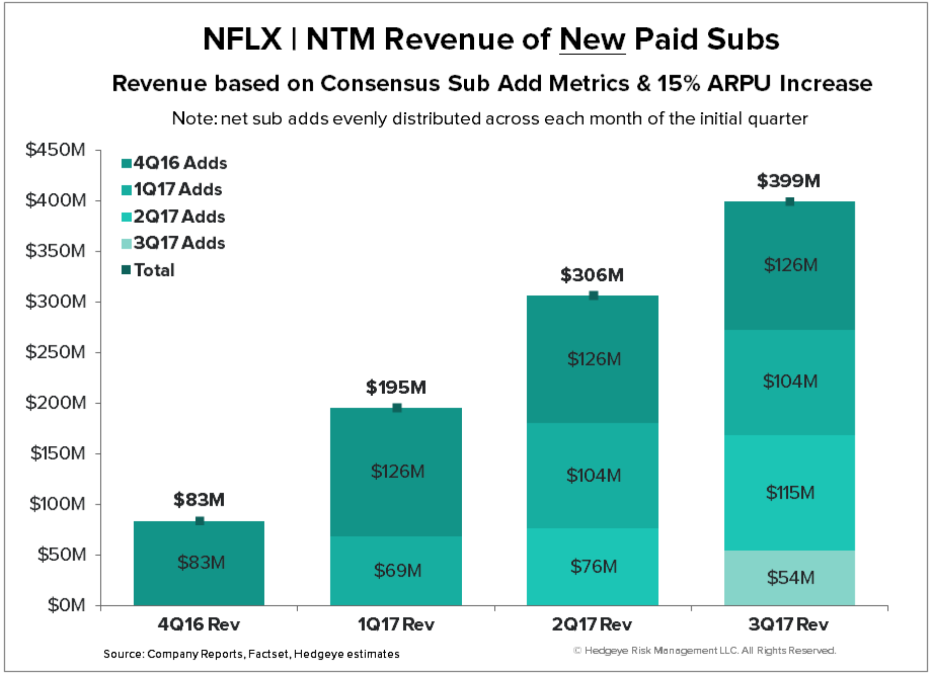


PROBABLY NOT MUCH OUTSIDE THEIR CASH

The operating model has been bleeding cash. Even with the ARPU increase from ungrandfathering, we estimate that NFLX will not have much left to work with. The next few slides focus on its NTM Streaming operating budget

