BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Netflix (NFLX) EQ Review

Current EQ Rating*	Previous EQ Rating
3-	NA

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We are initiating earnings quality coverage of Netflix (NFLX) with a 3- (Minor Concern) rating.

This was a difficult one to rate, as we do not see any concrete signs of intentional management manipulation of the numbers. Overall, our main concern with the business model is the degree to which the company's massive buildout of produced content is consuming huge amounts of cash resulting in a rapid buildout in debt. Management has admitted this condition will not change for years to come as the company has to spend to show subscriber growth to justify the 100+ PE.

While this report focuses on earnings quality issues and does not delve into subscriber trends or the analysis of new competition, we have to observe that of the "FANG" stocks, NFLX stands out as being the one that does not belong. Facebook, Amazon, and Google (Alphabet) do not have frighteningly leveraged balance sheets and do not report dramatically negative cash flows. They also dominate their respective markets with no real competitors in their niches. NFLX either is or soon will be dealing with the likes of AT&T, Disney, Comcast, and Apple. Finally, having lived as analysts through the dotcom bubble, the bull cry of "some day they may generate cash, but for now, just look at that subscriber growth" feels very 1999 to us.

On the earnings quality front, amortization of streaming content assets represents over half of total operating expenses and is totally based on management estimates regarding the useful life of titles. We admit this is not the company's fault, but merely a byproduct of the business model. Nevertheless, the huge degree of guesswork in itself lowers the quality of the reported earnings in our mind. In addition, we observe that while management has made attempts to educate investors about its content accounting practices (there is a 27-page slide show on the website dedicated to that subject), the current disclosure still does not leave investors with a clear picture of the policy or more importantly, a way to reliably detect any changes in policy that could be materially inflating earnings. Also, management has made multiple changes in the language it uses to describe its policies which does generate some questions. These issues lead us to initiate earnings quality coverage with a 3- rating.

More specifically, we cite the following observations about the company's results:

- NFLX reported net income of $1.3 billion for the 12 months ended 3/19, a doubling from the year-ago period. However, operating cash flow for the same period fell to negative $2.8 billion from a negative $1.6 billion a year ago. This mismatch is being driven by massive spending on streaming content assets and has recently been accelerated by a shift to the company producing its own content which requires even more cash be paid up front. Management has indicated that it will continue to spend aggressively on new content which will result in negative cash flow for "many years."

- The spending spree has led to a rapid buildup in debt which currently stands at $10.3 billion. In addition to this, the company has an additional $8.4 billion in present value of content liabilities on the balance sheet related to payments that must be made over the next few years under existing content licenses plus another $3-$5 billion in content liabilities that are likely to be paid but are not on the balance sheet yet. Amortization is by far the company's largest expense, yet it is added back in the EBITDA figure which in our minds makes the debt/EBITDA calculation fairly useless. However, comparing the almost $40 billion in cash payments expected to be made on its debt and content liabilities over the next five years to the 2018 full year's revenue of less than $16 billion gives one the idea of just how big the debt load already is.

- The period over which the company amortizes its content assets is the key to its reported earnings. Small changes can totally erase the company's reported earnings (which investors are currently paying over 100x to buy). We note that the company has made multiple changes to its disclosure regarding amortization over the years. For example, in 2017, it changed from stating that the typical amortization period fell between 6 months to 5 years. However, in the third quarter of 2017, it changed the language to imply that the amortization period could range as high as 10 years. Management publicly indicated that the language change did not indicate a change in its policy.

- Current disclosures reveal that the amortization is accelerated with more recognition towards the first year of a title's release. Also, 90% of the total value of a title is typically expensed by the end of the fourth year. Other disclosures seem to indicate that approximately 40% of a typical title's value is expensed in the first year. Without access to viewership data, we cannot say this is not realistic, nor is it grossly out of line with the somewhat vague disclosures of competitors with similar models such as AT&T and Disney.

- In 2010, the company used to disclose gross streaming asset values but discontinued the disclosure after only one year. Without this figure, it is very difficult to make a reasonably accurate calculation to track changes in the average amortization period. In addition, the current shift to produced content from licensed content would likely make it difficult to draw solid conclusions from changes in the average period. Future disclosures should be monitored for language changes or impacts on profits from changes in estimates.

