FINC-GB 3125 Corporate Strategy & Finance in Entertainment, Media & Technology

Should Disney Acquire Netflix?

An Internal Memo from the Strategy Team to Mr.Bob Iger

By: Siddharth Dayama

EXECUTIVE SUMMARY

- An analysis of both Netflix's current financial valuation and strategic fit indicate that we derive more value from an arm's length relationship with Netflix than we would if Netflix became a vertically integrated part of the Disney content distribution business.
- **Our recommendation is not only to avoid integrating with Netflix, but also to strengthen offerings and relationships with Netflix's competitors (Amazon, Hulu, etc.) so as to dilute the uniqueness of Netflix's consumer offering and increase our leverage as a supplier**.

FINANCIAL ANALYSIS

Experience suggests that an acquisition would require a control premium anywhere from 25-30% on top of current market cap of $4.78B. Considering NFLX is in a position to capitalize on increasing mobile penetration, and has recently begun expanding outside of the United States we could potentially pay a lot for this acquisition. For example, Exhibit 1 (an estimate from Wikiwealth) takes into account this potential growth and estimates NFLX to be worth $113 per share. Utilizing a multiples based analysis (as shown in Exhibit 2) NFLX could soon be trading at over $98 per share. Given we estimate fair value under these approaches to be between $98-113, we do not anticipate acquiring a controlling stake in Netflix would be accretive:

$90.73 [current stock price] x (1 + 30%) [control premium] = $117.95 > $113

In doing a completive analysis, we also see that NFLX margins are relatively small in comparison to our own and according to CapIQ there has been negative EBITDA growth LTM. When taking this

along with their trading multiples (listed below), this might read as a story that NFLX is in high growth phase similar to the profile with AMZN, who similarly provides the same kind of streaming content.

Company Comp Set

Company Name	LTM Gross Margin %	LTM EBITDA Margin %	LTM EBIT Margin %	LTM Net Income Margin %	LTM Total Revenues, 1 Yr Growth %	LTM EBITDA, 1 Yr Growth %
Amazon.com Inc. (NasdaqGS:AMZN)	23.7%	3.6%	0.9%	0.07%	31.34%	19.44%
Netflix, Inc. (NasdaqGS:NFLX)	29.2%	4.1%	2.9%	1.26%	21.02%	(66.22%)
The Walt Disney Company (NYSE:DIS)	21.2%	25.9%	21.2%	13.44%	3.39%	13.48%

Company Comp Set

Company Name	TEV/Total Revenues LTM - Latest	TEV/EBITDA LTM - Latest	TEV/EBIT LTM - Latest	P/Diluted EPS Before Extra LTM - Latest	P/TangBV LTM - Latest	NTM TEV/Forward Total Revenue (Capital IQ)	NTM TEV/Forward EBITDA (Capital IQ)
Amazon.com Inc. (NasdaqGS:AMZN)	1.9x	55.6x	266.5x	NM	22.9x	1.49x	27.2x
Netflix, Inc. (NasdaqGS:NFLX)	1.2x	29.9x	43.3x	111.2x	NM	1.11x	28.1x
The Walt Disney Company (NYSE:DIS)	2.4x	8.7x	10.4x	15.7x	9.1x	2.24x	8.2x

STRATEGIC CONSIDERATIONS

NFLX is a great story, but this acquisition would actually destroy premium rents we receive due to our powerful supplier leverage. Under our current NFLX licensing contract, we stand to make $350m a year in royalties. More to the point, Netflix content rights costs are outstripping their revenues, implying that NFLX's content partners get more than their fair share of its growth. From 2007-2011, revenues grew at a 27% CAGR, but the size of its content library on its balance sheet grew at a 98% CAGR (Exhibit 3). Whether or not they succeed, we succeed. Why buy the cow when you can get the milk for free? Taking into account the fact that NFLX might also need a cap raise just to pay future licensing obligations, it doesn't make sense for DIS to invest in a company that may have diminishing returns.

We currently have a 27% stake in Hulu and in providing high quality content to consumers through this venue we already have a stake in this market. Given the wind down of DIS Movie Online, we should focus on building out Hulu given it is a proven brand with excellent technology that gives us a significant place in streaming content delivery, and in the subscription space. Further, as a competitor Hulu fragments the content market and reduces NFLX leverage. Increased Hulu share will improve our

ability to extract rents from NFLX. Next steps for us are to provide a plan to use agreements with HULU, On-Demand, HBO/Starz, and others to increase rivalry for Netflix.

