

Netflix, Inc.¹

By early 2005, Netflix had revolutionized the movie rental industry, growing to 3 million subscribers in its eight short years of existence. Netflix's tremendous success was primarily attributable to its innovative business model, built on two disarmingly retro technologies: the DVD and the U.S. Postal Service. For a monthly subscription fee averaging \$18, consumers gain access to an unlimited number of rentable DVDs, most delivered within a couple of days of being ordered online.

This was not the first business success for Netflix founder and CEO, 44-year-old Reed Hastings. Hastings had already sold his first company, Pure-Software, in the mid-1990s for \$750 million. He then went back to school, getting a master's in education from Stanford, and subsequently became president of the California Board of Education. His career in education ended around the time he rented *Apollo 13* from a Blockbuster store. After getting socked for \$40 in late fees, Hastings began wondering why video rentals don't work like health clubs, which give members unlimited access for a flat monthly fee. His original business plan relied on mailing VHS cassettes to customers, but in 1997 he realized that DVDs, still new at that time, would be a much easier and more durable format for mailing.

Hastings started Netflix in 1998 from a warehouse in the heart of Silicon Valley. By early 2005, Netflix had 35 warehouses around the country, mailing out over 1 million DVDs per day to customers. Netflix had increased its subscriber base to 9 percent of households in its local San Francisco Bay area market and just 2.3 percent of households in the rest of the country, leaving plenty of room for future growth. Netflix's success had caught the attention of industry giants, who struggled to imitate Netflix's business model. Both Blockbuster and Wal-Mart introduced services similar to Netflix but couldn't match Netflix's combination of excellent customer servicing and shrewd marketing. Wal-Mart subsequently exited this business in May 2005, outsourcing it to Netflix.

Yet competition and rapid expansion were taking their toll on Netflix's profitability. Quarterly EPS peeked at \$0.29 in the third quarter of 2004 and had dropped to \$0.08 by the fourth quarter of 2004, with a loss projected for the first quarter of 2005. The lower profitability stemmed primarily from squeezed margins due to greater competition and more aggressive use of the unlimited rental option by subscribers. Netflix's stock price followed its earnings, plunging from almost \$40 in early 2004 to just \$12 by early 2005. But even this seemed like a rich valuation given that losses were being projected for the first quarter of 2005.

Critics argued that Netflix was simply pricing its service too cheaply. The video rental market had long depended on hefty late fees to drive profitability. By eliminating late fees and allowing unlimited rentals, it seemed that Netflix was simply selling its service at too low a price to earn a respectable profit. Netflix countered that its low profitability was attributable to ongoing investments in growing its subscriber base. Once this subscriber base matured, economies of scale, strong subscriber retention, and reduced subscriber usage of the unlimited rental option were expected to deliver healthy profits.

While having appeal in the current marketplace, Netflix's argument had one fundamental flaw. Its business model was likely to become obsolete in a few short years. A similar fate had met America Online almost a decade earlier. America Online invested heavily in building the largest subscriber base in the online content provider business, only to see this business rendered largely obsolete by the ISP (Internet service provider) business a few years later. Few industry observers expected mail delivery of DVDs to be the long-run delivery format for movie rentals. Video on demand through cable and satellite TV companies and Internet downloading were widely expected to become the standard delivery channels within the next decade.

Despite these concerns, Netflix marched full steam ahead with its aggressive growth strategy. Numerous Wall Street analysts applauded this strategy and recommended the stock as a "buy" to their brokerage

¹ This case was prepared by Professor Richard Sloan as the basis for class discussion, rather than to illustrate either effective or ineffective handling of a business situation. Copyright © 2005 by Richard Sloan.

clients. For example, a representative analyst argued that.²

We are raising our EPS estimates and increasing our 12-month price target to \$34. We expect record levels of subscriber acquisitions during 2005 to bode well for future profitability and we are increasing our 2005 EPS estimate to \$0.34 and our 2006 EPS estimate to \$1.13. We are reiterating our Buy rating and increasing our price target to \$34 (30 2006 EPS) based on increased 2006 estimates.

Detailed information on Netflix's business strategy, financial situation, and expansion plans are provided in its Form 10-K for the year ended December 31, 2004. For comparative purposes, similar information also is provided for Block-buster in its Form 10-K for the corresponding period. These documents are available as online exhibits at www.lundholmandsloan.com.

QUESTIONS

Business Strategy Analysis

1. Identify Netflix's source(s) of competitive advantage in the movie rental business relative to (i) traditional bricks-and-mortar video rental outlets, such as Hollywood Entertainment, and (ii) Web-based services offering the downloading of movies over the Internet, such as Movielink.
2. Evaluate the sustainability of Netflix's current sources of competitive advantage in the movie rental business.

Accounting Analysis

3. Contrast and evaluate how Netflix and Blockbuster account for their movie rental libraries. Do you think that any differences are justified?
4. Assume that instead of using its current accounting practices for its DVD library, Netflix instead expensed all costs associated with its DVD library as they were incurred. Estimate the *operating income* Netflix would have reported for the year ended December 31, 2004.
5. Briefly explain why Netflix's provision for income taxes (i.e., tax expense) for its 2004 fiscal year is so small.

Ratio Analysis

6. Compute rental library turnover ratios for Netflix and Blockbuster for fiscal year 2004. Carefully justify your choice of numerator in each of these ratios.
7. Identify the major reason(s) for the difference between the two turnover ratios that you computed above. Be as specific as possible.
8. Compute the gross margin earned on *movie rentals* for Netflix and Block-buster for fiscal year 2004.
9. Identify the major reason(s) for the difference between the two margins that you computed above. Be as specific as possible.

Forecasting Analysis

10. Load the Netflix case data into eVal and provide a set of forecasting assumptions that yield a \$0.34 EPS estimate for FY2005 and a \$1.13 EPS forecast for FY2006. (Note: case data can be imported by going to the Case Data sheet in eVal and selecting the yellow block of data for the company, and then pasting this block of data into the yellow cells at the bottom of the Financial Statements sheet using Paste Special - Values from the Edit menu.)
11. Evaluate the plausibility of the forecasting scenario you provided in answer to the preceding question.
12. Define and evaluate the "churn" metric computed by Netflix and explain why low churn is crucial to Netflix's long-run profitability.

Valuation Analysis

² This analyst quote represents the case-writer's personal synthesis of the published views of the numerous analysts that were bullish on the stock in 2005.

13. Load the Netflix case data into *eVal*, set the valuation date to March 1, 2005, and critically evaluate the default valuation provided by *eVal*.
14. In early 2005, Netflix was trading at around \$12 per share. Using *eVal*, provide a set of forecasting assumptions that approximates this price. Use a cost of equity capital of 10 percent and a valuation date of March 1, 2005. Do you think that these forecasting assumptions are plausible?
15. Evaluate the method used to establish the price target of \$34 quoted in the introduction to the case.