NTM STREAMING REV: $9.5B-$10.4B

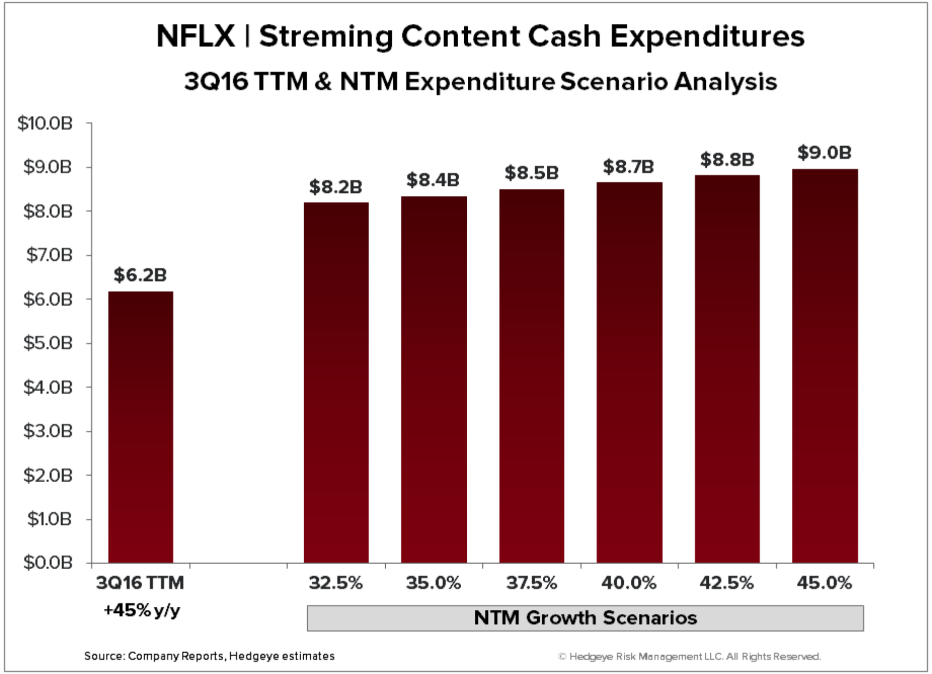


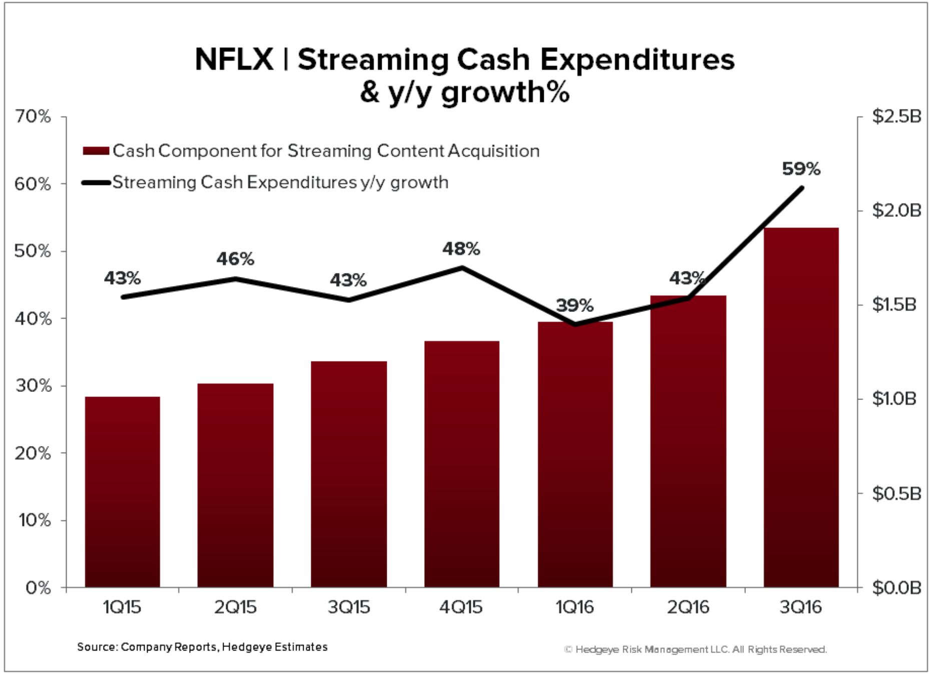


~$9B FROM CURRENT USERS + $0.9B FROM NEW USERS

Mgmt suggested in its 2Q16 10-Q that is was expecting a 10%-20% y/y increase in ARPU by 4Q16. Our NTM new revenue estimate is convoluted since we're working off consensus estimates that we believe are lofty…

NTM STREAMING OUTLAYS: ~$8B-$9B

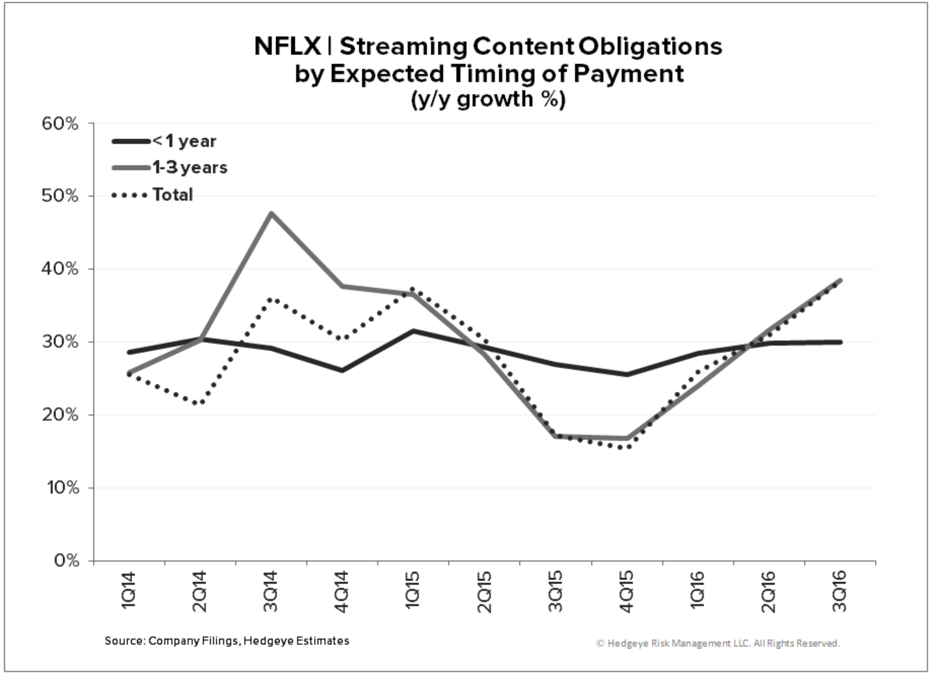


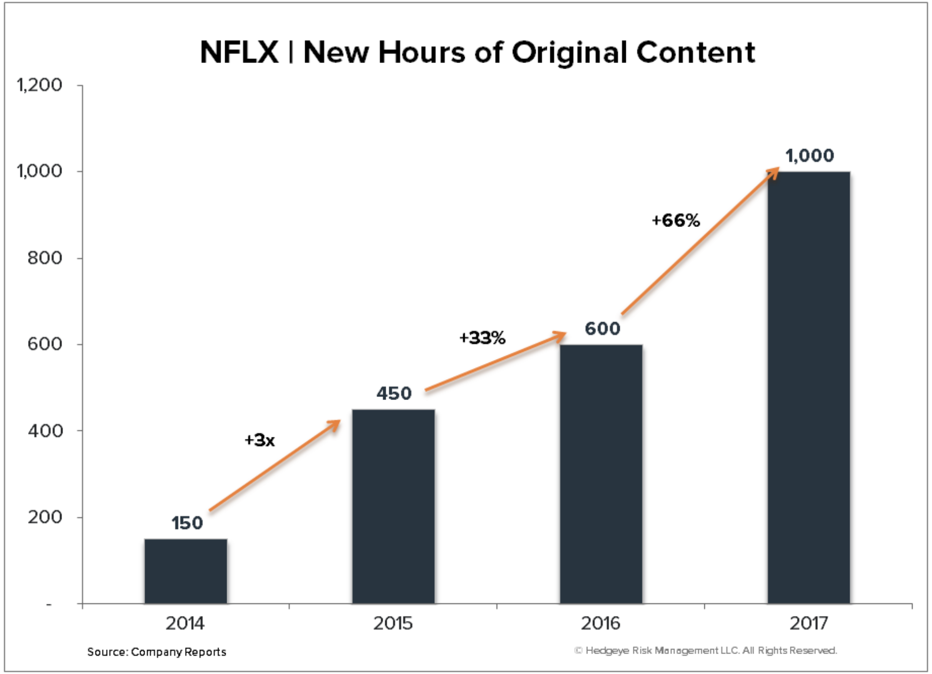


WE'RE JUST REFERRING TO CONTENT OUTLAYS, NOT TOTAL COGS

We suspect the growth rate in content spend could wind up being closer to the high-end of the NTM growth range in the chart considering the trajectory of both its contractual obligations and original content (next slide)