Although Netflix has significant content assets, few of them are exclusive, and therefore their strategy and position are largely imitable. Hulu+ could compete as long as it secures similar content, and with studios as owners that is a good bet. NFLX's two biggest assets are merely short-term assets "Current content library, net" for $1.33 billion and the long-term asset "Non-Content Library, net" for $1.36 billion. As explained in their 10-Q, they typically enter into multi-year streaming content deals with studios that provide their source of assets and liabilities.

71% of Netflix's total assets are streaming content deals. Many of the deals in which they are involved are non-exclusive meaning anyone else can purchase the same rights. So since NFLX owns minimal intellectual property and has no patent portfolio, there is not much value on their balance sheet. Its entire streaming product is just a marriage of software and licensing deals nothing truly unique. Furthermore, if Disney acquires Netflix we would largely be paying a control premium to buy back our film assets, which we originally sold to Netflix at a significant premium. This is as wasteful as it is circular.

When it comes to the flagging DVD component of the NFLX business, there are also other competitors in that space that may be cheaper if we are inclined to buy. For example, Red Box which provides DVDs through a drop box system locally through the country. It is cheap, it is fast and it is an alternative. The DVD model that NFLX has been enjoying may also suffer in the immediate future. With the United States post office experiencing heavy deficits, the cost of shipping may go up which would result in higher operating costs to NFLX (cutting deeply into their bottom line). However, Red Box is unaffected by the postal system so would not be impacted. We do not believe we would face any kinds of regulatory constraints if we were to make that. If we look at the supply and demand of content, the

supply of content is continually increasing and we do not think that Netflix has some sort of monopoly that controls any significant portion of demand. Finally, what matters to the overall Disney ecosystem is that lots and lots of customers see our movies in order to build brand and drive all of our non-film revenue streams. The Red Box discussion highlights that many different avenues are open to achieve this end, and that we are best of betting on broadly distributed high-quality content, while allowing consumer taste, and a strategy toward maximizing windowing and royalties, to determine distribution. Owning Netflix only limits our flexibility.

NETFLIX AND INDUSTRY EVOLUTION

The cost of cable has risen in light of higher royalty fee arrangements. Take for example ESPN, the higher royalty fees that they pay passes through to consumers in the form of higher cable bills. In light of the current macroeconomic environment, consumers may reach a point where they are no longer willing or able to pay high cable bills. Instead, they will turn to streaming video as their primary source of news and entertainment, and demand content al le carte.

If content unbundles from networks and cable providers, a variety of alternative hosts will be able to capitalize on this and NFLX will not be the only game in town. In such an environment, we would have flexibility to provide content directly to consumers over the Internet, without the retribution of our cable system partners. Direct to consumer and Hulu could share shift much of the impression currently viewed on cable nets.

Also, windowing would be less important and Netflix either would become all catalogue titles, or would try to aggregate early-run content as cable subs do today. The later would transform the Netflix business model, which is currently not conducive to providing consumers with new release and early-run content. This is because Netflix has to pay a royalty for every stream, but consumers pay one monthly cost. If Netflix were to try to carry more up to the moment content, driving more streams, its

costs would go through the roof. They make the most money when customers use them infrequently because royalties are determined based on number of views.

In its current state, NFLX does not offer much in terms of premium content and it is leaving viewers to seek out other substitutes (hence, this year's reduction in subscriber guidance). NFLX was designed to capture visitors who are interested in slightly older material and NFLX was able to provide this at low cost because they paid lower royalty fees on that content. If NFLX were to change their value proposition to provide premium content their operating costs would go up significantly.

DIS would also like to maintain its good standing relationships with the cable providers. Cable providers also dabble in old content and acquiring NFLX would put us in direct competition with them. If we were to eat at their market they would be less willing to work with us in the future and we have no desire to cannibalize those cash flows. NFLX is simply not large enough to risk severing relationship with our Subs.