- Marketing spending fell almost 100 bps as a percentage of sales in the 3/19 quarter. The company has indicated it expects to achieve synergy in this area, but given the influx of competition and the need to continue to drive big subscriber growth to justify the sky-high multiple, we are skeptical that the trend is sustainable.

- Stock-based compensation expense jumped by $150 million in the twelve months ended 3/19 over the comparable year-ago period. We observe that if the company had paid cash to its employees instead of options, the cash flow decline in the period would have been over 12% worse than reported.

- NFLX's "other income/(expense) account is very volatile, driven mostly by FX remeasurements in its euro-denominated notes and to a lesser degree remeasurement of content liabilities. Management openly discusses this item its quarterly letters so we are not overly concerned by this item.

The Cash Flow Shortfall Is Accelerating with No End in Sight

The following table shows the calculation of NFLX's free cash flow for the last three 12-month periods ended March 31:

	3/31/2019	3/31/2018	3/31/2017
Net Income	$1,265.170	$670.831	$337.242
Operating Cash Flow	-$2,823.521	-$1,678.849	-$1,589.250

We can see that despite the company reporting skyrocketing net income, its cash from operations is deteriorating rapidly. The following table gets to the heart of what is causing the rapid decline:

12 months ended:	3/31/2019	3/31/2018	3/31/2017
Net Income	$1,265.170	$670.831	$337.242
Additions to Streaming Content	-$13,054.436	-$10,443.844	-$8,685.353
Change in Streaming Content Liabilities	$606.297	$912.634	$1,233.184
Cash Spending on Streaming Content	***-$12,448.139***	***-$9,531.210***	***-$7,452.169***
Amortization of Streaming Content	***$7,907.930***	***$6,640.978***	***$5,035.660***
Other Non-Cash Adjustments	$451.518	$540.552	$490.017
Operating Cash Flow	-$2,823.521	-$1,678.849	-$1,589.250

We can see that cash spending on content is growing at an increasing pace while amortization is growing much more slowly, allowing for positive and rising profits even as cash flow falls further into negative territory. We will look more closely at the company's amortization policies later in the report and focus on the increase in spending on streaming content in the rest of this section.

NFLX's original business model revolved around renting DVD's through the mail via a subscription model. In the mid-2000s, the rollout of faster Wi-Fi allowed the company to deliver its licensed content for presentation over its streaming platform. The company recognized the licenses as assets which it originally amortized on a straight-line basis over the expected license term. With the company rapidly expanding its licensed content and more of the cash spent up front, it was common to see the cash spend on licensed streaming content outrunning amortization expense.

To boost the competitiveness of its offerings, the company began to license *Netflix* branded original content such as *House of Cards* and *13 Reasons Why*. Finally, in 2015, it began producing its own original content such as *Stranger Things* and *Bird Box*. When the company produces its own content, the resulting assets are capitalized, but amortization does not begin until the production is first made available to subscribers. Not only is this more expensive, but the cash can be spent months or even years prior to the associated expense starting to be recognized on the income statement. This has served to further the growing gap between net income and cash flow. The following table shows the company's streaming content broken down by category:

	3/31/2019	12/31/2018	9/30/2018	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Licensed Streaming Content, Net	$14,297.658	$14,081.463	$13,458.275	$13,032.400	$12,508.344	$11,771.778	$11,462.217
Produced Streaming Content							
Released Content Less Amortization	$2,737.677	$2,403.896	$1,946.994	$1,786.221	$1,643.252	$1,427.256	$984.945
In Production	$3,494.467	$3,305.126	$2,757.434	$2,085.501	$1,613.898	$1,311.137	$1,338.208
In Development and Pre-Production	$348.515	$311.842	$222.885	$179.060	$161.497	$158.517	$163.393
	$6,580.659	$6,020.864	$4,927.313	$4,050.782	$3,418.647	$2,896.910	$2,486.546

Note that the released content grew 66% year-over-year in the 3/19 quarter while in production and pre-production content (which are not being amortized yet) more than doubled in the same period.

In addition, keep in mind that the company does not operate under the pay-per-view model. Customers subscribe for the right to have on-demand access to the entire content library. When a title is released, there is no assured inflow of cash associated with it. While a big hit like *Stranger Things* that draws public attention may bring in a meaningful number of new subscribers in the weeks following its release, less well-performing titles that don't make waves with the public are simply providing new content for existing subscribers to watch.