NO SIGNS OF CONTENT SLOWING

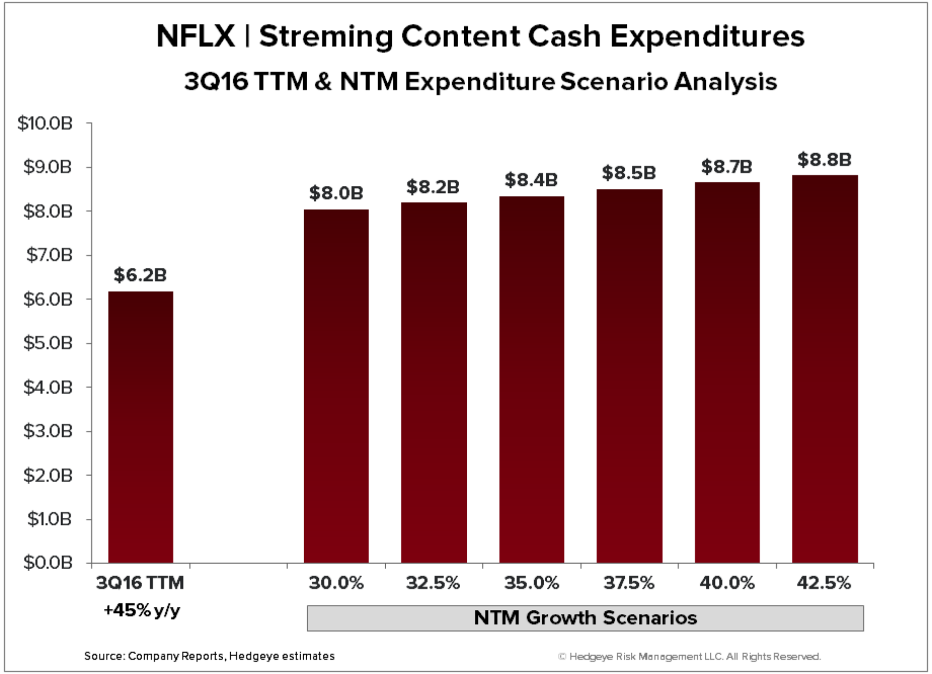


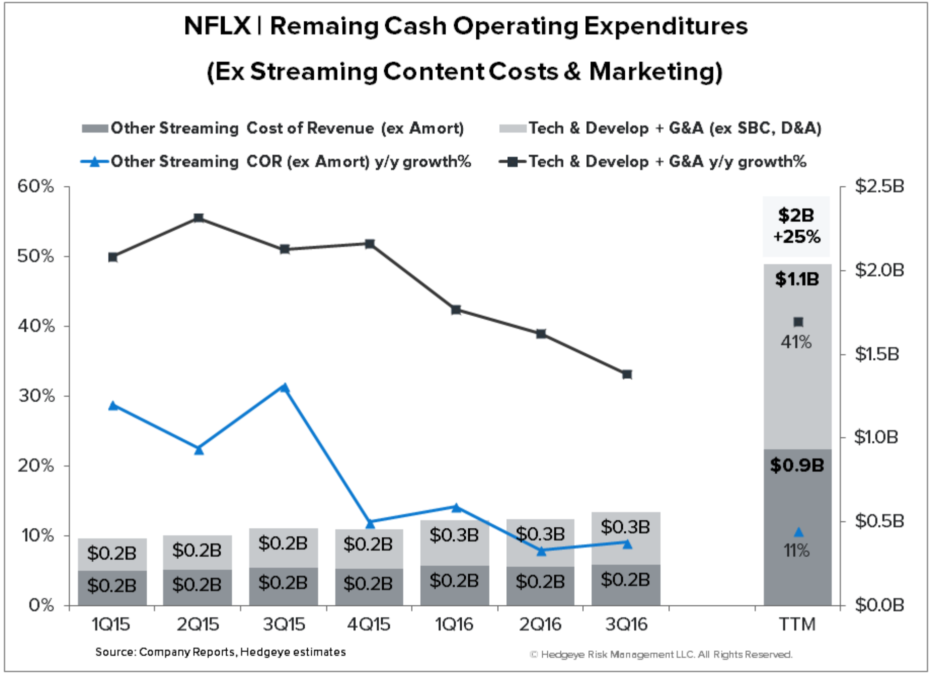


2017 SHAPING UP AS ANOTHER YEAR OF ELEVATED GROWTH

The growth in NFLX's NTM contractual obligations (prior slide) and planned original releases remains elevated. The combination of the two suggests another year of elevated growth