Bibliography

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3) http://news.yahoo.com/netflix-disney-films-tv-distribution-deal-013941123--finance.html
4) http://finance.yahoo.com/news/netflix-disney-sign-exclusive-deal-133904491.html
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Exhibit 1: Netflix DCF Analysis [1]

Millions USD	Historical Year Ended					Projected Year Ending									
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Stable >
Total Revenue	1,205	1,365	1,670	2,163	3,205	4,166	4,791	5,271	5,376	5,484	5,593	5,705	5,819	5,936	6,054
% growth rate	*n/a*	*13.2%*	*22.4%*	*29.5%*	*48.2%*	***30.0%***	***15.0%***	***10.0%***	***2.0%***	*2.0%*	*2.0%*	*2.0%*	*2.0%*	*2.0%*	***2.0%***
- COGS	786	910	1,079	1,357	2,040	3,125	3,162	3,479	3,548	3,619	3,692	3,765	3,841	3,917	3,996
% of revenue	*65.2%*	*66.7%*	*64.6%*	*62.8%*	*63.7%*	***75.0%***	***66.0%***	*66.0%*	*66.0%*	*66.0%*	*66.0%*	*66.0%*	*66.0%*	*66.0%*	*66.0%*
Gross Profit	419	454	591	805	1,165	1,042	1,629	1,792	1,828	1,864	1,902	1,940	1,979	2,018	2,058
% of revenue	*34.8%*	*33.3%*	*35.4%*	*37.2%*	*36.3%*	*25.0%*	*34.0%*	*34.0%*	*34.0%*	*34.0%*	*34.0%*	*34.0%*	*34.0%*	*34.0%*	*34.0%*
- Operating Exp	344	341	405	528	789	1,057	1,215	1,337	1,364	1,391	1,419	1,447	1,476	1,505	1,536
% of revenue	*28.5%*	*25.0%*	*24.3%*	*24.4%*	*24.6%*	*25.4%*	*25.4%*	*25.4%*	*25.4%*	*25.4%*	*25.4%*	*25.4%*	*25.4%*	*25.4%*	*25.4%*
- SG&A (Op Ex)	119	98	146	188	(51)	45	143	258	367	479	596	717	843	974	993
% of revenue	*9.9%*	*7.2%*	*8.7%*	*8.7%*	*-1.6%*	*1.1%*	*3.0%*	*4.9%*	*6.8%*	*8.7%*	*10.7%*	*12.6%*	*14.5%*	*16.4%*	*16.4%*
EBITDA	300	356	445	618	1,216	997	1,486	1,534	1,461	1,385	1,306	1,223	1,135	1,044	1,065
% of revenue	*24.9%*	*26.1%*	*26.6%*	*28.6%*	*37.9%*	*23.9%*	*31.0%*	*29.1%*	*27.2%*	*25.3%*	*23.3%*	*21.4%*	*19.5%*	*17.6%*	*17.6%*
- D & A (Op Ex)	225	243	259	340	840	1,012	1,072	1,078	997	912	823	730	633	532	542
% of revenue	*18.7%*	*17.8%*	*15.5%*	*15.7%*	*26.2%*	*24.3%*	*22.4%*	*20.5%*	*18.5%*	*16.6%*	*14.7%*	*12.8%*	*10.9%*	*9.0%*	*9.0%*
EBIT (oper profit	75	113	186	278	376	(15)	414	455	464	474	483	493	503	513	523
% of revenue	*6.2%*	*8.3%*	*11.1%*	*12.8%*	*11.7%*	*-0.4%*	*8.6%*	*8.6%*	*8.6%*	*8.6%*	*8.6%*	*8.6%*	*8.6%*	*8.6%*	*8.6%*
- Taxes	45	48	76	107	133	(7)	180	198	201	206	210	214	218	222	227
% of EBIT	*59.2%*	*42.7%*	*41.1%*	*38.5%*	*35.4%*	*43.4%*	*43.4%*	*43.4%*	*43.4%*	*43.4%*	*43.4%*	*43.4%*	*43.4%*	*43.4%*	*43.4%*
NOPAT	31	65	109	171	243	(9)	234	258	263	268	273	279	285	290	296
% of revenue	*2.5%*	*4.8%*	*6.5%*	*7.9%*	*7.6%*	*-0.2%*	*4.9%*	*4.9%*	*4.9%*	*4.9%*	*4.9%*	*4.9%*	*4.9%*	*4.9%*	*4.9%*

