New Constructts® — Diligence | Independence | Performance

STOCK RESEARCH
Period End Date: 12/31/2014
Closing Price as of 05/13/2015: $580.11

Netflix Inc. (NFLX)

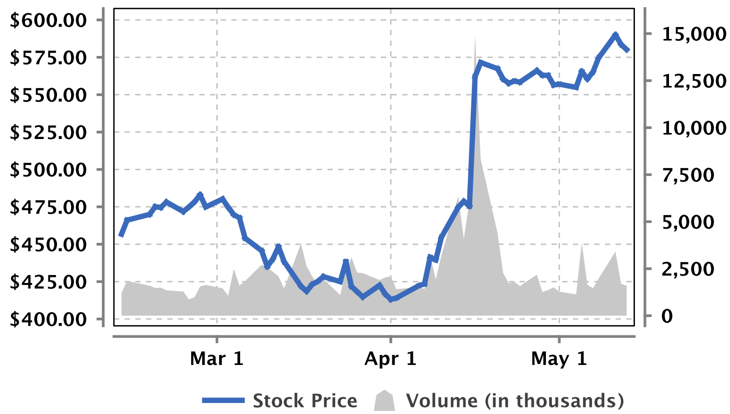
Dangerous

NASDAQ - Consumer Discretionary

Investment Recommendation

- We recommend investors sell NFLX.
- NFLX earns our Dangerous rating. See Investment Rating Details below.
- A Dangerous rating means this stock has more downside risk than upside potential.
- NFLX ranks in the 33rd percentile of the 3000+ stocks we cover.
- 349 out of 469 Consumer Discretionary Sector stocks.

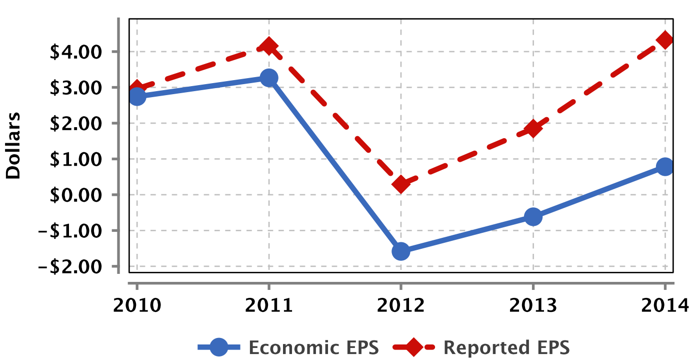
Price 05/13/2015:	$580.11
Economic Book Value per share	$42.79
52-Week Range	$315.54 - $594.00



Investment Rating Details

Overall Rating	Quality of Earnings		Valuation		
	Economic vs Reported EPS	Return on Invested Capital (ROIC)	FCF Yield	Price-to-EBV Ratio	Growth Appreciation Period (yrs)
Very Dangerous	Misleading Trend	Bottom Quintile	<-5%	> 3.5 or -1 < 0	> 50
Dangerous	False Positive	4th Quintile	-5%<-1%	2.4 < 3.5 or < -1	20 < 50
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6 < 2.4	10 < 20
Attractive	Positive EE	2nd Quintile	3%<10%	1.1 < 1.6	3 < 10
Very Attractive	Rising EE	Top Quintile	>10%	0 < 1.1	0 < 3
Actual Values	$0.78 vs. $4.32	10.5%	(1.4%)	13.56	101
S&P 500 (SPY)	Positive EE	20.9%	2.2%	2.13	21
Russell 2000 (IWM)	Neutral EE	8.0%	(3.0%)	4.12	50

Accounting vs Economic Earnings



Earnings & Valuation Diligence Summary

- NFLX's accounting earnings overstate its economic earnings.
- For NFLX, we made 14 income statement and balance sheet adjustments to convert accounting earnings to economic earnings in FY14 for a total value of $2,136 million.
- We made 3 adjustments equal to $2,961 million in our DCF valuation of the stock.
- NFLX ranks 712 of all the companies we cover for the number of earnings adjustments and 535 for the number of valuation adjustments.
- See Appendices 1 and 2 for details on our adjustments.

Stock Performance

Year to Date	69.8%
Last 30 Days	22.2%
Last 60 Days	32.3%
Last 90 Days	27.0%
Last Year	67.1%

Key Market Statistics

Enterprise Value (MM)	$35,879
Market Value (MM)	$35,096
Shares Outstanding (thousands)	60,498
30 Day Avg Volume (thousands)	3,066
EBV per Share	$42.79

Need Help?