NTM TOTAL OP EXPENSES: $10-11B

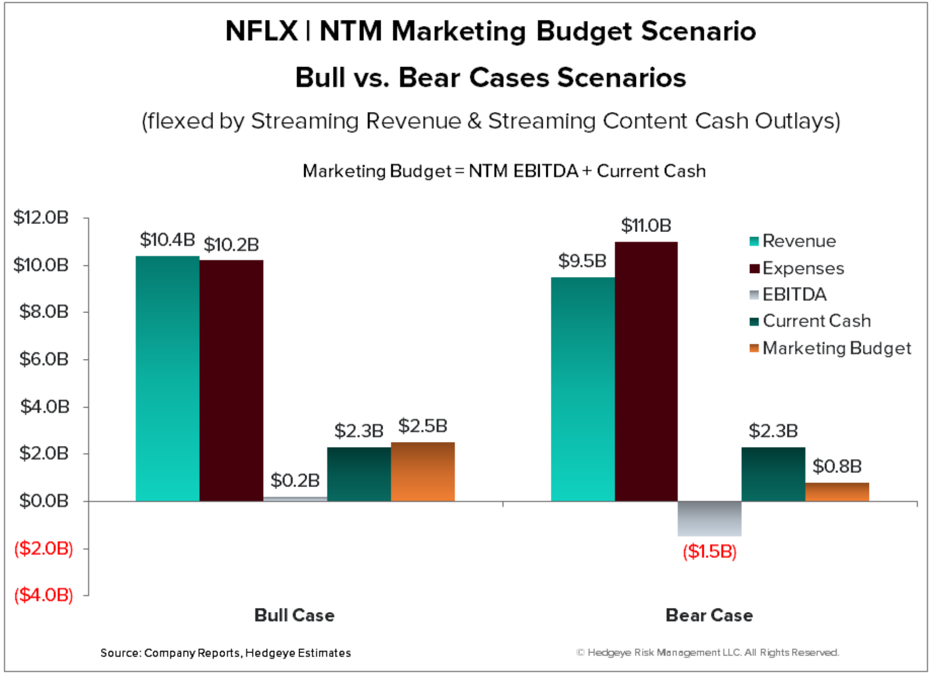


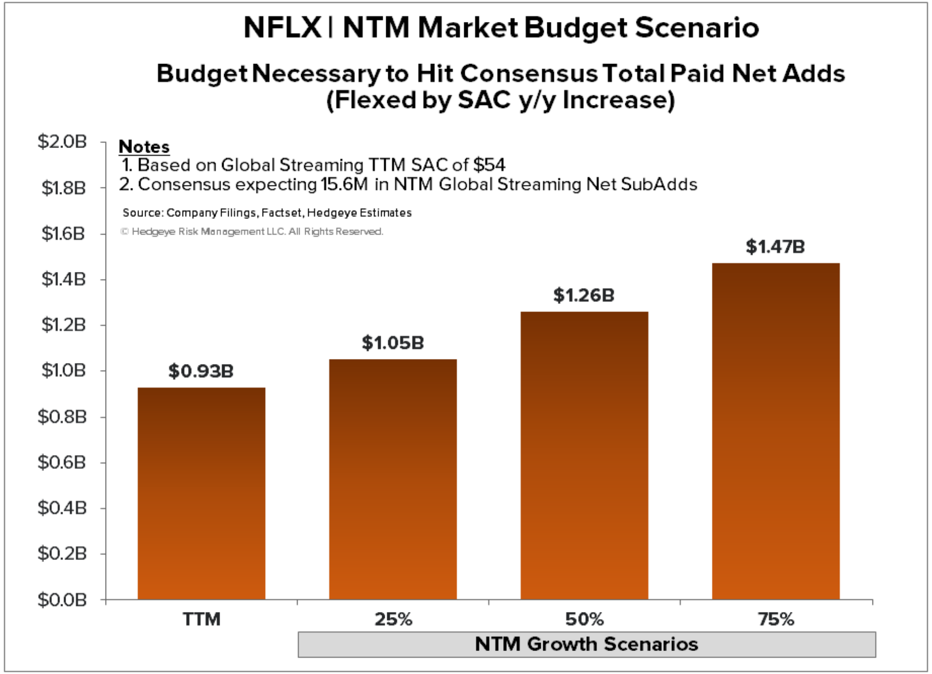


STREAMING CONTENT = $8B-$9B + ≥$2B REMAINING OP EXPENSES = $10-$11B

Remaining Cash Operating Expenses (ex Marketing) is NFLX Other Cost of Streaming Revenue and Tech & Development + G&A (net non-cash charges). Note that $2B assumes no y/y growth in the NTM.

NTM MARKETING BUDGET?