Despite this, the arms war for content led by AT&T, Disney and more recently Apple means the company has to continue to build out its content to compete. If subscriber growth does not remain robust, the 100+ PE ratio will come under scrutiny. This brings up the main question of concern which is when will cash hemorrhage end? Management stated in its 3/19 quarterly letter that it expects free cash flow to begin to "improve in 2020 and each year thereafter, driven by our growing member base, revenues, and operating margins." However, improvement does not mean to turn positive, just less negative. According to the 3/19 10-Q filing, positive cash flow is many years in the future:

> *"We expect to continue to significantly increase our investments in global streaming content, particularly in original content, which will impact our liquidity* ***and result in future negative net cash provided by (used in) operating activities and free cash flows for many years.*** *We currently anticipate that cash flows from operations, available funds and access to financing sources, including our revolving credit facility, will continue to be sufficient to meet our cash needs for at least the next twelve months."*

Meanwhile, Debt Is Rapidly Increasing with No End in Sight- And There's More than Debt to Worry About

As we noted above. accelerating cash spend on produced content has resulted in NFLX reporting increasingly negative cash flow from operations and management has admitted that the trend will not reverse anytime soon. Not surprisingly, debt continues to climb. Total debt stood at over $10 billion at the end of the 3/19 quarter. However, in addition to the debt, the company carries an even larger amount of streaming content obligations as shown in the following table which breaks out scheduled payment over the next several years:

	Total	< 1 year	<1-3 years	<3-5 years	> 5 years
Streaming Content Obligations	$18,922.789	$8,888.491	$8,416.736	$1,480.670	$136.892
Debt	$14,768.151*	$535.960	$2,245.273	$1,328.564	$10,658.355
Operating Lease Obligations	$1,724.867	$152.540	$258.447	$303.881	$1,009.999
Other Purchase Obligations	$710.437	$432.297	$243.833	$34.307	$0
	$36,126.244	$10,009.288	$11,164.289	$3,147.422	$11,805.246

*Note this is amounts to be paid on the company's notes as of 3/19. The balance sheet value of the debt is $10.3 billion as of 3/19.

The following footnote related to the streaming content obligation line above is well worth the read:

> *"Streaming content obligations include amounts related to the acquisition, licensing and production of streaming content. An obligation for the production of content includes non-cancelable commitments under creative talent and employment agreements and other production related commitments. An obligation for the acquisition and licensing of content is incurred at the time we enter into an agreement to obtain future titles. Once a title becomes available, a content liability is recorded on the Consolidated Balance Sheets.* ***Certain agreements include the obligation to license rights for unknown future titles, the ultimate quantity and/or fees for which are not yet determinable as of the reporting date. Traditional film output deals, or certain TV series license agreements where the number of seasons to be aired is unknown, are examples of these types of agreements. The contractual obligations table above does not include any estimated obligation for the unknown future titles, payment for which could range from less than one year to more than five years. However, these unknown obligations are expected to be significant and we believe could include approximately $2 billion to $5 billion over the next three years, with the payments for the vast majority of such amounts expected to occur after the next twelve months.*** *The foregoing range is based on considerable management judgments and the actual amounts may differ. Once we know the title that we will receive and the license fees, we include the amount in the contractual obligations table above."*

So, in addition to the quantifiable future content obligations such as future royalties paid to actors and directors and other payments related to licensed content which currently total almost $19 billion, **the company will likely have to spend an additional $2-5 billion over the next few years which is not in the total above or reflected anywhere on the balance sheet.** Keep in mind these content liabilities are very real as the company has to pay them even if they stopped production today. As college football fans, we are reminded of the 1980s SMU scandal where even after boosters decided to stop paying new recruits fearing detection by the NCAA, they still had to keep up payments to the current players for the next 4 years.

NFLX made $13.0 billion, $9.8 billion and $8.6 billion in cash additions to streaming content assets in each of the last three fiscal years. It will have to pay at least $9 billion over the next year just based on content that has already been completed and licensed not counting cash spend on new content. Obviously, we can expect continued increases on cash spend on content for the foreseeable future along with negative cash flows and a rising debt load.