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- Start Your Membership Today
- Get More Ratings
- Stock Rating Methodology

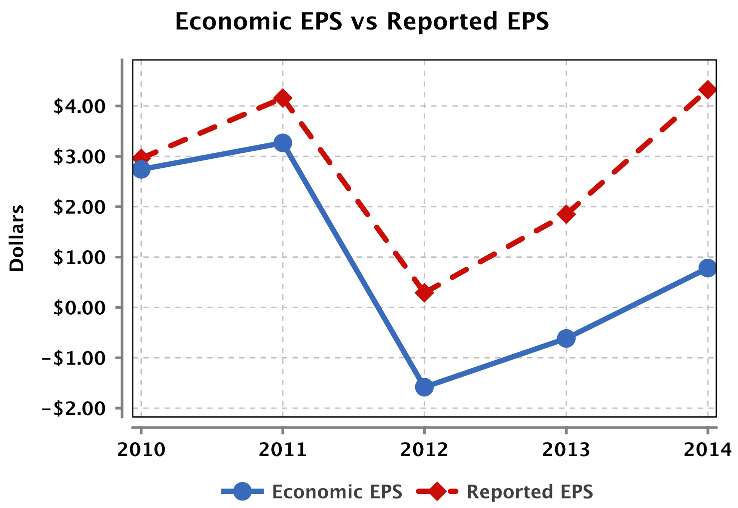
Economic vs Reported Earnings

Economic Earnings are Very Attractive

Economic Earnings are almost always meaningfully different than reported earnings. We believe Economic Earnings provide a truer measure of profitability and shareholder value creation than reported earnings because they have been adjusted to remove over twenty accounting distortions.

The majority of data required to reverse accounting distortions is available only in the Footnotes and MD&A, which we analyze rigorously. Our core competency is gathering and analyzing all relevant financial data from filings so that we can deliver earnings analysis that best represents the true profitability of businesses.

Economic Earnings per share (EEPS) for NFLX are $0.78 for the last fiscal year and earn a Very Attractive rating.



Return on Invested Capital (ROIC)

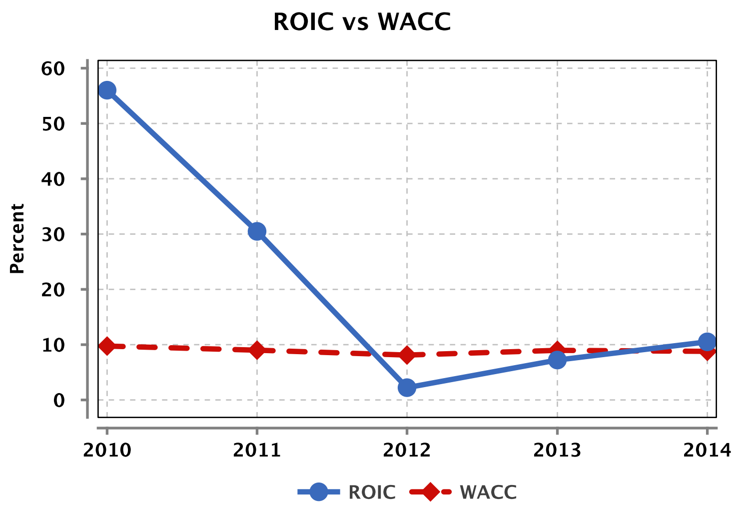
ROIC vs WACC is Attractive

ROIC measures a company's return on all cash invested in the business. It is the truest measure of profitability. Stock valuations are more highly correlated to ROIC than any other metric.

Weighted-Average Cost of Capital (WACC) is the average of debt and equity capital costs that all publicly traded companies with debt and equity stakeholders incur as a cost of operating.

Companies must earn an ROIC greater than WACC to generate positive economic earnings and create value for shareholders.

NFLX's ROIC of 10.5% compared to its WACC of 8.5% in the last fiscal year earns an Attractive rating.