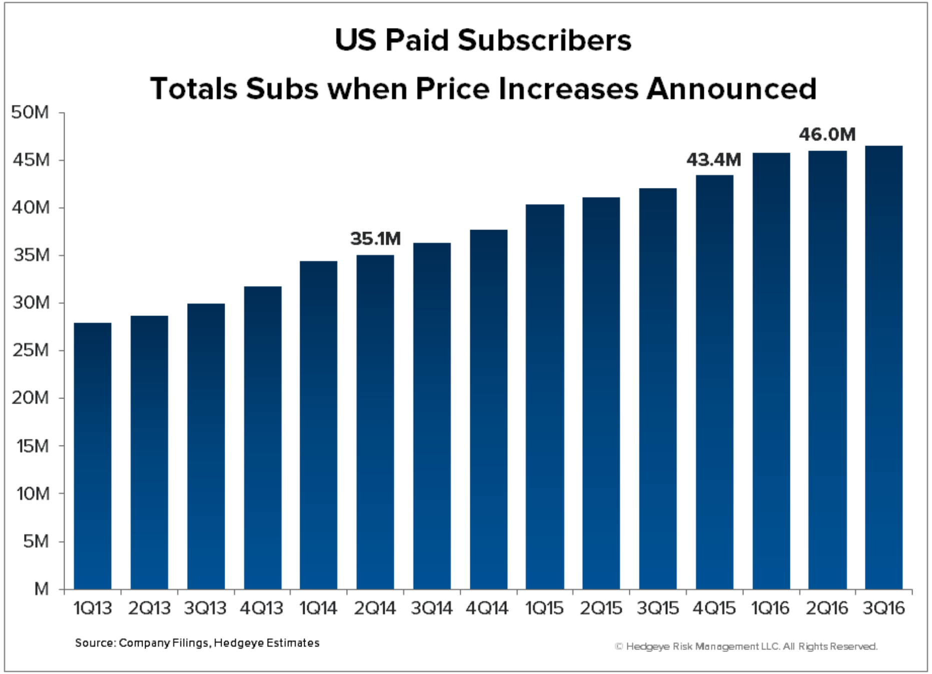


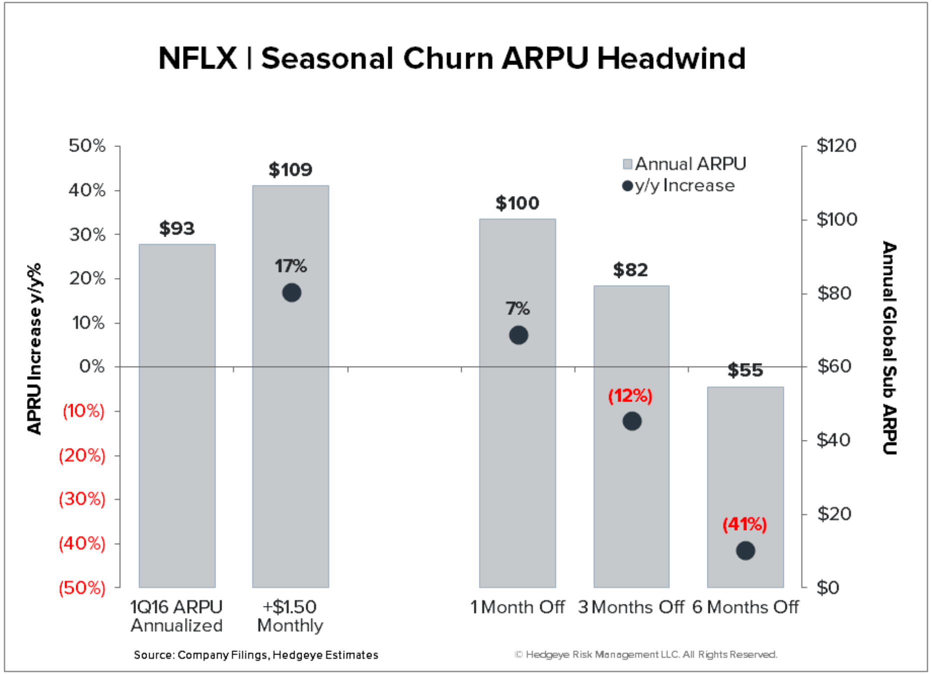


DOESN'T LOOK THAT BAD UNTIL YOU START THINKING ABOUT IT

The midpoint of the bull & bear cases suggests NFLX could fund a material marketing budget after considering EBITDA contribution, but there are series of other factors at work that could hamper that budget