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Free Cash Flow to the Firm Analysis															
+ D & A	225	243	259	340	840	1,012	1,072	1,078	997	912	823	730	633	532	542
% of revenue	*18.7%*	*17.8%*	*15.5%*	*15.7%*	*26.2%*	*24.3%*	*22.4%*	*20.5%*	*18.5%*	*16.6%*	*14.7%*	*12.8%*	*10.9%*	*9.0%*	*9.0%*
- CapEx	45	208	239	158	135	373	429	472	482	491	501	511	521	532	542
% of revenue	*3.7%*	*15.2%*	*14.3%*	*7.3%*	*4.2%*	*9.0%*	*9.0%*	*9.0%*	*9.0%*	*9.0%*	*9.0%*	*9.0%*	*9.0%*	*9.0%*	*9.0%*
Working Capital	(181)	(151)	(134)	(96)	(190)	(247)	(284)	(312)	(319)	(325)	(332)	(338)	(345)	(352)	
% of revenue	*-15.0%*	*-11.0%*	*-8.0%*	*-4.4%*	*-5.9%*	*-5.9%*	*-5.9%*	*-5.9%*	*-5.9%*	*-5.9%*	*-5.9%*	*-5.9%*	*-5.9%*	*-5.9%*	
- WC Investment	n/a	31	16	38	(94)	(57)	(37)	(28)	(6)	(6)	(7)	(7)	(7)	(7)	(7)
% of revenue	*n/a*	*2.2%*	*1.0%*	*1.8%*	*-2.9%*	*-1.4%*	*-0.8%*	*-0.5%*	*-0.1%*	*-0.1%*	*-0.1%*	*-0.1%*	*-0.1%*	*-0.1%*	*-0.1%*
Free Cash Flow	n/a	70	113	314	1,042	687	914	892	784	695	602	504	403	297	303
% of revenue	*n/a*	*5.1%*	*6.8%*	*14.5%*	*32.5%*	*16.5%*	*19.1%*	*16.9%*	*14.6%*	*12.7%*	*10.8%*	*8.8%*	*6.9%*	*5.0%*	*5.0%*
Present Value Factor		*Industry WACC*		9%		0.914	0.836	0.764	0.698	0.638	0.584	0.533	0.488	0.446	0.446
Present Value of Free Cash Flows			*Lt Grth*	2%		628	764	682	548	444	351	269	196	132	**1,827**

Conclusion: Per Share Value	
Invested Capital (Equity and Debt) Value	5,841
+ Excess Cash	798
- Interest Bearing Debt, Preferred and Minority Interest	402
Equity Value (Net Present Value)	6,237
Divide: Shares Outstanding	55
Fair Value per Share	$113

Working Capital Inputs	2007	2008	2009	2010	2011
Current Assets	417	361	411	641	1,831
- Excess Cash	385	297	320	350	798
- Current Liabilities	213	216	226	389	1,225
+ Short Term Debt	1	1	1	2	2
Working Capital	(181)	(151)	(134)	(96)	(190)
% of revenue	*-15.0%*	*-11.0%*	*-8.0%*	*-4.4%*	*-5.9%*
Interest Exp (net)	20	15	13	16	17
Total Debt	36	39	238	236	402

Exhibit 2: Multiple Based Valuation

Stock	Netflix as of Thursday, Dec 6, 2012	
Stock Price	**$86.17**	
Shares Outstanding	58,829,000	Fully Diluted- Most Recent Quarter (as of Sep 30, 2012)
Market Value	5,069,294,930	
Debt	400,000,000	Most Recent Quarter (as of Sep 30, 2012)
Cash	798,355,000	Most Recent Quarter (as of Sep 30, 2012)

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TEV	4,670,939,930	
EBITDA	146,560,000	Trailing Twelve Months (as of Sep 30, 2012)
Multiple	31.87	

Stock	Netflix as of 2013	
Projected Stock Price	$98.53	Price= Equity Value / Shares Outstanding
Shares Outstanding	55,545,531	Assumed Contant
Market Value	$5,472,702,666	Equity Value = TEV-Debt+Cash
Debt	$564,777,116	Function of Revenues at 15% (Income Statement of 10Q)
Cash	$1,129,554,232	Function of Revenues at 30% (Income Statement of 10Q)
TEV	$4,907,925,550	EBITDA x Multiple
EBITDA	$153,995,894	
Multiple	31.87	Estimated to remain constant

Exhibit 3: Revenues and content costs from Feb 10, 2012 10K

			Year ended December 31,			
	2011	2010	2009	2008	2007	CAGR
			(in thousands, except per share data)			
Revenues	$ 3,204,577	$ 2,162,625	$ 1,670,269	$ 1,364,661	$ 1,205,340	28%

			As of December 31,			
	2011	2010	2009	2008	2007	CAGR
Total content library, net	1,966,643	361,979	146,139	117,238	128,371	98%