Streaming Content Assets

As we covered above, at this point, almost all of NFLX's business model is built around licensing and producing TV show and movie content and presenting to customers in a flat-fee subscription format. (Note that we will focus on the company's streaming content ignore the DVD portion of the business in this analysis as it is not a material part of the business.)

When the company spends cash on licensing and production, the company records the amounts as streaming content assets which are then amortized over time. The amortization of these assets represents the bulk of the company's expenses on its income statement. The following table shows the company's reported net income, the amortization of streaming assets and the cash spent on those assets for the last seven quarters:

	03/31/2019	12/31/2018	09/30/2018	06/30/2018	03/31/2018	12/31/2017	09/30/2017
Net Income	$344.052	$133.934	$402.835	$384.349	$290.124	$185.517	$129.590
Amortization of Streaming Content Assets	$2,124.686	$2,053.660	$1,911.767	$1,817.817	$1,748.844	$1,713.863	$1,627.477
Gross Additions to Streaming Content Assets	$2,997.746	$3,784.252	$3,238.717	$3,033.721	$2,986.747	$2,477.659	$2,315.017
Change in Streaming Content Liabilities	-$14.698	$266.653	$65.868	$288.474	$378.885	$53.446	-$34.587
Cash Spent on Streaming Content Assets	$3,012.444	$3,517.599	$3,172.849	$2,745.247	$2,607.862	$2,424.213	$2,349.604
Difference	-$887.758	-$1,463.939	-$1,261.082	-$927.430	-$859.018	-$710.350	-$722.127

The difference between cash spent on content and the amortization of content represents accrual accounting's attempt to match current expenses with current revenue. We can see that a relatively small narrowing of the gap between the two amounts could wipe out the company's reported profits.

At this point, we want to be clear that this in itself does not mean that NFLX is being aggressive in its accounting and the company is a sell. This is simply the nature of the business model. However, we do think investors should constantly be aware of the huge degree to which the earnings of the "N" component of the "FANG" are dependent on management's estimations.

Also as discussed above, licensed content is growing rapidly, posting 14%, 19% and 17% year-over-year increases in the last three quarters, respectively. However, produced content has grown much more rapidly as the company has made a push in the last few years to create its own original movie and "TV-style" episodic content resulting in an almost doubling in total produced streaming content assets in recent quarters. Note that the company does not begin to amortize produced content until its first month of availability on the platform. This means that all cash production costs can be made many months before they even begin to be reflected in the income statement. The huge buildup in "In Production" produced assets is an indicator of how much the company has recently spent that has yet to be recognized as an expense.

Frequent Changes to Amortization Policy Disclosures

Obviously, the time period over which the company amortizes these assets is the key factor that will determine what profits the company reports. The company's disclosure regarding its amortization policy has evolved over time. In the 2015 10-K, for example, the company noted the following points regarding its amortization policies:

- Content that ***did not*** premiere on Netflix was amortized on a straight-line basis over the shorter of the licensing contract window or the estimated period of use with the typical amortization period ranging from 6 months to 5 years.

- Content that ***did*** premiere on the Netflix service was amortized on an accelerated basis over the shorter of 4 years or the license period. The accelerated status reflected the concentration of views near the release date as well as additional merchandising and marketing efforts.

- If the cost per title could not be estimated, the license was not capitalized and costs were expensed on a straight-line basis over the license period. This occurred when the agreement did not specify the number of titles, the license fee per title of the window of availability per title.

Disclosure in the 2016 10-K changed by omitting the detail above and stating the policy in more general terms with the key point being:

> *"Based on factors including historical and estimated viewing patterns, we amortize the content assets (licensed and produced) in "Cost of revenues" on the Consolidated Statements of Operations, over the shorter of each title's contractual window of availability or estimated period of use, beginning with the month of first availability.* ***The amortization period typically ranges from six months to five years****. For content*

where we expect more upfront viewing, for instance due to additional merchandising and marketing efforts, we amortize on an accelerated basis."

The new disclosure did not give detail regarding the use of straight-line versus accelerated amortization schedules. Other than that, there was not a material conflict with the old disclosure.