S/T CHURN COULD HIT REV/ARPU

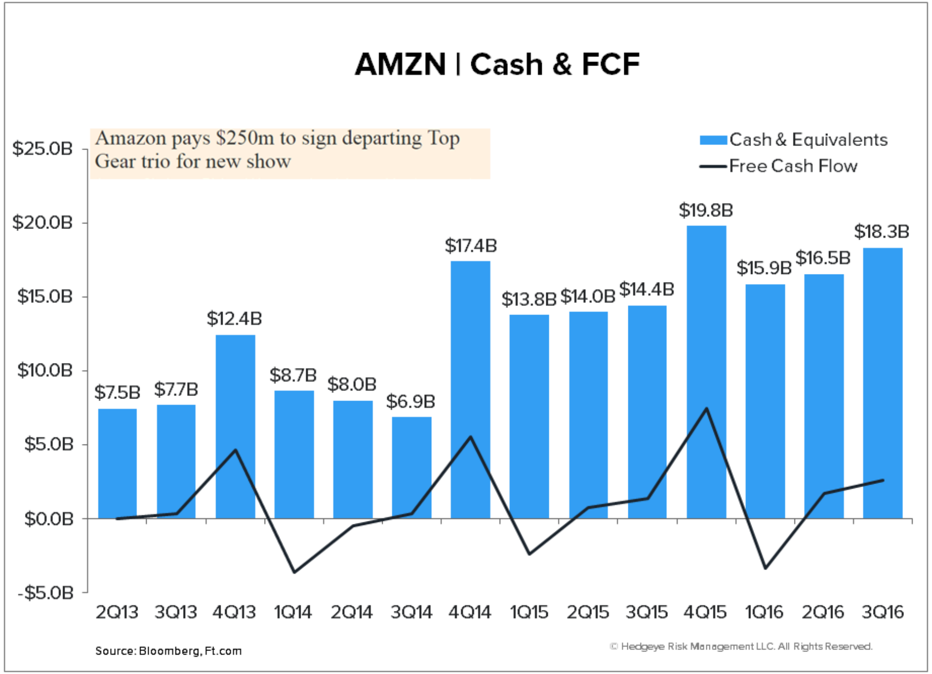


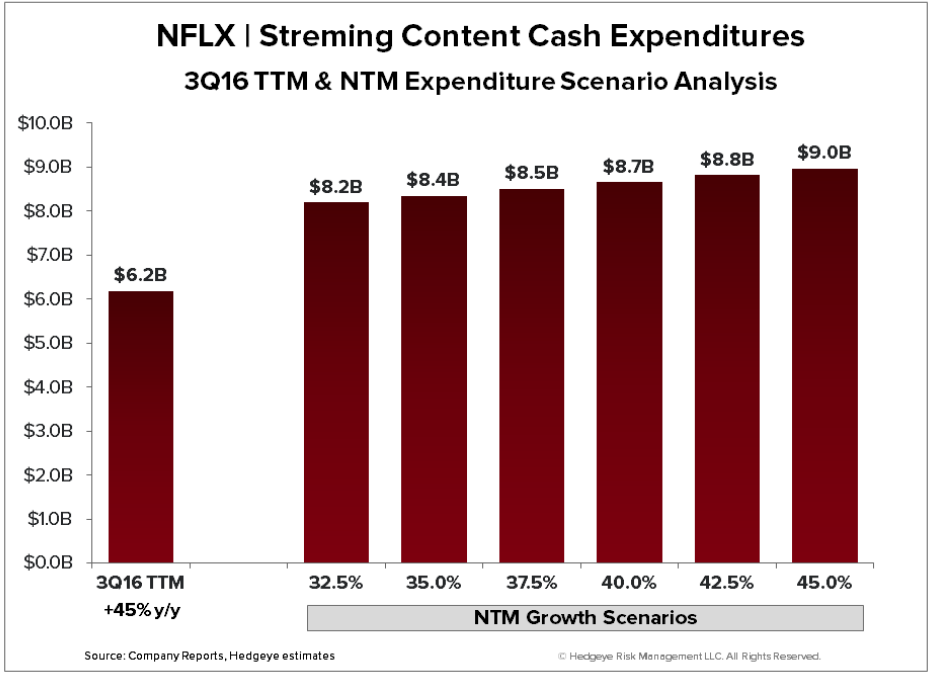


COULD LIMIT TAILWIND FROM PRICE INCREASES

Mgmt suggested <u>over</u> 50% of its accounts were in ungrandfathered plans, but the trajectory of its sub metrics suggest those subs may be the overwhelming majority, but prior churn makes it tougher to gauge.

NFLX MAY BIGGER CONTENT BUFFER

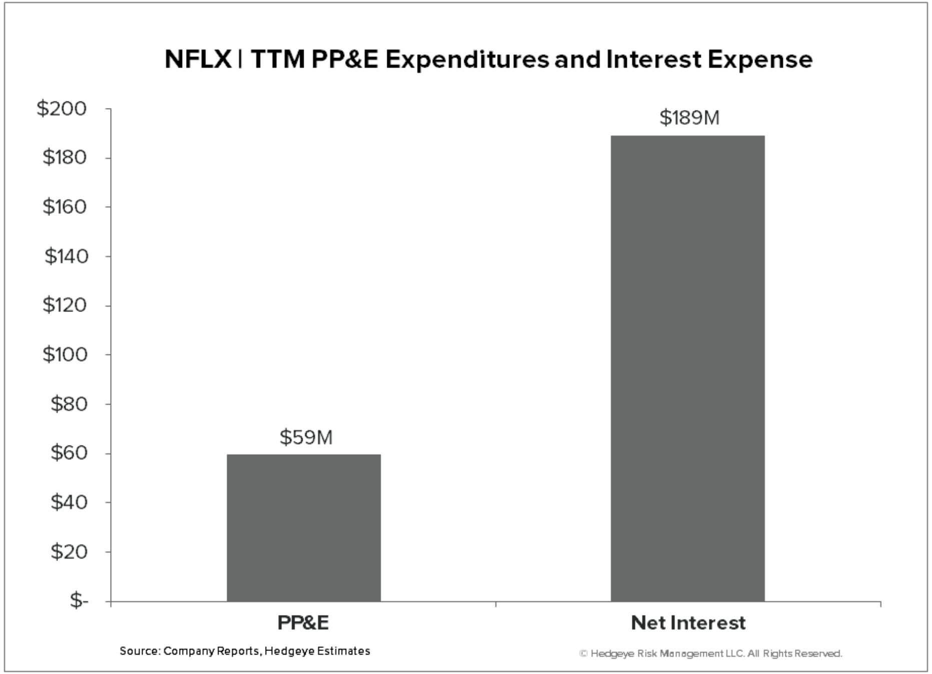


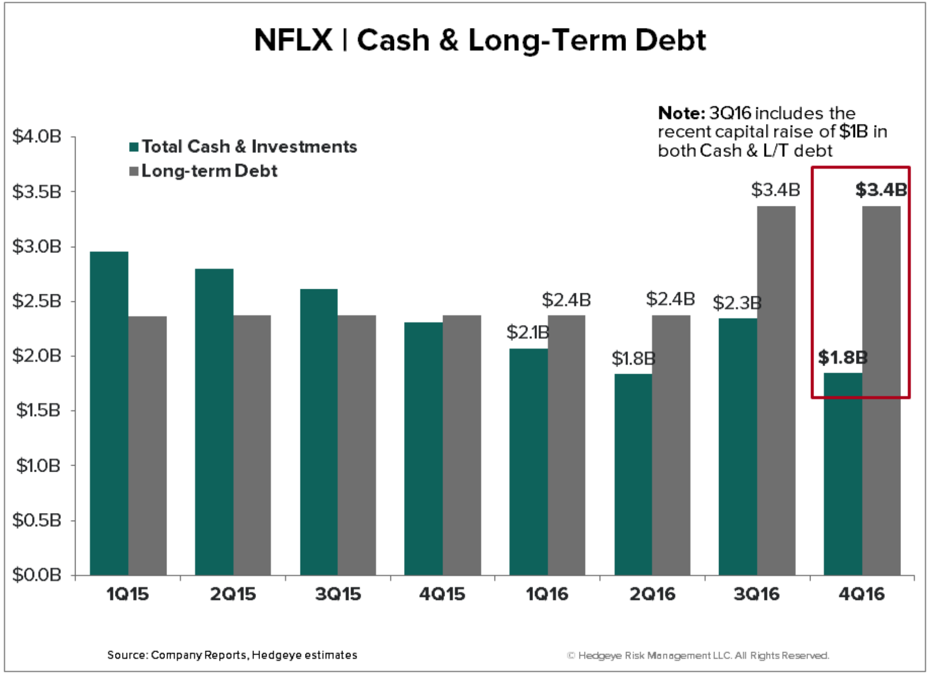


AMZN COULD WIND UP DRIVING UP CONTENT COSTS FOR THE INDUSTRY

AMZN'S foray into streaming means there's a new better-capitalized/aggressive bidder for content, which means NFLX could be outbid in some cases, but at a minimum faces rising unit costs via increased competition

