



\$100k PORTFOLIO

An Aggressive Approach to Conservative Investing

Buying the World's Stupidest Company

By Ian Wyatt,
Editor-in-Chief

"We are still concerned with the company's escalating content costs and aggressive international expansion plans."
- Standard & Poor's

"Sometimes the problem with a company can be summed up in one word: Stupid...[It] is an example of a company that at one point in time had a modest advantage over the competition, which in its early days were video stores, and has since lurched from one failure to another, followed by shareholders who don't know any better."
- Seeking Alpha

"It all adds up to the dumbest corporate maneuver I've seen in my 32 years as a mindless consumer. It is as if Pepsi announced that they would be switching over to producing only Crystal Pepsi, but using the New Coke formula."
- Unhappy consumer

Three months ago, I told you that I was putting in two "stink bids" on the S&P 500. These trades were designed to let us buy the broad stock market in the event that prices fell dramatically in the short term.

Long-term \$100k Portfolio subscribers remember that we used this same strategy right after the "Flash Crash" in 2010 and have since earned a profit of 19% on that trade.

While our two "stink bids" remain open and unexecuted, I'm always on the lookout for stocks that are temporarily trading at exceptionally low prices. There is almost always a reason for the crash in a company's share price. However, we all know that the market tends to overextend both ends of the pendulum.

Today I'm going to tell you about one specific company whose shares were recently richly valued. Investors now have a unique opportunity to establish a position in this company at a bargain price thanks to management's missteps – and a very large swing of the pendulum to the downside.

You see, every once in a while, an outstanding company falls from grace.

Sometimes it's simply that the market for its products has changed. Other times, it's external factors such as expiring patents, a lawsuit, an unexpected catastrophic event, or a competitor entering the business. And occasionally, it's just because management screws up.

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Either way, the result is that a company and its stock go from being a Wall Street darling to a dog, often in a matter of just a few weeks.

This is exactly what's happened with **Netflix (Nasdaq: NFLX)** over the last five months.

The volatility of Netflix shares has been quite remarkable. During the first half of the year, shares continued their meteoric rise from \$200 to \$304 per share in early July.

But over the last five months, through a series of self-inflicted wounds – namely poor decisions by management at the very top of Netflix – this growth stock darling fell a remarkable 77%....

Netflix shares now trade at around \$70.

The company's total value – or market capitalization – briefly topped \$16 billion but has since sunk to less than \$4 billion.

Shares of Netflix were no doubt richly valued and overpriced at \$200 or \$300 per share. Even when the business was firing on all cylinders, the stock was expensive.

Especially after management's missteps, the shares deserved a good haircut – but the market (as it tends to do) went too far.

And when big successful companies like Netflix get this beaten down, the result is usually (but not always) a huge gain over the following months.

Today I'll explain why Netflix stock – with a market value of less than \$4 billion – is a compelling value. And I'll explain how the stock could double in the next 6 to 12 months, even if the company continues to flounder.

You see, Netflix is a pioneer in the video rental business. The company essentially put the video rental gorilla – Blockbuster – out of business.

Netflix invented the DVD-by-mail business and has since been rapidly extending its business to video-on-demand. As I'll highlight in this issue, there is much to like about the Netflix business even after the company's stumbles and fumbles over the past few months.

As is the case when companies screw up, most Wall Street analysts, fund managers, and investors hate the company. But therein lies the opportunity for contrarian investors who are able to see the forest through the trees. Let me explain...

The Cable Company of the Future

I've been a Netflix subscriber for so long that I often forget that many people don't know much about the company.

I became a subscriber in 2003 after buying my first DVD player that included a 30-day trial membership to Netflix. The Netflix service was revolutionary at the time, offering members DVDs sent by mail to their home.

The concept was simple. Netflix had a web site that listed movies. Members selected movies that they wanted to watch, adding them to a queue. Depending on the billing plan, the member would receive anywhere between one and five DVDs on loan from Netflix at any given time. When a member returned a movie in the postage pre-paid envelope, Netflix would mail the next movie in their queue. The business model seemed pretty simple and straightforward.

At the time that I joined, I paid a bit less than \$20 a month for the company's standard three-DVDs-at-a-time plan. I always looked forward to the DVDs arriving from the company's warehouse in the bright red envelopes that are now synonymous with the Netflix brand.

A few years later, Netflix launched a video streaming services that allowed members to get videos on demand via the Internet at no additional cost. Around the same time, the company began offering reduced subscription fees for subscribers who ONLY wanted to stream videos, and not receive any DVDs.

