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Time to Hit the Eject Button?

By NEIL A. MARTIN

Netflix, the video-rental titan, is facing bruising battles in Hollywood and on Wall Street. Why the short sellers may have it right.

Talk about a Feel-Good Movie. Shares of **Netflix**, the video-rental giant, have more than tripled this year as millions of Americans have discovered the joys of cheap and easy video rentals by mail. In the past few weeks, however, the show has started to resemble a stomach-churning thriller.

Studio executives have been slamming Netflix, suggesting they will soon be charging the company much more for rights to rent out movies. Short sellers have been pounding the table, citing not only rising costs but sharply increased competition and the abrupt departure of the company's chief financial officer. In response, CEO Reed Hastings took the unusual step last week of publicly rebutting the shorts' arguments, point by point.

Barron's, as much as anyone, has admired Hastings. He has transformed home entertainment and greatly enriched his shareholders. But it now looks as if Hastings is meeting his match. It may well be time for investors to hit Eject.

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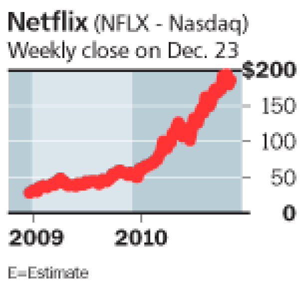
credit to come

Even to some bulls, Netflix's shares (ticker: NFLX) have become exceptionally pricey, trading at 48 times estimated earnings for next year. Some bears think the stock, at 185 per share, could be cut by two-thirds. That might be overly dramatic, but shares have lost 11% since Nov. 30 and may face some steep drops ahead.

The cost issue is real. Netflix's costs of acquiring content—more than a third the company's total expenses—look set to rise by more than 120%, to about $1.3 billion, for next year, based on recent deals and conservative estimates of future prices.

"We think earnings are going to slow dramatically due to margins under pressure as Netflix is forced to pay more for its content," says portfolio manager Whitney Tilson, the short-seller who triggered Hasting's rebuttal last week. Short positions account for nearly a third of Netflix's publicly available shares.

Hastings says he's committed to maintaining margins, but it's hard to see how he'll do it without buying fewer titles and fewer hits, crimping subscriber growth. Operating margins already are slipping, to 12.6% in the third quarter from 14.9% in the second.



The studios are clearly ready to raise charges. Once intrigued by Netflix, they now see it as a threat to the value of their content and are tightening the screws. "This has been an era of experimentation, and I think it's coming to a close," **Time Warner** (TWX) Chief Executive Jeff Bewkes has said. Craig Kornblau, president of home entertainment at Universal, put a sharper point on that the other day, calling Netflix "cannibalistic." According to the Los Angeles Times, Kornblau told a gathering of studio executives that Netflix "can pay us more or we can reduce the quality of what we give them,"

Netflix certainly will be facing more competition—both in bidding for titles and attracting subscribers. Outfits like **Apple** (AAPL), **Amazon.com** (AMZN) and privately held Hulu already have developed virtually instant, Internet delivery of videos to computers and gadgets. Hasting has said repeatedly that this type of business is Netflix's future—and he knows the competition is getting stiffer. In his answer to the criticisms, posted on the investment blog Seeking Alpha, he said new competition is "the single best near-term [short-selling] thesis, but no one knows if it will happen in 2011."

The fact is, Netflix already trails the competition by one key measure. Of the 50 top-grossing films of all time worldwide, Netflix offers only seven via streaming, its form of instant delivery. Apple's iTunes makes 32 of those movies available for downloading and Amazon let you download 23. Netflix streams just one big hit from 2010, *Alice in Wonderland*. Unless the company improves the lineup quickly, its streaming effort could fall down a rabbit hole of its own.

AGAINST THE BACKDROP OF these challenges, investors were understandably jolted when Chief Financial Officer Barry McCarthy resigned on Dec. 7 after selling a majority of his Netflix shares. McCarthy said he left because it was clear he wouldn't become CEO anytime soon. The explanation might have sat better if other insiders hadn't been selling, as well. Based on filings in November and early December, insiders and non-officer directors of Netflix now hold about 20% fewer shares than they did in March. Hastings himself accounted for the bulk of that selling. A Netflix spokesman declined to comment on any of the sales.

The Bottom Line

Netflix's stock, long a darling of growth investors, has given up 11% in the past month amid worries about costs. Some short sellers think the stock could be cut by two-thirds.

The biggest wild card may be on the legal front. A little-noticed federal-court decision in September, involving the software industry, could allow studios to license their wares to rental outfits rather than sell them, as they now do. That could mean stricter limits on the how and when the movies are rented. "The ruling could further strengthen the hand of content owners," says Nicholas Rodelli, senior analyst at accounting and legal-research firm CFRA. "It could have far-ranging implications." The good news for the industry: Any resolution of the case could be more than a year away.

And yes, Netflix still has much going for it. Even after boosting its subscriber base by more than 50% this year, to some 19 million people, it has penetrated only 17% of American households. That's leaves a huge opportunity, and the company has yet to go overseas. Plus, the stock may have a floor—the price a big tech firm might be willing to pay to acquire Netflix.

The problem is that gaining the next 19 million subscribers will be much, much harder. For now, consider Netflix shares to be rated IB—Investors, Beware.

Movies on the Move

Netflix's red envelopes have become ubiquitous. But investors may be too caught up in the show.

Recent Price	$185.35
52-Week Hi	$209.24
52-Week Lo	$48.52
Market Value (bil)	$9.7
P/E 2011E	48.3
Operating Margin 2Q '10	14.9%
3Q '10	12.6%

Sources: Thomson Reuters; company reports

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