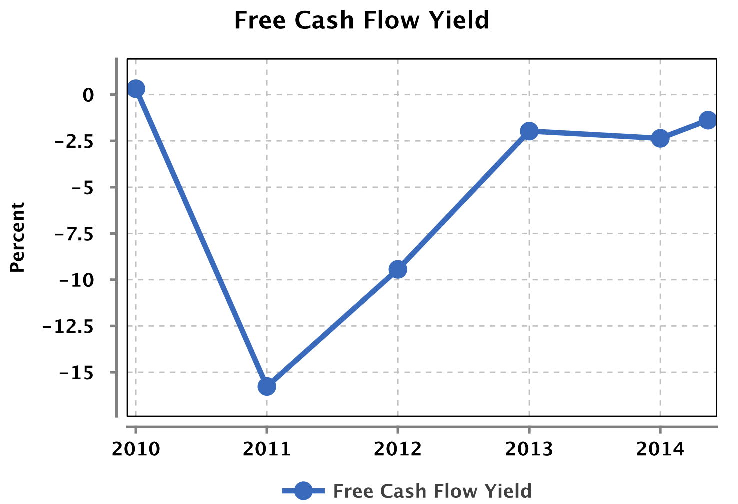
Free Cash Flow Yield (FCF Yield)

Free Cash Flow Yield is Dangerous

Free Cash Flow reflects the amount of cash free for distribution to all stakeholders (including debt & equity). FCF Yield divides free cash flow by enterprise value.

Using Free Cash Flow Yield to pick stocks is not a new strategy. However, our strategy yields superior results because we use a better measure of Free Cash Flow. In the same way our Economic EPS are better measures of profitability than reported EPS, our measure of Free Cash Flow is better than traditional accounting-based Free Cash Flow.

NFLX's current FCF is ($494) million. The FCF Yield is (1.4%) and earns a Dangerous rating.



Price-to-EBV Ratio

Price-to-EBV Ratio is Very Dangerous

Price-to-Economic Book Value (EBV) measures the difference between the market's expectations for future profits and the no-growth value of the stock.

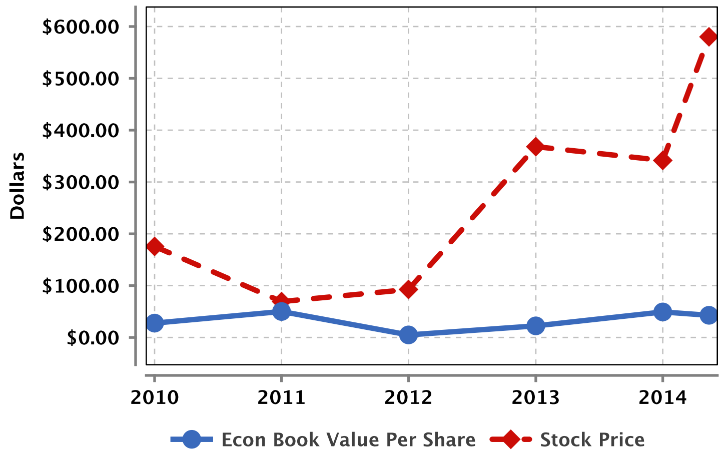
EBV measures the no-growth value of the company based on the company's current Net Operating Profit After Tax (NOPAT).

When prices are higher than EBV, the market predicts the NOPAT of the company will increase and expectations for profit growth are reflected in the stock. If the stock price equals EBV, the market predicts NOPAT will remain the same and there are no expectations for profit growth reflected in the stock. When stock prices are lower than EBV, the market predicts NOPAT will decrease and expectations for permanent profit decline are reflected in the stock.

In general, we like to buy stocks with low expectations for profit growth and sell/short stocks with high expectations for profit growth.

NFLX's current Price-to-EBV per share is 13.6 and earns a Very Dangerous rating.

Stock Price vs Economic Book Value (EBV) Per Share



Growth Appreciation Period

The Growth Appreciation Period is Very Dangerous

The market-implied duration of profit growth or GAP measures the number of years the company must maintain an edge over its competitors by earning ROIC greater than the weighted-average cost of capital on new investments.

We believe NFLX embeds a Very Dangerous level of market expectations because there is a very large difference between the expected financial performance implied by its market price and the company's historical performance.

At NFLX's current stock price of $580.11, the market is expecting revenue to grow at 7.1% for more than 100 years. Over this period, NFLX is also expected to generate an average Economic Earnings Margin of 2.5%.

