To: The McIntire Investment Institute, Managers

From: Andrew Potter
About: Netflix

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Share Price as of 4/20/2007	$22.10
Shares Outstanding	68.76 Million
Market Capitalization	1.52B
Enterprise Value	1.13B
52-Week Range	$18.12-33.12
Float	54.05 Million
Avg, Daily Vol. (3 mo)	1,912,970
P/E Ratio	31.08

Business Description

SECTOR: Services / INDUSTRY: Music & Video Stores

Based in Los Gatos, California, Netflix is a website that offers DVD rentals by mail for a flat rate. Founded in 1998 with an IPO in 2002, Netflix has grown from a small firm to offering over 75,000 titles with almost 6.3 million subscribers. Along with its headquarters in Los Gatos, Netflix has established distributing warehouses in several major cities across the US. Pioneering the way for online DVD rentals, Netflix offers many advantages to traditional in-store movie rental including free postage, overnight shipping, no late fees, and flat rate subscriptions. Netflix currently offers five subscription plans, ranging from $4.99 a month for one DVD to an unlimited plan costing $23.99, with the most popular plan being three DVDs for $17.99. Netflix currently has two lines of operations: it's DVD by mail service and a more newly instituted instant downloadable movies by the computer. The instant downloadable DVDs via the internet was a new idea launched two years ago and is beginning to be rolled out to more customers in the first quarter of 2007.

Netflix bases its success on three factors: gross margin, subscriber acquisition cost, and churn. Churn refers to the monthly number of subscriber cancellations divided by the sum of subscriber additions then measured over the quarter. Under these three factors Netflix keeps track of their growth and operating costs and uses them to evaluate their business objectives

Although Netflix pioneered a new way for movie rental, it is a latecomer in a very established industry. Large well established rental-based firms such as Blockbuster, Hollywood Video, and also Video wholesalers such as Amazon, Best Buy, Walmart, etc. Cable companies are also offering up more competition for Netflix as more programs become available with instant on demand features along with an increased popularity of digital recording boxes such as TiVO or Digital Video Recording (DVR). With the increase of an internet customer base, Netflix continues to gain market share in the movie rental industry, however intrusion by both large firms and smaller firms offering the same online and at home rental options has caused a more grim future outlook.

Thesis Points

(I) No Sustainable Competitive Advantage

Since its founding, Netflix has had a first mover advantage. They pioneered a very integrated and organized system in online DVD rentals, when both online shopping and use of DVDs were increasing in popularity at an exponential rate. At the time, the most popular mode of video rental was through large chain stores like Blockbuster or Hollywood video, with smaller portion of the market being filled by independent rental stores. The biggest holder of the market share for video rentals was Blockbuster, but Blockbuster lost much of its market share by not exploring new ways to reach customers (like the internet) as well as angering many customers with unfair late policies.

Starting in the third quarter of 2006, however, Netflix's biggest competitor Blockbuster introduced its Total Access campaign, developing an online rental system modeled almost identically after Netflix. On top of having an effective online rental system with identical prices to that of Netflix, Blockbuster also maintains 8,000 stores nationwide and has a much more established name. Flooding the market place with ads, Blockbuster met the three million subscriber mark they set for themselves for first quarter of 2007 and still has a huge potential for growth. Netflix has no distinct advantage from which it can obtain a customer base at a quicker rate than Blockbuster.

(II) Lack of Innovative Growth Strategies

Although Netflix has announced plans to begin to offer movies online for instant downloads, this strategy has not been met with a overwhelming popularity as well as it is not a very original idea. Many web sites already offer this service at low cost like itunes, and in some instances for free (www.alluc,net), while Netflix's more direct competitors like Blockbuster plan to unveil the same service at the same cost within the year.

Aside from being an undifferentiated strategy, as confirmed by VAR, this market does not have a significant potential for growth. There is already an immense amount of competition operating in this field, and for many movie watching customers, the viewing experience is essential to their overall satisfaction in viewing. Although being able to retrieve new movies instantly and easily on the internet is an appealing prospect for many, it is not necessarily the most appealing way to watch a movie. Almost any movie viewer would prefer to watch the movie on a comfortable, with a larger screen and company. Movies on the computer are not conducive to the "Friday night" viewer who relaxes with some friends around a bowl of pop corn.

Other than instant movie downloads via the internet, Netflix has announced no new innovative growth processes. It has had trouble moving into the international markets and has already attained a highly efficient rental system within the US.

(III) No Prospective markets to Move into with Current Assets

Being an internet based company; Netflix has very few fixed assets. Aside from regional distributions centers and a list of almost 75,000 titles Netflix has very few assets. This fact significantly limits the capacity Netflix has to change or implement new moneymaking strategies. Netflix has acquired a decent cash flow, however, with its current organization and asset strategy there is little flexibility for internal growth in the face of a rising threats from competitors.

(IV) Reduced Outlook for 2007

Early last week Netflix announced a reduced outlook for the 2007 year. Although it will still be attaining new subscribers and making a profit, Netflix is showing signs of slowing and possible evidence that it is beginning to succumb to competitive pressure particularly from Blockbuster's Total Access campaign. Already in the first quarter of this year Netflix had more than 200,000 fewer newer subscribers than their fourth quarter of 2006. The market has reacted to these downturns, but only with a small decline in stock price, and the entrance point is certainly still available.