OTHER CASH COMMITMENTS

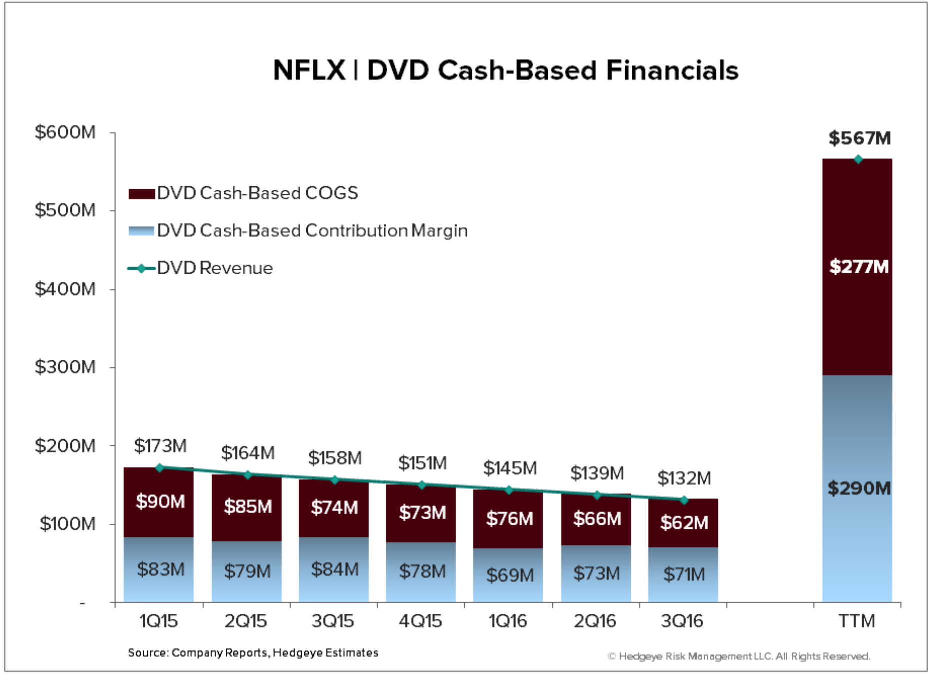


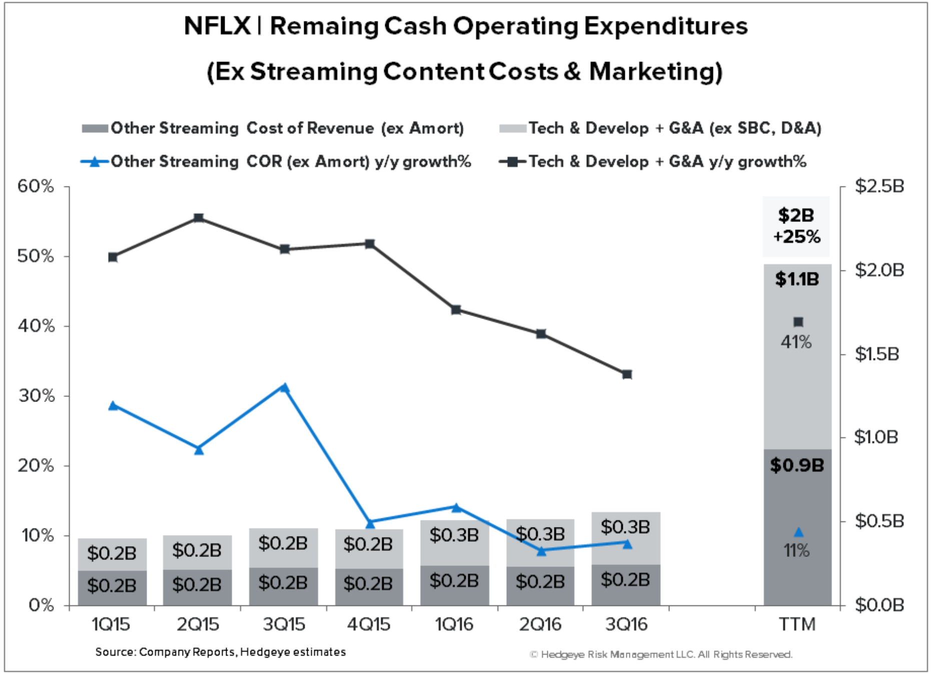


TTM PP&E + INTEREST EXPENSE ≈ $250M, LIKELY INCREASES FROM HERE

PP&E could moderate since NFLX isn't expanding to any countries, but Net Interest will increase on both a +40% in debt load + lower NTM cash balance, especially since NFLX expects 4Q free cash burn ≈ 3Q levels (~$500M)

WHAT ABOUT THE DVD SEGMENT?