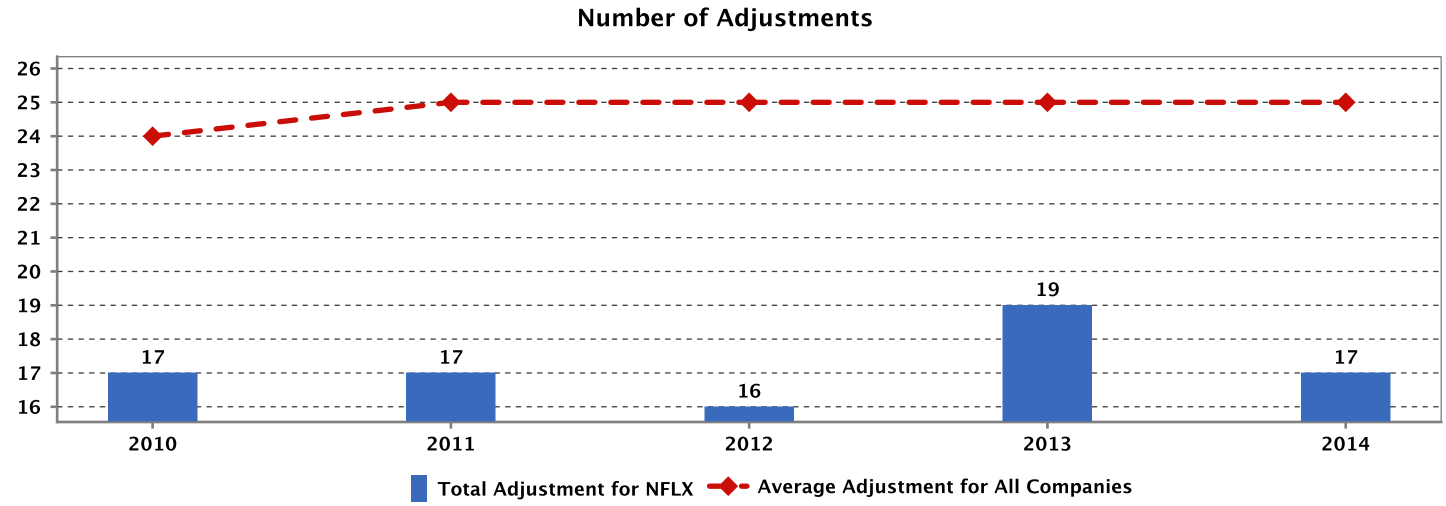
These results are derived using our dynamic discounted cash flow model.

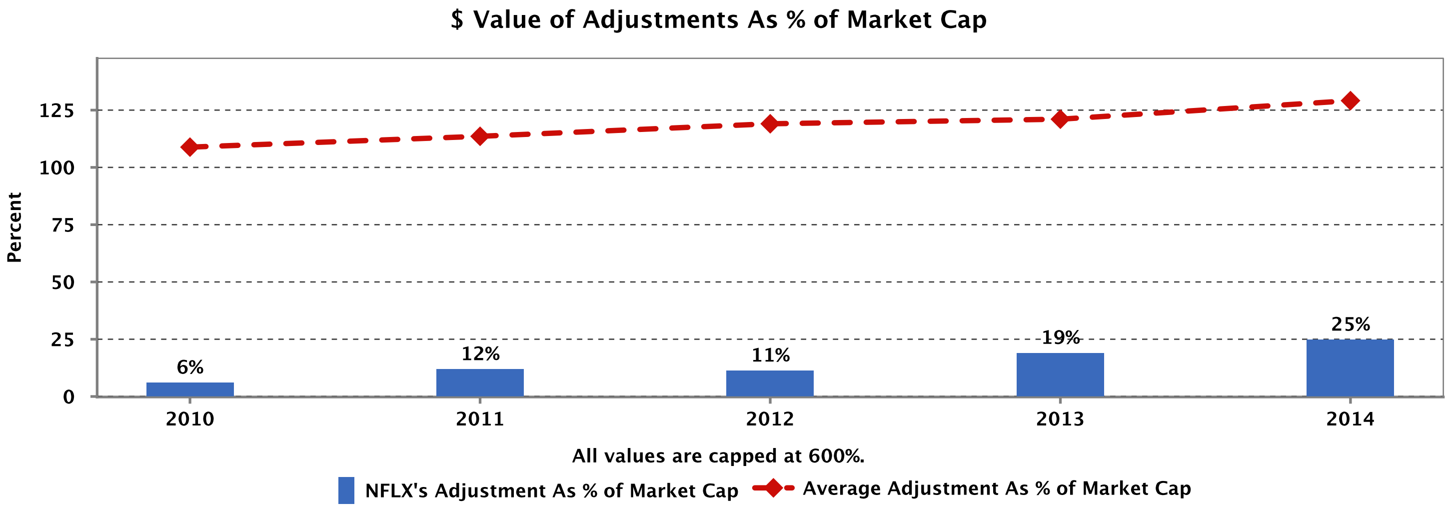
Performance Hurdles	Historical Performance			Market Expectations
	5 Yr	3Yr	Last FY	Default based on current price
Stock Price	$175.70	$92.59	$341.61	**$580.11**
Revenue CAGR	26.3%	23.5%	25.8%	**7.1%**
Avg Economic Earnings Margin	12.4%	(2.0%)	1.7%	**2.5%**
Growth Appreciation Period	-	-	-	**> 100 years**