At first, this online streaming business was pretty cumbersome. I remember using Netflix streaming video in the early days to watch a video on my laptop while I was on the road for business. However, when I was at home with my big screen TV, there wasn't much appeal of watching a blurry movie on my Dell.

Today I continue to receive three DVDs at a time from Netflix. But I also regularly use the online video streaming component of the service. I've hooked Netflix up to my TVs so that using my remote control I can find a Netflix movie and watch it with the same ease of selecting a channel from DirecTV.

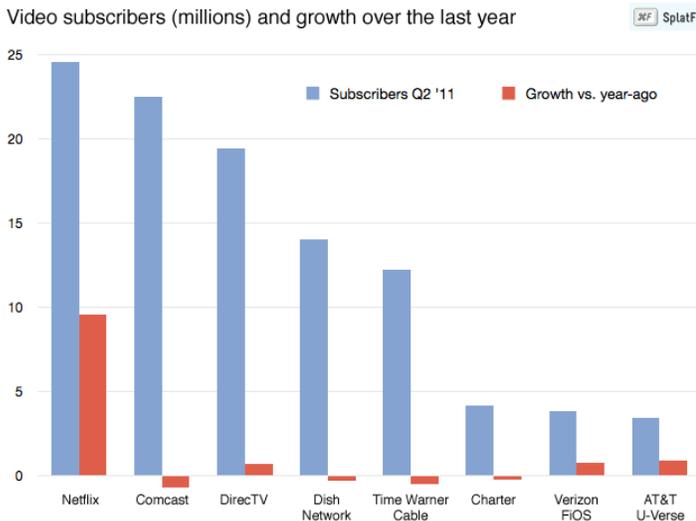
It is not surprising that the streaming video business has evolved though. The technology has continued to improve, and today even subscribers who aren't "tech-savvy" can figure out how to get Netflix onto their TV. Similarly, the quality of streaming videos that are downloaded via an Internet connection has improved dramatically.

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In many ways, Netflix is the cable company of the 21st century. At the end of the company's third quarter, Netflix served 23.8 million subscribers. That number might not mean anything to you – but it's a truly astounding number of customers.

In terms of subscriber count, Netflix currently has MORE subscribers than any of the other cable or satellite companies in the U.S.

Netflix: Bigger Than Cable and Satellite TV



While Netflix built its business by delivering DVDs by mail, the video streaming business is certainly the future. In the U.S., Netflix currently has 21.4 million streaming subscriptions and 13.9 million DVD subscriptions. There is currently a large overlap, with many users including myself opting to receive both DVDs and streaming video content.

The company's streaming business is impressive. While the service doesn't include the latest new releases or every movie ever made, the content is diverse. In many ways, Netflix streaming isn't too different from premium cable networks like HBO, Showtime or Starz that have a library of movies and TV shows available to subscribers on demand.

Earlier this year, it was reported that Netflix video streaming accounts for 29% of ALL domestic, peak-hour Internet traffic. It accounted for 21% just six months earlier. In comparison, free video web site YouTube accounts for only 10% of Internet traffic by the same measure.

All in all, Netflix sounds like a great business. Right?

So what went wrong?

Timeline of Stupid Decisions

Founder Reed Hastings, who has received numerous accolades for building an amazing business and reinventing the way people rent movies, leads Netflix.

However, it appears that the success of Hastings and his management team at Netflix has made them a bit too confident and comfortable. As a result, starting in July 2011, they made a series of poor decisions that puzzled and infuriated subscribers, increased cancelations, and damaged the good brand image that the company had built since its founding in 1997.

Here is a brief summary of the management missteps that inflicted pain on Netflix shareholders:

- **September 1:** Netflix abruptly cancels its basic \$9.99 per month subscriber plan that includes 1 DVD and video streaming. Subscribers now must pay \$7.99 for each of the two separate plans, a 60% price increase.
- **September 19:** Hastings apologizes in the form of a bizarre late-night email (2:45 a.m.!) to subscribers and announces the spin-off of its DVD rental business under the new "Qwikster" brand, requiring DVD subscriber to re-subscribe. The email left many subscribers wondering whether Hastings was drunk when he sent it.
- **October 10:** Netflix wakes up after a month-long hangover and reverses course after subscriber backlash, canceling its Qwikster plans.
- **October 24:** 805,000 Netflix subscribers canceled their membership during the third quarter of 2011.

This series of mistakes resulted in significant subscriber defections and created a black cloud around the Netflix brand.

