INVESTMENT BRIEF
Netflix, Inc.

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New Investment: Netflix

Netflix is a leading global paid streaming video service, with 213 million subscribers – 74 million in the U.S. and Canada and 139 million in the rest of the world – that distributes its content to over 190 countries. The company pioneered the streaming delivery of TV shows and movies over the internet, a service previously delivered through cable subscriptions and DVD rentals or purchase.

I first began doing investment analysis on Netflix in the spring and summer of 2019, and developed a deep appreciation for the quality of the business, its large and sustainable advantages, and its outstanding management team. An inability at that time to really get comfortable with its price, which was then under $300 per share (!), kept me from buying it. The selloff in its shares in April of this year, when the market was disappointed by its quarterly subscriber growth, presented a good opportunity for us to establish a position.

Scale Advantage

Netflix's primary advantage is scale, and this single advantage works on multiple levels.

Today, Netflix's subscriber count of over 200 million far exceeds its nearest streaming competitors such as Disney+ (118 million), HBO Max (69 million), Hulu (44 million), and Apple TV+ (estimated 40 million). While Amazon Prime boasts more than 200 million members globally, Prime Video, I would argue, has a very different objective (helping to lock in Prime members) than a pure streaming subscription and almost certainly garners many fewer viewing hours than Netflix.

As a result of its relative size, Netflix benefits from a vastly lower *per subscriber* cost than competitors when investing in new creative content. For example, if Netflix spends $100 million on a season of a TV show (for reference *The Crown* was reported to cost $130 million per season) that gargantuan price tag would be only $0.47 per current subscriber, whereas its top streaming competitors would incur per subscriber costs 2-5x higher. In this way, Netflix can rationally outspend and outbid competitors for the marginal piece of content.

Indeed, Netflix has had the largest content budget for years and expects to spend more than $17 billion in 2021. Its content spend has been and remains larger than any of the above listed competitors by a significant margin. Year after year of large and increasing investments in content have earned Netflix the largest global viewing base among streamers, which has in turn resulted in a recurring revenue stream that has grown on average by about 30% per annum over the past five years. This dependable revenue generation has in turn enabled deeper commitments to spending on content that further enhance the broad appeal of Netflix's service.

This "flywheel" has built momentum and scale, and is a virtuous and continuous loop that supports the company's leading position, as illustrated in the graphic below. My hypothesis is that this dynamic will enable the business to maintain its leading position in streaming video for a long time to come.

Netflix's breadth of content and command of consumer viewing hours brings additional advantages that further drive viewer engagement. First, it holds a data advantage around viewing habits, which improves personalized viewing recommendations and provides greater insight into future programming decisions, so that Netflix may deploy its content budget more effectively. Second, it increases the odds that Netflix streams a hit – that TV series that becomes the season's favorite, embeds itself in the cultural zeitgeist, and gets discussed and shared on social media or around the (probably virtual) watercooler.

Netflix's head start in developing the technology, user interface, and streaming delivery systems that allow customers to easily find the content that they love is an advantage, too. The sheer task of delivering video content to nearly 200 countries around the globe on any connected device in a fast and reliable way should not be underestimated. This, too, is an area where the rest of the competition must work hard to catch up, if they do at all.

Its global distribution is another facet of scale that is unparalleled. Netflix was well ahead of any competitors in developing propriety, local content in many countries around the world. In fact, a number of video competitors have pre-existing commitments that yield the international rights to their content libraries to other distributors for some time yet, inhibiting their launch in to certain international markets.

Netflix's combination of local content and international distribution has led to surprising discoveries of cross-cultural appeal of some hit shows. While the company's goal is to build deep relationships with creative communities around the globe in order to create locally authentic stories, subtitled and dubbed shows like *La Casa de Papel (Money Heist)* and *Lupin,* garnered huge worldwide audiences. No show, however, demonstrates this phenomenon better than Korean thriller, *Squid Game*, which is now Netflix's most watched TV show ever with 1.6 billion hours viewed in its first month on the service, almost three times the viewing hours of *Bridgerton: Season 1*, the English-language leader.

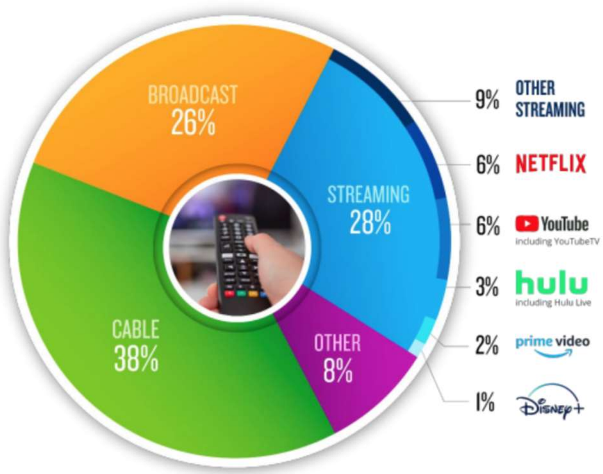
Netflix has the ability to put storytellers and creators into the world from anywhere in the world, a new possibility enabled by Netflix's global distribution model. This is an instance where the company's scale attracts talent. The mere possibility that a creator's show may catch fire outside of its local market further aids the magnetic attraction from creators and actors to Netflix's unparalleled reach and distribution.

<u>Market</u>

A strong tailwind is propelling the growth of streaming video's share of TV viewing time. Streaming market share, measured by hours of viewing time, is growing rapidly at the expense of traditional, or linear, TV. This trend gained a foothold and persists because streaming is such a wildly better offer for consumers. It is massively more convenient – you can watch exactly what you want, when you want, on an array of devices, at a price that is far cheaper than a traditional cable subscription.