Protecting You From Misleading Accounting Loopholes

Our experts know where the (accounting) bodies are buried. Since 1996, we have combed through 70,000+ corporate filings. We know how to find what companies may try to hide. We protect clients from the constantly changing landscape of accounting loopholes and hidden items buried deep in footnotes, the Management Discussion & Analysis ("MD&A") and other disclosures. Our experts review thousands of pages of corporate disclosures and filings to ensure that you have the best possible research on earnings quality and valuation.

Values in millions	2010	2011	2012	2013	2014
Total Adjustments Summary for Netflix Inc.					
Number of Adjustments	17	17	16	19	17
Average for all companies	24	25	25	25	25
Total Value of Adjustments	$1,227	$2,440	$2,313	$3,908	$5,097
Total Value of Adjustments as % of market cap	6%	12%	11%	19%	25%
Average for all companies	109%	114%	119%	121%	129%





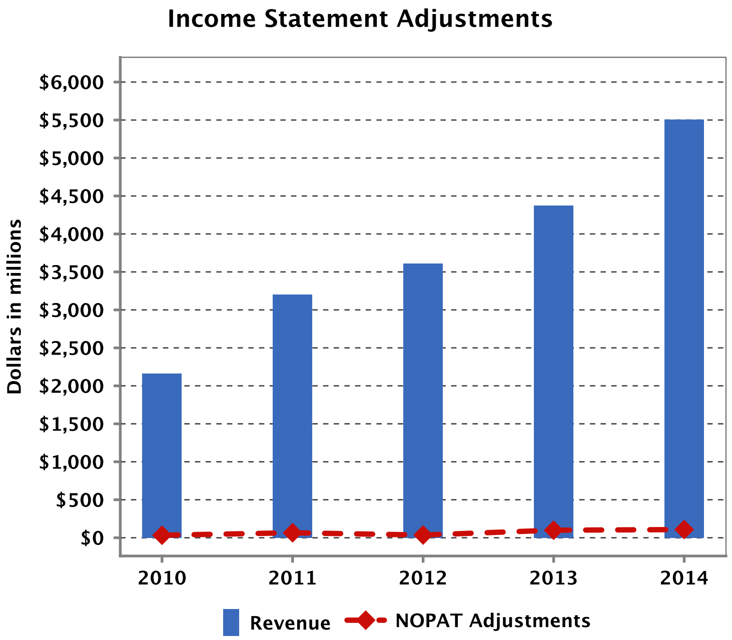
Income Statement Adjustments

We made 4 adjustments to convert Netflix Inc.'s reported 2014 earnings to NOPAT, for a net impact of $20 million. We net 1 income adjustment of $44 million against 3 expense adjustments of $64 million.

86% of companies require more adjustments to reported earnings as a percent of revenue than NFLX to calculate NOPAT.

Reported earnings don't tell the whole story of a company's profits. They are based on accounting rules originally designed for debt investors, not equity investors, and are often manipulated by companies to manage earnings. Only economic earnings that incorporate due diligence in the financial footnotes provide a complete and unadulterated measure of profitability.

Our adjustments to reported earnings enable us to calculate an accurate NOPAT, a key component of our ROIC and economics earnings calculations. There are, in general, 9 types of adjustments that we make to convert reported net income to NOPAT. NOPAT is the after-tax operating cash generated by the business, excluding unusual items, financing costs and other non-cash items.