The company had a long history of being loved for the convenience of DVDs by mail, great streaming content, and low prices. However, with subscribers complaining loudly about the company, the P.R. of the last several months turned incredibly negative.

The impact of these events on the price of Netflix shares has been devastating. Any long-term shareholders have been ruined by the crash in Netflix stock. Now trading at around \$70, the stock is down 77% from its high.

Step Decline for Netflix Shares



As a Netflix subscriber, my rates have gone up. Through 2010, I was paying \$16.99 per month for 3 DVDs and unlimited streaming videos. In January of this year, that increased to \$19.99 per month. The fee increased again in September to \$23.98 per month after the many changes were implemented.

In eight months, my membership fees were raised by over 40%. While the change from \$17 to \$24 is relatively insignificant for well-heeled subscribers, it's not a surprise that there was some backlash against the price hike.

After all, in this economy many people are looking to spend less money. So for a company to institute a price increase of 40% in less than a year is certainly going to piss off lots of customers.

And it has. As I already noted, Netflix lost over 800,000 subscribers in Q3 alone. But we should put this loss of customers into context.

That's only 3.3% of Netflix's total subscriber base of around 23.8 million. In essence, Netflix raised rates 40 - 60% and lost 3.3% of their customers. That's still a very large net gain!

That sounds like great news to me as an investor.

As a consumer, I felt like I was getting a great value at \$16.99 per month for the Netflix service. And today the \$8 price increase hasn't changed my mind. I still get great value out of the service and wouldn't think about canceling, even if the price increased to \$30 per month. Netflix is simply part of my video entertainment spending, and I wouldn't consider canceling unless the service started to deteriorate.

Many consumers were rightfully upset with the way Netflix made changes to their business. Some of them protested the changes by canceling their memberships.

However, the overwhelming majority of subscribers decided to stick with Netflix because they love the service. I certainly am in that boat, despite the bonehead decisions made by the company.

Global Growth Opportunity

Despite the recent drop in domestic subscribers, Netflix is expanding internationally.

Netflix has been live in Canada for one year now and already has over one million subscribers. That amounts to 10% household penetration in just one year in a brand new market.

Meanwhile, Netflix launched streaming video in 43 Latin American countries in early September. The market is too new to show much in terms of meaningful results. But Latin America currently has four times the number of broadband Internet connections as Canada, showing the potential for growth.

The most recent expansion plans include the United Kingdom and Ireland in the first quarter of 2012, an announcement that coincided with the bleak third-quarter earnings report.

To continue growing rapidly, Netflix is always increasing the content available to its members. While the DVD rental business was relatively straightforward (i.e. buy movies and rent them to customers), the streaming business is different.

When the streaming business was in its infancy, Netflix was able to negotiate relatively low licensing fees from the companies that provide the content. However, with Netflix now serving on-demand video to over 20 million consumers in the U.S. alone, content owners have begun demanding more and more. So with over 15,000 streaming titles available, Netflix is spending lots on content rights.

One concern about Netflix is how increasing content licensing fees will impact the company's bottom line. For example, it's estimated that the company spent ~\$180 million on content licensing in 2010. While the company doesn't break out specifics on content costs, Hastings has said that the company is spending \$1 billion to \$2 billion a year on content, and has \$3.5 billion in content commitments over the next few years.

With expansion around the globe, it's likely that these content costs will continue to rise. For Netflix, locking up the streaming rights to TV shows and movies has been at the core of the company's strategy to become the leading online video company.

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Today Netflix views HBO as its primary competitor, with the premium cable channel launching its own streaming service. While HBO may be tracking Netflix in the streaming video business, Netflix is in turn following in the footsteps of HBO. Earlier this year, Netflix won a bidding war against HBO to create a U.S. version of the British drama "House of Cards." The company plans to spend 5 – 15% of its annual content budget on original content.

Hastings has indicated that he views the landscape today as a land grab. If Netflix didn't continue down the path of expansion around the world today, the door might be shut in 12 – 18 months as competitors ink content licensing deals and begin to gain significant traction. As a result, he decided to push forward with an expansion agenda, even though the result would be short-term financial pain for the company and its shareholders.

Dim Near-Term Financial Outlook

For years, Netflix has been a well-managed and financially healthy company. It has turned out consistent revenue growth with solid profit margins year in and year out – exactly what investors want to see.

It was this impressive financial performance that sent shares soaring briefly past \$300 in mid-2011.

Even with the mistakes of the second half of 2011, Netflix is expected to report annual EPS of \$4.08, a 38% increase from last year. That lines up almost exactly with my earlier calculations. Similarly, revenues are expected to grow by nearly 50% to \$3.2 billion.

