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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Netflix (NFLX) EQ Update-6/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

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

We maintain our earnings quality rating of 3- (Minor Concern).

NFLX hit a road bump after reporting new subscriber adds in the 6/19 quarter of roughly half of the original forecast. Our earnings quality rating on NFLX does not incorporate a projection of subscriber growth rates or competition but rather on how well current earnings reflect economic reality. The company's disclosures make it difficult to follow trends in estimated useful lives of produced and licensed content which are the single largest factor in determining what earnings the company reports. However, we have the following observations regarding the quarter:

- The nature of the company's business model requires it to make huge upfront cash payments when licensing and producing content while subscription revenue comes in over time. The company has made it clear that it will be "many years" before it is able to report positive free cash flow. As a result, trailing 12-month operating cash flow was a negative $2.85 billion compared to a negative $1.7 billion in the year-ago comparable period.

- NFLX suffered notable title losses during the quarter including losing the license for *Friends* and *The Office* and will soon lose its entire line of Disney content. Management appeared to almost spin this as a positive, implying it will free up cash to spend on its own produced content. However, the push to produced content requires even more upfront cash spending than licensing content which will delay the cash breakeven point even longer. The company's price increases and rising competition will make the stakes even higher for the company to produce its share of its own big hits.

- Marketing expense fell as a percentage of revenue to 12.3% in the 6/19 quarter compared to 15.2% in the 6/18 quarter. Management indicated that this was a timing issue in the supporting of new titles. *Stranger Things 3* was released subsequent to the end of the second quarter along with new international titles the company plans to invest in during the back half of the year. Marketing investment should increase in the second half and we will be concerned if that does not materialize.

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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