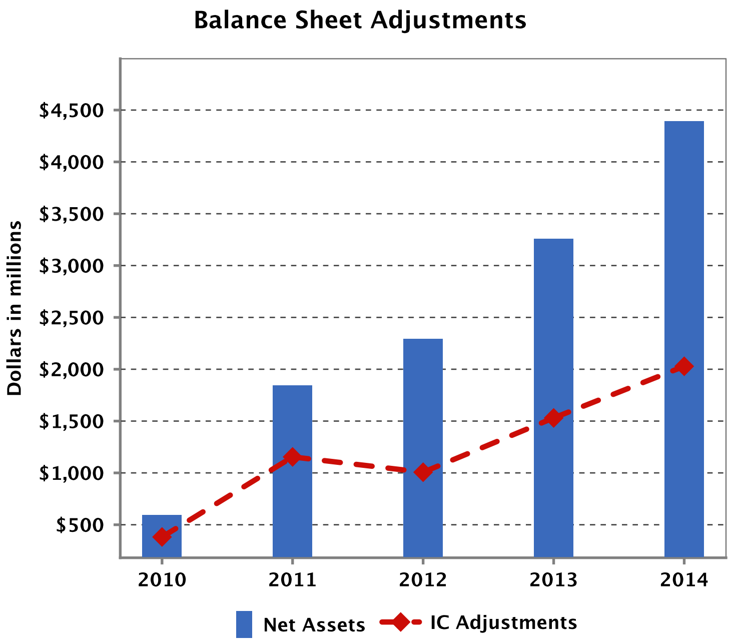
Balance Sheet Adjustments

We made 10 adjustments to convert Netflix Inc.'s reported 2014 net assets to Invested Capital, for a net impact of $1,660 million. We net 5 asset decrease adjustments of $1,844 million against 5 increase adjustments of $184 million.

52% of companies require more adjustments than NFLX to calculate Invested Capital.

The most notable accounting distortion to reported net assets for NFLX in 2014 is $390 million in adjustments for midyear acquisitions, which is 9% of reported net assets. To ensure an accurate measurement of cash-on-cash returns, we adjust invested capital to reflect the time-weighted value of all acquisitions. Without this adjustment we would be measuring NOPAT for the portion of time the assets were under control against total assets, skewing the ROIC calculation.

Our adjustments to reported net assets enable us to calculate an accurate Invested Capital, a key component of our ROIC and economics earnings calculations. There are, in general, 12 types of adjustment that we make to convert reported net assets to Invested Capital. Invested Capital is the sum of all cash that has been invested in a company over its life without regard to financing form or accounting name.

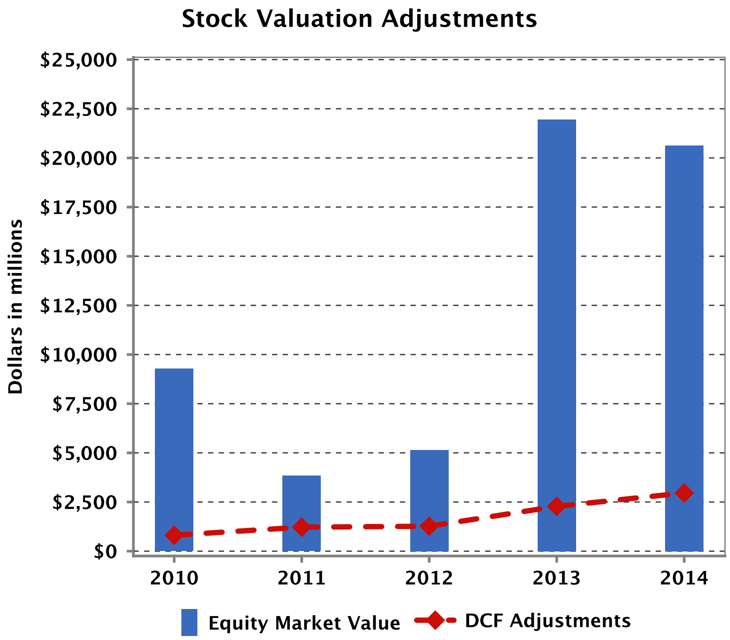


Stock Valuation Adjustments

We made 3 adjustments for a net impact of $294 million to our DCF model for Netflix Inc. in 2014. 2 adjustments decrease value by $1,628 million and 1 adjustment increases value by $1,333 million.