Then, starting with the 2017 10-Q, the company changed to its current disclosure:

> *"The Company acquires, licenses and produces content, including original programming, in order to offer members unlimited viewing of TV series and films.* ***The content licenses are for a fixed fee and specific windows of availability. Payment terms for certain content licenses and the production of content require more upfront cash payments relative to the amortization expense****. Payments for content, including additions to streaming assets and the changes in related liabilities, are classified within "Net cash used in operating activities" on the Consolidated Statements of Cash Flows.*
>
> *[...]*
>
> ***Based on factors including historical and estimated viewing patterns, the Company amortizes the content assets (licensed and produced) in "Cost of revenues" on the Consolidated Statements of Operations <u>over the shorter of each title's contractual window of availability or estimated period of use or ten years, beginning with the month of first availability. The amortization is on an accelerated basis, as the Company typically expects more upfront viewing, for instance due to additional merchandising and marketing efforts and film amortization is more accelerated than TV series amortization.</u>*** *The Company reviews factors impacting the amortization of the content assets on an ongoing basis. The Company's estimates related to these factors require considerable management judgment."*

The obvious material change to the new disclosure was stating that the typical amortization period ranged from 6 months to 5 years to stating that the amortization period could range as high as 10 years. At the time, management publicly stated that the change in language did not mark a material change in its amortization schedule or policy. However, the change in the language is certainly striking and leaves one wondering why it was made.

A Closer Look at Current Policy

By combining the points of the new disclosure above with statements the company makes in other presentations, we know the following aspects of its current amortization policy.

- The amortization schedule is generally more accelerated than straight-line to reflect that titles will be viewed more when first released with views trailing off thereafter.

- On average, 90% of a content asset is expected to be amortized within four years after its first month of availability.

- Content is amortized over the shorter of a title's window of availability, estimated period of use, or ten years.

- Film is more accelerated than TV. This makes sense, as customers are likely willing to continue to subscribe to be able to go back and watch all 11 seasons of *Frasier* for the third time (done that) than they are to subscribe just to see a Marvel movie they saw at the theater two years ago.

- Produced content requires more cash up front. In the case of licensing deals, payments can be spread out into the future. As we noted above, there is more of a lag between the cash spend and the commencement of amortization with produced content since the company can release licensed content (and begin amortizing) as soon as a deal is struck.

- Topical programming such as talk shows is expensed upon airing rather than being amortized over time.

In addition to disclosing the above aspects of its amortization policies, management provides a schedule showing how much of the existing content balances are expected to be amortized over each of the next few years. Below is a breakdown of that disclosure as of the 3/19 quarter:

In addition, the company provides data on how much of its existing content assets are expected to be amortized over the next one, two and three years. We broke this down in the following table:

	Licensed Content	
Current Balance	$14,298	
expected to be amortized in:		% of Beg. Balance
Year 1	$5,415	37.9%
Year 2	$3,691	25.8%
Year 3	$2,552	17.8%
		81.5%

	Produced Content	
Current Balance	$2,738	
expected to be amortized in:		% of Beg. Balance
Year 1	$935	34.1%
Year 2	$756	27.6%
Year 3	$559	20.4%
		82.2%

These amounts cannot be treated as exact schedules since the beginning balances include partially amortized amounts. Nevertheless, given the growth in the assets, the base is still relatively young, so this should give a decent picture of the general schedule. We can see that the percentage of assets amortized per year match the first two characteristics of being accelerated in addition to resulting in 90% of assets being amortized by the end of year 4.

How does NFLX Compare to Others?

Unfortunately, it is currently difficult to assess the realism of the company's amortization schedule without access to viewership data. Other companies in the industry are also light with the detail in their disclosures. For example, AT&T simply states

> *"For premium pay television and over-the-top (OTT) services that are not advertising-supported*, **each licensed program's costs are amortized on a straight-line basis over its license period or estimated period of use, beginning with the month of initial exhibition.** When we have the right to exhibit feature theatrical programming in multiple windows over a number of years, historical audience viewership is used as the basis for determining the amount of programming amortization attributable to each window."