However, the recent subscriber cancelations coupled with growing content costs and expansion into new markets including Canada, Latin America, and Europe is expected to crush the company's profitability in 2012.

The company hasn't given any guidance other than a passing mention of "losses in 2012" in a recent SEC filing.

In November, Netflix raised \$400 million in cash by issuing stock and debt that will dilute shareholders by 10%. A single mutual fund company – T. Rowe Price – bought the stock placement. And a longtime Netflix investor – Technology Crossover Ventures – bought the debt.

The sad part of the story is that even in a quarter in which the company sold \$200 million of stock at around \$70 a share, Netflix also spent \$40 million repurchasing its own stock at an average price of \$218 per share. Ouch!

Still, the capital raise will go a long way in firming up the company's balance sheet during a time of financial uncertainty. With the potential for losses through 2012, the capital infusion will provide a cash cushion.

For whatever it's worth, the consensus analyst expectations call for a 14% increase in revenues and profits falling to just \$0.59 per share.

But analysts have been having trouble keeping up with Netflix. The same group of analysts who were largely bullish on shares when they traded for \$200 - \$250 are now bearish on the stock. Of the 32 analysts that follow Netflix shares, only five of them (or 15%) rate the stock a "Buy" or "Strong Buy." Despite the nearly 80% drop in price, the analysts seem to think this stock is now a dud with little upside potential.

The fact that Wall Street is so negative on Netflix shares is actually a positive, in my opinion. It indicates that investor sentiment remains very negative toward the stock, despite the drop in valuation.

The reason this is positive for investors considering a position in Netflix is because of the upside potential. With pessimism running so high, even a slight shift in opinion could result in substantial buying of the stock.

Netflix is Worth Considerably More Than \$4 Billion

Clearly the team at Netflix screwed up. They made some downright stupid decisions.

The reasons to buy Netflix shares in the \$70 - \$80 range are relatively straightforward.

First, the company is a leader in the online video streaming business. While there are competitors such as Hulu Plus, HBO to Go, Amazon Prime and most recently Verizon, Netflix remains the clear leader.

Second, Netflix's licensing of content from movie studios and TV networks creates a "moat" for the business. Some critics point out that Netflix is nothing more than a website that distributes the content of other companies. But that type of analysis greatly discounts the value of the agreements and partnerships that the company has in place.

Third, the damage done to the good Netflix brand name over the last few months has been terrible. Negative press and word of mouth will likely harm the company in the immediate future. However, I believe it's likely that the company will be able to repair its brand by continuing to offer great content to consumers at a reasonable price.

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Fourth, Netflix is aggressively expanding around the world. This is being done at a considerable cost and will have a negative financial impact in 2012. But for investors who can look beyond the next 12 months, it's clear that the company is laying the groundwork that will allow for profitable operations beyond North America.

Today, Netflix has 21 million subscribers who pay \$7.99 per month for its online video streaming service. That translates into monthly revenues of \$170 million, or annualized at \$2.05 billion. The value of Netflix at less than \$4 billion is a multiple of just two times streaming subscriber revenues. And it puts no value on the company's large and healthy DVD-by-mail business.

What Happened the Last Time This Stock Fell 75%

This isn't the first time that Netflix has gone through a rough patch.

Investors who have been familiar with Netflix over the long term will remember the challenges the company faced a few years ago.

Back in 2004, Netflix was the leader in DVD-by-mail. The company's business posed a real threat to Blockbuster, which was the biggest movie rental store in the U.S. After seeing its market share plummet, Blockbuster finally launched its own DVD-by-mail service to compete directly with Netflix.

Many critics thought that Blockbuster – with a well-known brand and stores spanning the country – would trounce the small video Internet company from Silicon Valley.

Netflix responded by slashing prices in order to remain competitive with Blockbuster. But investors sold off the stock on fears that the price wars with Blockbuster would hurt profits. Some investors even thought that Blockbuster would actually put Netflix out of business.

Netflix Shares Fall 75% in 2004 After Price Cuts



But we all know how that story ended.

People hated Blockbuster. For years, the company was the only video rental option. And the company routinely stuck it to their customers with large late fees and short rental periods on new releases. Nobody liked Blockbuster. As a result, few Netflix subscribers defected to join the competing service.

The battle with Blockbuster highlights the fact that Netflix and its CEO are willing to make short-term sacrifices in exchange for long-term growth.