77% of companies require more adjustments as a percent of market value to calculate valuation metrics.

The most notable accounting distortion to these valuation metrics for NFLX in 2014 was the value of outstanding ESO's after tax. We adjusted shareholder value by $504 million, which is 2% of the firm's market value. ESOs represent a liability based on future share dilution as employees exercise their options and add to the total number of shares outstanding.



Our valuation adjustments protect clients from unknowns that could blow stocks up. These adjustments enable us to derive more accurate calculations for Economic Book Value, Enterprise Value and our Discounted Cash Flow Model. There are, in general, 10 types of adjustments that we apply to our valuation metrics.

Appendix 1: Adjustments for Economic Earnings

Reported earnings don't tell the whole truth of a company's profits. We scour the footnotes and fine print so clients have the whole truth. Full details on our adjustment methodologies are here. See our Company Models tutorials to learn how you can modify adjustments and see where we find them in SEC filings.

Values in millions	2010	2011	2012	2013	2014
Income Statement Adjustments					
GAAP Net Income	$160.85	$226.13	$17.15	$112.40	$266.80
Total Non-Operating Expense Hidden in Operating Earnings	$0.39	$9.50	$0.00	$0.00	$0.00
Reported Net Non-Operating Items	$15.94	$25.55	$19.51	$57.27	$53.28
Change in Total Reserves	$0.00	$0.00	$0.00	$0.00	$0.00
Implied Interest for PV of Operating Leases	$3.33	$3.70	$6.06	$10.08	$10.82
Non-Operating Tax Adjustment	($6.20)	($19.84)	($9.59)	($31.71)	($43.69)
Net After-Tax Non-Operating Expense/(Income)	$0.00	$0.00	$0.00	$0.00	$0.00
NOPAT	**$174.32**	**$245.03**	**$33.14**	**$148.05**	**$287.21**
Balance Sheet Adjustments					
Total Assets (unadjusted)	$982.07	$3,069.20	$3,967.89	$5,412.56	$7,056.65
Total Current/Investment Liabilities	($388.58)	($1,225.05)	($1,675.93)	($2,154.20)	($2,663.15)
Reported Net Assets	**$593.49**	**$1,844.14**	**$2,291.96**	**$3,258.36**	**$4,393.50**
Short-Term Debt	$2.08	$2.32	$1.20	$1.10	$1.20
Excess Cash	($242.26)	($637.58)	($567.61)	($981.68)	($1,333.26)
Total Reserves	$0.00	$0.00	$0.00	$0.00	$0.00
Unconsolidated Subsidiary Assets (non-operating)	($0.00)	($0.00)	($0.00)	($0.00)	($0.00)
Discontinued Operations Adjustment	$0.00	$0.00	$0.00	$0.00	$0.00
Deferred Compensation Adjustment	$0.00	$0.00	$0.00	$0.00	$0.00
Deferred Tax Adjustment	($17.47)	($38.30)	($67.90)	($90.60)	($120.30)
Over Funded Pensions (Asset)	($0.00)	($0.00)	($0.00)	($0.00)	($0.00)
Off-Balance-Sheet Operating Leases	$43.00	$49.87	$94.26	$144.85	$157.94
Accumulated Unrecorded Goodwill	$0.00	$0.00	$0.00	$0.00	$0.00
Accumulated Goodwill Amortization	$0.00	$0.00	$0.00	$0.00	$0.00
Accumulated Asset Write-Downs After-Tax	$4.81	$4.81	$7.17	$14.99	$20.69
Accumulated OCI (Other Comprehensive Income)	($0.75)	($0.71)	($2.92)	($3.57)	$4.45
Invested Capital	**$382.90**	**$1,224.55**	**$1,756.17**	**$2,343.45**	**$3,124.21**
Average Invested Capital	**$311.17**	**$803.72**	**$1,490.36**	**$2,049.81**	**$2,733.83**

Appendix 2: Adjustments for our Discounted Cash Flow Model, Economic Book Value, and Enterprise Value Calculations

We use a dynamic discounted cash flow (DCF) model to quantify the market expectations for future cash flows in stock prices. This approach, also known as "expectations investing" or "reverse DCF", is the most transparent and objective approach to valuing stocks. More in our DCF model video tutorial.