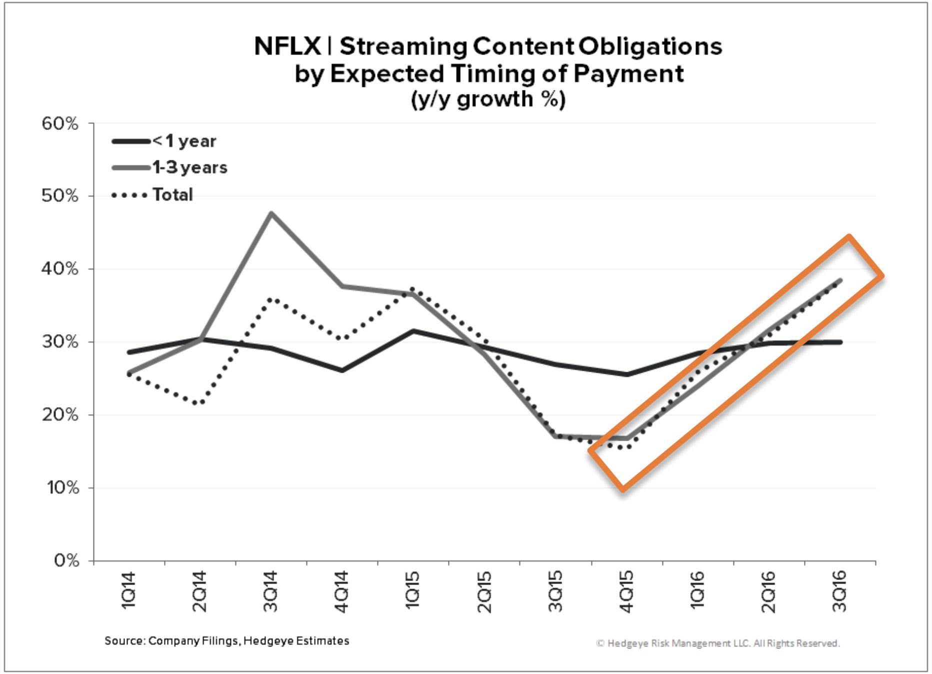


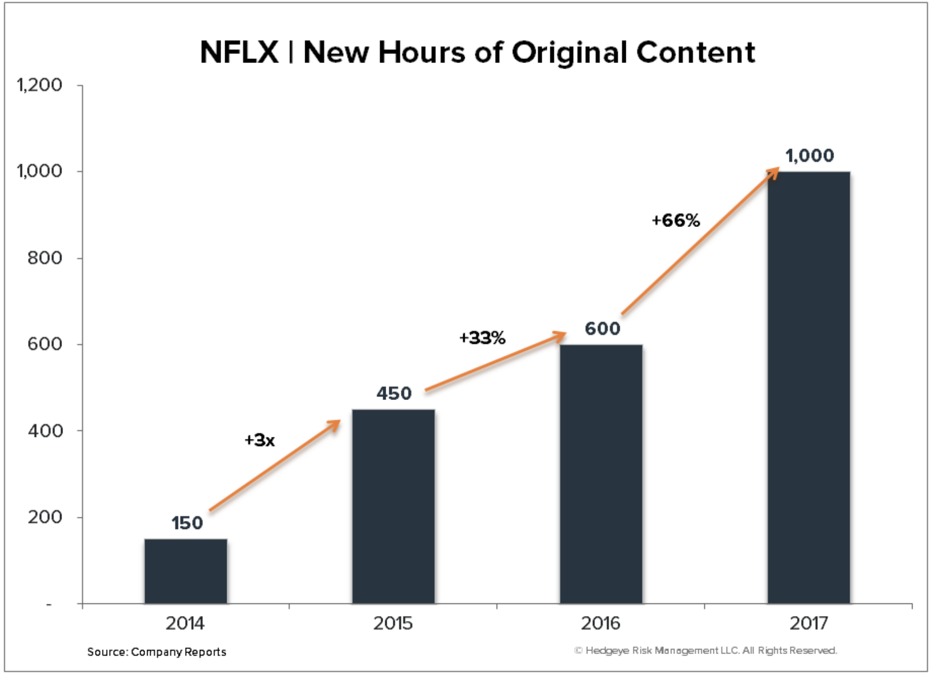


IT'S IRRELEVANT

The reason we left it out before was to simplify our scenario analysis. While still a decent source of cash, it's in secular decline, and it's so small that any reasonable increase in Remaining Op Ex could wipe it out

CAN'T NFLX JUST RAISE MORE MONEY?





IT PROBABLY WILL, BUT THOSE FUNDS MAY ALREADY BE EARMARKED

NFLX is already planning for 2018, and its accelerating 1-3 yr obligations could mean accelerating growth in content spend. Also, NFLX will need to start paying for its 2018 in 2017 since it requires more upfront payment.

NFLX | ASSESSING THE SETUP

Summary: We suspect the NFLX debate to favor the bears in 2017 given heightened & simultaneous net add headwinds across each of its streaming segments from the elimination of the churn deterrent and no new countries to launch into to compensate for the ROW post-launch drag. Further, we don't believe NFLX can raise a large enough marketing budget to compensate, and even if it did, we're not sure it would matter. We want to exposure to NFLX's seasonally weak quarters since we expect heighted seasonality to pressure US net adds in those quarters, and mgmt to shift marketing budget away from the int'l markets to try and compensate, in turn pressuring int'l sub adds at the same time. The entry point is up for debate given the pre-emptive 1Q17 sandbag, but we don't have a good track record playing the quarters, so we may just jump ahead of 4Q16 given the risks below.

Risk to Thesis: The stock is yo-yo, and consensus adjusts its estimates as such. There may only be 1-2 good catalysts in 2017.

Timeline

- **4Q16**: Mgmt preemptively sandbagged the 1Q17 guide on the 3Q16 print, so may sit out depending on our tracker
- **1Q16**: Likely entry point before, 2Q guide likely disappoints on material y/y increase in consensus net adds metrics.
- **2Q16:** If 2Q guide inline, expect miss on both 2Q sub add metrics and associated 3Q guide
- **3Q16:** Riskier print since same seasonal factors could lead to improving 4Q trends on likely rebased consensus estimates

FOR MORE INFORMATION, CONTACT US AT:

SALES@HEDGEYE.COM

(203) 562-6500