Within six months of hitting an all-time low of around \$9, shares had more than doubled. And one year later, Netflix shares had tripled to over \$30.

Potential for Upside Surprise

Today, there is very little love for Netflix.

Investors who have been "long" the stock have experienced considerable losses if they're still holding onto their shares. The stock is trading at prices not seen since early 2010.

The media has been incredibly negative on Netflix over the past few months. Most Wall Street analysts, mutual funds, hedge funds, and individual investors share the negative view of the company.

In many ways, Netflix reminds me of stocks in the financial sector in 2009. In other ways, the company's decline was very similar to shares of **BP (NYSE: BP)** in 2010, when the stock fell from \$60 to less than \$30 in a couple months as the Gulf of Mexico disaster unfolded.

When negative sentiment is rampant, it doesn't take much good news to move a company's shares dramatically higher. At this point, almost everyone assumes that Netflix will continue to struggle for an extended period of time, that losses might be worse than expected, that the company's international expansion will take longer than anticipated, and that subscriber defections will continue. After such a poor showing by management and the stock over the last few months, Netflix watchers will continue to expect the worst.

As a contrarian investor, I'll point out that there are many opportunities for upside surprises.

Netflix has a very solid business that would continue to be very profitable if it weren't for the rapid international expansion coupled with high subscriber cancellations. If the company is able to exceed expectations in just a few areas, it's likely that the stock will recover considerably in a relatively short period of time.

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Because everyone is expecting the worst, even slight improvements will be welcomed as a sign that Netflix has turned things around.

In spite of the many challenges his company faces today, in a letter to shareholders Hastings highlighted something that stuck out to me. During the most recent quarter, Netflix added 4.7 million new subscribers. This marked a 20% increase over the same period of time one year ago. Meanwhile, the cost to acquire a new subscriber was \$15 – the same amount the company spent in the second quarter before all of the management mistakes. And compared with last year, the cost to acquire a new customer fell by 25%.

This tells me that while some existing Netflix subscribers were very unhappy with the price changes, new subscribers continue to see value in the company's ever growing video library. The company is attracting more subscribers than ever before in the U.S., and the efficiency of its marketing spending is increasing.

While this point is significant, most media outlets instead choose to focus on the many negatives related to the company, including its need to raise \$400 million, the coming losses in 2012, subscriber cancelations, and growing cost to license content. While all those concerns are quite valid and continue today, there are signs of health in the business too.

Buying shares of Netflix today is a bet on the online video streaming business. In order to consider buying the stock, one must believe that the future of video watching isn't the neighborhood video rental store or DVDs by mail. The future is selecting videos and downloading them in real time over a high-speed Internet connection. I believe this is the future, as does Reed Hastings and 20 million Netflix streaming subscribers.

The other big question is whether Netflix will be able to rebuild its brand. I believe the company is already taking the necessary steps to patch things up with its existing subscribers. Meanwhile, Netflix continues to expand

aggressively here in the U.S. and around the world, adding new users who have never had a bad experience with the company.

I expect that 12 months from now shares of Netflix will be valued at over \$100. Longer term, I think \$150 a share is quite reasonable.

This bullish outlook is based on my view that the company will rebuild its brand in the U.S. and gain traction as it expands around the world. While there certainly are concerns today, the worst-case scenario appears to be priced into the stock today.

With a market capitalization of less than \$4 billion, Netflix is currently a very small company, with just a quarter of the \$16 billion market value the company had six months ago.

The size of the company is so small that it would be an easy acquisition for a larger company that wanted to lock up the video streaming business. Who would consider buying Netflix? Perhaps Apple (\$365 billion), Google (\$203 billion), Amazon (\$88 billion), Disney (\$66 billion) or Comcast (\$62 billion). For any of these companies, Netflix would be a tiny acquisition relative to their market capitalizations.

While an acquisition doesn't appear imminent, the potential for one will likely provide a "floor" under Netflix shares. I believe that floor is likely around \$60 per share.

With limited downside risk and significant potential for getting things back on track, the risk-reward of Netflix appears incredibly attractive.

In the *\$100k Portfolio*, I intend to buy an initial position of 100 shares. This will translate into a ~4% allocation of the portfolio.

Suggested Action: Buy 100 shares of Netflix (Nasdaq: NFLX) below \$80.

All the best,



Ian Wyatt
Editor & Chief Investment Strategist
\$100k Portfolio

Full Disclosure: I currently own shares of Netflix in my personal investment account. I plan to purchase shares in my *\$100k Portfolio* investment account and add to my existing position in the stock.

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