Values in millions	2010	2011	2012	2013	2014	Current
Excess Cash	$242.26	$637.58	$567.61	$981.68	$1,333.26	$1,333.26
Net Assets from Discontinued Operations	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Net Deferred Tax Liability	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Net Deferred Compensation Assets	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Fair Value of Unconsolidated Subsidiary Assets (non-op)	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Fair Value of Total Debt	($304.20)	($496.99)	($551.06)	($681.75)	($1,123.54)	($1,123.54)
Fair Value of Preferred Capital	($0.00)	($0.00)	($0.00)	($0.00)	($0.00)	($0.00)
Fair Value of Minority Interests	($0.00)	($0.00)	($0.00)	($0.00)	($0.00)	($0.00)
Value of Outstanding ESO After-Tax	($264.85)	($85.49)	($151.14)	($614.97)	($504.05)	($993.00)
Pensions Net Funded Status	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Total Valuation Adjustments	**($326.80)**	**$55.10**	**($134.59)**	**($315.04)**	**($294.33)**	**($783.27)**

Appendix 3: Explanation of New Constructs' Stock Ratings

Ratings

In-depth risk/reward analysis underpins our stock rating. Our stock rating methodology grades every stock according to what we believe are the 5 most important criteria for assessing the quality of a stock. Each grade reflects the balance of potential risk and reward of buying that stock. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

Overall Rating	Quality of Earnings		Valuation		
	Economic vs Reported EPS	Return on Invested Capital (ROIC)	FCF Yield	Price-to-EBV Ratio	Growth Appreciation Period
Very Dangerous	Misleading Trend	Bottom Quintile	< -5%	> 3.5 or -1 < 0	> 50
Dangerous	False Positive	4th Quintile	-5% < -1%	2.4 < 3.5 or < -1	20 < 50
Neutral	Neutral EE	3rd Quintile	-1% < 3%	1.6 < 2.4	10 < 20
Attractive	Positive EE	2nd Quintile	3% < 10%	1.1 < 1.6	3 < 10
Very Attractive	Rising EE	Top Quintile	> 10%	0 < 1.1	0 < 3

Ratings

Economic earnings and return on capital metrics are significantly more accurate when as-reported financial statements have been adjusted to reverse accounting distortions and Red Flags. The majority of the data required to reverse accounting distortions is available only in the Notes to the Financial Statements, which we analyze rigorously. Our core competency is gathering and analyzing all relevant financial data (from the Financial Statements and Notes) so that we can deliver earnings analysis that best represents the true profitability of businesses. See the figure below for a list of the Red Flag adjustments we make to a company's reported GAAP profits in order to reverse accounting distortions and arrive at a better measure of a firm's profits.

Accounting Issues and Red Flags that Distort GAAP

- Employee Stock Options
- Pension Over/Under Funding
- Excess Cash
- Restructuring Charges
- Pooling Goodwill
- Minority Interests
- Discontinued Operations
- Preferred Stock
- Mid-Year Acquisitions
- Off-Balance-Sheet Financing
- LIFO Reserve
- Unrealized Gains/Losses
- Goodwill Amortization
- Unconsolidated Subsidiaries
- Capitalized Expenses
- Deferred Compensation
- Net Deferred tax Assets and Liabilities

New Constructs® - Profile

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies.

How New Constructs Creates Value for Clients

1. **Superior Recommendations** - Our stock-picks consistently outperform. See our track record in our stock-picking accolades and Proof Is In Performance reports.
2. **More Accurate Research** - Our patented Research Platform for reversing accounting distortions and discounted cash flow analysis leverages better data to deliver smarter research.
3. **Time Savings** - We check the fine print in thousands of corporate filings so you don't have to. As reported by Barron's, our expertise in analyzing SEC filings delivers Hidden Gems and Red Flags that drive long-term stock-picking success.
4. **Transparency** - We are proud to share the results of our analysis of over 50,000 10-Ks. See the Corporate Disclosure Transgressions report we provided to the SEC. Our reports detail all data and assumptions. Company Models enable users to change them.
5. **Objectivity** - New Constructs is an independent research firm, not tied to Wall Street or investment banking services. See our presentation to the Senate Banking Committee, the SEC and many others in DC.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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