OLD	Reducing estimated number of subscribers				
	1Q07	2Q07	3Q07	4Q07	FY07
Total Subscribers	6,900,000	7,300,000	7,815,000	8,340,000	8,340,000
New Subscribers	584,000	400,000	515,000	525,000	2,024,000
NEW					
	1Q07	2Q07	3Q07	4Q07	FY07
Total Subscribers	6,797,000	6,880,000	7,250,000	7,450,000	7,450,000
New Subscribers	481,000	83,000	370,000	200,000	1,134,000
CHANGE	*-1.5%*	*-5.8%*	*-7.2%*	*-10.7%*	*-10.7%*

Risks

(I) Unsubstantial Position for Blockbuster

There is no doubt Netflix has been feeling the pressure in the marketplace from Blockbuster's Total Access campaign, however, several times Netflix CEO Reed Hastings as well as many analysts assert that Blockbuster's new position is unsubstantial to make money on. Aside from having the same pricing strategy for online DVD rental as Netflix, Blockbuster also has to manage some 8,000 stores nationally that have been teetering on profitability for the past few years. Right now Blockbuster on average makes about twelve dollars per customer when they need to be making seventeen to become profitable. What Blockbuster is trying to do is win back a large customer base that has been deteriorating over the past years. This is the largest risk if shorting Netflix, because the chance that the Total Access campaign either falling short in gaining substantial market share or the pricing strategy being too aggressive to maintain are relatively high compared to other risks and if failed, would greatly help Netflix.

(II) Netflix Retains a Very Loyal Customer Base

Another risk is that customers from Netflix are loyal to the Netflix brand name. Netflix is a first mover in the segment of online DVD rental and have attracted nearly seven million customers and continue to grow. It could be that people are unwilling to switch to the similar Total Access plan; however, I think this possibility is a little less likely considering the value of what Blockbuster is providing in the marketplace. In a service like this, people will favor what's most efficient and inexpensive and right now the balance is definitely in favor of Blockbuster

(III) Rapid Growth in Popularity for Instant Downloadable Movies

This is another possibility that could end up favoring Netflix. By the end of the year Netflix will have an extensive amount of options and will once again be a first mover in this regard. I think its very logical and my VAR backs this opinion up, but I don't think it's very likely that this segment of the marketplace is going to grow to be that popular. And even if downloadable movies were to become very popular, there already exists many different competitors offering the same service, including near entrants like Blockbuster. So I do not think this is a significant, however, it is possible that Netflix could acquire more subscribers because of it.

Value Added Research

Mark Tramontin – Bought a small Movie shop in Charlottesville in 1993. Sneak Reviews focuses on giving personalized service with more rare and musical titles.
Comments: Mr. Tramontin liked Netflix because they had a very large selection with good customer reviews readily available. However, he thinks for the common viewer Blockbuster is a much more conceivable operation because the spontaneity with which many viewers decide to rent on. Furthermore, he did not see the prospect of instant online movie downloads being much of a moneymaker for any company in the future because he believes it detracts so much from the movie watching experience.
Jack Lindgren- Marketing Teacher, McIntire School of Commerce
Comments: Professor Lindgren was still pretty bullish on Netflix and had a bad opinion of Blockbuster. He made a good point that in the past Blockbuster did make a lot of people angry with their tricky late policies, and in effect, opened up the market for a company like Netflix to expand and gain market share, however I think the statistics, particularly regarding recent subscriber acquisition, would speak contrary to Professor Lindgren's opinion that he doesn't think the Total Access campaign is working.
Bob Lind – Netflix and Blockbuster customer
Comments: Mr. Lind liked the idea of Netflix when it first came out and was an early subscriber. He has never had a complaint about it, except for you have to plan out days in advance what movie to rent and there are times when he would find himself going to Blockbuster even though he had available movies under his plan at Netflix, because the convenience having a nearby store offered.
Becky Nagel – Netflix and Blockbuster customer
Comments: Mrs. Nagel does not use either service that much but likes the variety of titles provided by Netflix and for that reason remains subscribed to Netflix's cheapest package
Ryan Lee – Blockbuster employee for 4 months, Charlottesville, Virginia

Comments: This brief interview was not overly informative, however, Ryan felt like the Total Access campaign has made Blockbuster more cutting edge, and has noticed a lot of people using the Total Access boxes located outside the store.
Meghan Simms – Blockbuster employee for 18 months, shift supervisor, Glencoe, Illinois.
Comments: Ms. Simms definitely noticed an increase in store traffic with the new Total Access campaign and feels like Blockbuster has a new look from the position it was in one year ago. She said the majority of her customers are still using the traditional way to rent movies, however, there has been some store traffic utilizing the online feature of exchange.

Suggestions

From my experience with McIntire Investment Institute this past year, one aspect of the club I would like to see changed up is the stock selection process. Every week there is a stock presentation yet one thing I felt the entire year is that it was very hard to not only participate in the decision of the stock choice, but to even know what that decision is. I know the MII blog was started, but it has gotten very little use at all. The managers should communicate via that blog their decision process within a few days of the presentation given. I think overall member participation should be increased and in this way, if the Manager's actively promote the blog they will be able to get greater member participation and ultimately individual members will learn a lot more about investing.

Another suggestion I have is for the managers to offer on the McIntire web site a list of stocks they have personally been thinking about or looking at a little in order to give members a jump board into looking into ideas for a presentation.

Summary

Netflix is a good short option because of their lack of competitive advantage and lack of future growth strategies. Being a first mover in the industry of online movie rental, Netflix for the past nine years has experienced significant growth and acquired nearly seven million subscribers, however with the competitor Blockbuster moving now offering this same service at the same price as well having the distinct advantage of utilizing its already 8,000 stores to integrate the movie rental process. There are risks to the venture, the biggest being that Blockbuster's online rental proves to be unsustainable. The VAR I attained for this presentation generally added to my thesis point or confirmed what the numbers I had investigated lead me to believe.

I think a good entrance point is within this quarter before the next earnings report comes out. I feel that numbers and outlooks will continue to decline as Blockbuster attains greater and greater marketshare and Netflix adds fewer subscribers.