It could be argued that amortizing over the period of the license fee on a straight line basis sounds similar to NFLX's original method of amortization and is actually less conservative that NFLX's current accelerated schedule.
Likewise, Disney states:

> ***"Film and television production, participation and residual costs are expensed over the applicable product life cycle based upon the ratio of the current period's revenues to estimated remaining total revenues (Ultimate Revenues) for each production. For film productions, Ultimate Revenues include revenues from all sources that will be earned within ten years from the date of the initial theatrical release. For television series, Ultimate Revenues include revenues that will be earned within ten years from delivery of the first episode, or if still in production, five years from delivery of the most recent episode, if later. For acquired film libraries, remaining revenues include amounts to be earned for up to twenty years from the date of acquisition.*** *Costs of film and television productions are subject to regular recoverability assessments, which compare the estimated fair values with the unamortized costs. The Company bases these fair value measurements on the Company's assumptions about how market participants would price the assets at the balance sheet date, which may be different than the amounts ultimately realized in future periods. The amount by which the unamortized costs of film and television productions exceed their estimated fair values is written off. Film development costs for projects that have been abandoned are written off. Projects that have not been set for production within three years are also written off unless management has committed to a plan to proceed with the project and is actively working on and funding the project.*
>
> ***The costs of television broadcast rights for acquired series, movies and other programs are expensed based on the number of times the program is expected to be aired or on a straight-line basis over the useful life, as appropriate.*** *Rights costs for multi-year sports programming arrangements are amortized during the applicable seasons based on the estimated relative value of each year in the arrangement. The estimated value of each year is based on our projections of revenues over the contract period, which include advertising revenue and an allocation of affiliate revenue. If the annual contractual payments related to each season approximate each season's estimated relative value, we expense the related contractual payments during the applicable season. Individual programs are written off when there are no plans to air or sublicense the program."*

Disney's film production costs are not truly comparable given that most will be released in the theater. Its disclosure regarding TV broadcast rights does not disclose an average time and seems to indicate that content is amortized both on a straight-line and accelerated basis. Thus a comparison to NFLX is difficult to make.

The point is, all of these companies depend on considerable estimates when determining what to expense against subscription revenue in a particular period. To calculate what NFLX's amortization would have been if it expensed 45% in the first year instead of 40% is not helpful as there is no agreed upon schedule to which to compare. However, investors should be aware of any changes to the amortization period, which we will explore more in the next section.

Can We Detect Material Changes in the Average Amortization Periods?

In many industries, it is very informative to track the average rate of depreciation or amortization by comparing the current amortization expense to the gross asset base. Any lengthening in the average period should be viewed with caution as it can indicate a company becoming more aggressive in its assumptions to benefit earnings.

In the 2010 10-K, NFLX actually disclosed the gross streaming asset base. However, it discontinued that disclosure the following year which makes it very difficult to get an accurate estimate of what the average period is. It is unfortunate that the company does not provide this as it could give meaningful insight into trends in recognition policies. In addition, given the current rapid buildout of produced content, the average amortization period is likely being skewed towards a shorter period which could mask any extension of the amortization periods.

We do note that in the 2016 10-K, the company disclosed that it took a $19.6 million charge related to a change in estimates of the useful period of certain content. However, this does not seem to be a regular occurrence. We will continue to closely watch disclosures closely for any signs of meaningful changes to the amortization schedule. In the meantime, investors should be mindful of just how much of NFLX's earnings are based on pure estimation.

Marketing Down as a Percentage of Sales

NFLX mentioned in its 3/19 quarterly letter that it expects to achieve leverage on its reported operating margins of 300 bps in 2019 with some of that coming from marketing. The following table shows marketing spending as a percentage of revenue for the last 12 quarters:

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Sales	$4,520.992	$4,186.841	$3,999.374	$3,907.270
Marketing	$616.578	$730.355	$435.269	$526.780
% of Sales	13.6%	17.4%	10.9%	13.5%
	3/31/2018	12/31/2017	9/30/2017	6/30/2017
Tech and Development	$3,700.856	$3,285.755	$2,984.859	$2,785.464
Marketing	$536.777	$466.527	$312.490	$274.323
% of Sales	14.5%	14.2%	10.5%	9.8%

Marketing spend fell almost 100 bps as a percentage of revenue in the quarter. The marketing percentage has been somewhat volatile in the past. However, management seems to be guiding to expect a sustained decline in upcoming quarters. However, we are skeptical that this can continue for long given increasing competition and the need to continue to drive subscriber growth to justify the sky-high multiple. We consider this an area on which to focus in upcoming quarters.