In the United States, Netflix's most mature market, 64% of television viewing time is still spent watching cable or broadcast TV, while streaming's share is only 28%. However, streaming's share is growing rapidly. Nielsen estimates that it was 14% in 2019, 20% in 2020, and could reach 33% by the end of 2021. This low share leaves significant room for Netflix and other streaming services to grow. "Cutting the cord" and discontinuing cable altogether still has a long way to go, too. The number of pay TV households in the US peaked at about 100 million in 2014 and has declined to about 75 million today. Industry source eMarketer expects this number to continue to decline, falling to 60 million by 2025.

Share of Total US TV Time, September 2021(Total Day, Persons 2+)



Source: Nielsen, 10/14/21.

The available market to all streaming services will continue to grow as linear TV hours decline, and will support a number of "winners" in the streaming war. Among this group, Netflix is destined to be a long-term leader in viewing hours as a result of its broad and ever-expanding content slate, and it seems Disney+ or Prime Video have the best shot at being a second offering with broad but unique content.

There is room for a number of streaming services in most household budgets. In fact, calling these services "competition" may miss the point entirely. Even when aggregating the price of four or five streaming services, the cumulative cost may still be only half the cost of the average American cable package. With each having unique content, they are more accurately viewed as complementary rather than competitive.

Much has been made in the past few years of the "streaming wars", the onslaught of streaming competition that has now come to market with the likes of Disney+, Peacock and Paramount+ joining the ranks of Prime Video, Apple TV+, and Hulu. The clear concern was that Netflix would lose share as this competition arrived. Recent research from Comscore and LightShed Partners, however, estimates that not only are Netflix and YouTube the clear leaders in connected video, the number of hours spent on those two platforms has *increased* by 18% between January 2020 and June 2021, just as some of this much feared competition has come to market.

Management & Culture

Netflix carries a unique culture. One immediate "tell" to an outsider like me that there is something special going on is that the company has invented/reinvented itself *three times* on its path to achieving the leading position it now occupies.

Netflix was initially a DVD-by-mail business, an emerging challenger to the nearly 9,000-store video rental behemoth Blockbuster. (There is a great story of Netflix's founders offering to sell the company to Blockbuster for $50 million in early 2000. They were rebuffed. Within 10 years, Blockbuster was bankrupt.) In 2007, Netflix began remaking itself as a service delivering streaming video over the internet by licensing third-party content from content owners for a fee. Then, in 2011, Netflix purchased the exclusive broadcast rights to the forthcoming series *House of Cards*, and entered the content ownership game – betting the company on a new direction that set it on a course to be the TV series and movie production heavyweight that is it today, and setting the virtuous loop previously described in motion.

This unusual ability to adapt is a superpower, and indicates to me that there just may be value in future optionality from this same team, that they might find ways to grow the value of the business that I can't imagine today.

Fortunately, Netflix's cultural foundation is not too hard to diligence as an outside investor. Netflix culture is famously shared in a 100+ slide presentation known as the "Netflix Culture Deck" authored in 2009 and readily found on the internet today. In 2020, Netflix Co-Founder, Reed Hastings, co-authored a book, No Rules Rules: Netflix and the Culture of Reinvention, that expounds on the key tenets of Netflix's culture. These sources suggest that none of the company's uniqueness or adaptive traits result from luck or serendipity alone.

Building off of shortcomings in his previous entrepreneurial ventures, Hastings and team have created unnatural but logical culture imperatives, such as building extreme talent density (adequate performance gets a generous severance) and radical candor (don't try to please your boss, give candid feedback) that have resulted in a gradual *reduction* in rules you might find in an employee handbook or the types of decisions you must run by a manager before making. It culminates in a culture Netflix self-describes as Freedom and Responsibility.

The culture has iterated and evolved over many years and has resulted in a fast-moving, highly talented team that is rewarded with outsized, top-of-market compensation. From the outside, it seems Netflix has innovated ahead of competitors and enjoyed more than its fair share of success. Its strong, unique culture is clearly a huge reason why.

Future & Valuation

Netflix is likely to end up with 400 – 500 million global subscribers within the next five years and a recurring revenue base more than twice its current $30 billion. Most of the growth in future subscriber count will come from markets outside of the U.S. and Canada, where Netflix has less penetration and where average revenue per member is lower. In more mature markets, Netflix will continue to gently increase prices over time, which it historically has done every 18 months or so in the United States without any noticeable loss of subscribers. Netflix's guiding principle is to deliver outsized entertainment value in the form of shows and movies that people love relative to the cost of its service. Netflix's premium offering in the U.S. today costs $18 per month, resulting in an extraordinarily low price per hour viewed to the user. For this reason, occasional future price increases of 5-8% are unlikely to cause any loss of subscribers.

Even though Netflix's content costs are presented as costs of goods sold, which is usually a variable expense, this cost actually behaves much more like a fixed cost. Once a piece of content is created it is sold again and again across the user base. The fixed nature of this cost results in significant operating leverage in the business. In fact, Netflix's operating margin has increased from 7% in 2017 to the mid-20% range today. Management expects these margins to continue to increase on average by 3% per year for some time. On some far off date, when the business hits more of a state of maturity, the operating margins are likely to be surprisingly high. Coupled with recurring subscription revenues, Netflix will be highly cash generative, even with continued increases in annual content investment. Looking several years down the road, it is not hard for me to justify a stock price in excess of $1,000 per share.

It is tempting and perhaps even consensus to consider an investment in Netflix now and conclude "Oh, I've missed it." While anyone would have profited from owning this winning business earlier, my hypothesis is that Netflix is still in its earlier days of enjoying a top position that is likely to last for a long period of time.