FX Remeasurement Gains

NFLX's other income and expense can be extremely volatile. Over the last year, it has shifted from a substantial loss to providing a material gain:

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Other income/(expense)	$76.104	$32.436	$7.004	$68.028
Sales	$4,520.992	$4,186.841	$3,999.374	$3,907.270
% of Sales	1.7%	0.8%	0.2%	1.7%
	3/31/2018	12/31/2017	9/30/2017	6/30/2017
Other income/(expense)	-$65.743	-$38.681	-$31.702	-$58.363
Sales	$3,700.856	$3,285.755	$2,984.859	$2,785.464
% of Sales	-1.8%	-1.2%	-1.1%	-2.1%

The driving force behind the movement is foreign currency remeasurements gains on its euro-denominated notes and to a smaller degree by foreign currency remeasurement of cash and content liabilities. The company openly discusses these amounts in its quarterly letters and we do not consider these to be a significant source of concern, just something investors should take note of each quarter.

Higher Stock-Based Compensation Boosting Cash

The following table shows NFLX's stock-based compensation expense for the last three trailing 12-month periods ended in March.

	3/31/2019	3/31/2018	3/31/2017
Stock-Based Compensation	$353.462	$205.716	$176.141

The $150 million increase in 2019 could be viewed as an artificial boost to cash flow given that the alternative to the non-cash options compensation would have been $150 million in cash. As shown above, NFLX's operating cash flow declined by about $1.2 billion during the 12-month period ended 3/19, so if the company had paid cash in lieu of options, the decline would have been about 12% worse than reported.

GameStop (GME) – Dropping Coverage

We are eliminating coverage on GameStop (GME) with the stock in the $5s, new management being appointed, and the elimination of the dividend after an ugly first quarter. It also does not appear that there are any concrete plans on what to do with the business:

- After selling the phone stores, closing some stores, and launching a cost-cutting program – the company is now doing a reboot to look at all aspects of the business.

- A Blockbuster Video Store problem has been highlighted at GME where 20% of SKUs drive 80% of sales. (Blockbuster had the back wall of new release movies that generated almost all the business in a store full of older movies that were often ignored.

- A new transformation process has been launched to cut more costs and test ways to restock/arrange stores, changing pricing, and hiring a tier-one consulting group to examine the business. This sounds like step 1 for a company that has been restructuring for several years now.

- After eliminating the dividend because GME noted, "*we are confident that redirecting capital towards debt reduction and reserving capital for successful transformation initiatives will put us in a better position to drive increased shareholder value over the long term."* -- the company announced a 12 million share repurchase program only one-week later.

- The first quarter call had nearly every pep-talk cliché that said - "We're excited but don't know what we're going to do." For example, "*We're up to the challenge," "Associates across the organization want to win," "we can execute better," "we'll be deliberate and act with urgency," "we've shown the commitment to being laser-focused on the core elements of our business…"*

- However, the call also noted that other than divesting the Simply Mac unit – they haven't determined how to answer the problems reporting that it needs to: *"develop new revenue streams," "we need a cohesive pricing strategy," "GameStop needs to be*

> *there [in digital games] and I'm committed to ensuring that we will be."* They like the real estate and flexibility – all they need is something new to sell.

We have highlighted that the used video game market is in decay for GME because more people are buying downloads of games rather than physical products. There is also a cyclical lag from new sales to used sales that impacts the used market. After several quarters of weak sales (4 of the last 5 quarters)– we expect the used market to remain under pressure until a few quarters after the release of new game platforms by suppliers. This is ultimate problem. The margins here are much larger than other parts of the business and it locks in future sales because people sell used products for discounts on store merchandise. We noted recently that older games are also available on-line for lower prices from competitors, which saps demand for GME's used inventory. Also, it's another place where digital games are taking business from physical games.

The company still isn't broke – it has $543 million in cash and has retired a considerable amount of debt. Fixed debt is less than cash. Leases are the remaining part of debt with a two-year average life. We would expect it to close more stores as leases expire if it is going to build out more on the digital side. That would reduce costs and lease liabilities. One of the new executives worked at Best Buy for digital merchandising and gaming. Some sort of tie-up with Best Buy or having Nintendo, Sony, Microsoft use GME stores to show-case new products may be where this story is heading.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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