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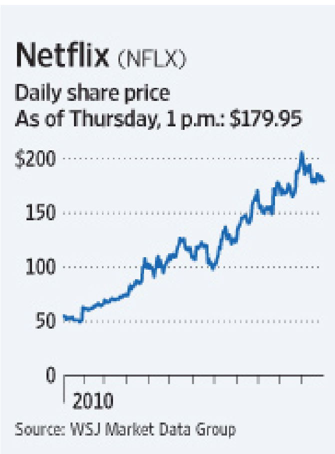
Pros Say Soaring Netflix Is Overdue for a Fall

By NEIL A. MARTIN

For video-rental giant Netflix, 2010 was a blow-out year.

The Los Gatos, Calif., company's shares (NFLX) more than tripled over the past 12 months to about $180 a share.



Earnings in the third quarter gained 26% as revenue soared and subscriber-acquisition costs fell. Netflix is believed to have ended the year with some 19 million subscribers, up 58% from 2009. That translates to about 17% of the 115 million U.S. households, which bulls say still gives the company plenty of room to grow.

But despite these upbeat prospects and recent indications by the company that business remains strong going into the new year, Netflix's shares have fallen about 10% from their 52-week high of $209 on Dec. 1. And they could fall further in 2011.

Trading at 74 times trailing earnings and 48 times forward net income, some investors believe the stock is overvalued -- based on the changing dynamics of the video-rental business; Hollywood's aggressive bid to squeeze more profits from Netflix's recently launched online streaming-video business; and growing competition from the likes of Google, Amazon.com and Apple's iTunes.

"We are fans of Netflix," says Kevin Landis, president of San Jose, Calif., asset manager SiVest Group, who began buying Netflix stock in 2008. Although he still holds it, Mr. Landis admits to taking profits in the wake of the stock's spectacular runup last year. "It's become very pricey," he says.

New York portfolio manager Whitney Tilson has been short on the stock for nearly a year. He believes higher costs and rising competition will eat into Netflix's margins and earnings and most likely cut the stock's recent rally short. He says the stock is worth about 25 times trailing earnings, which translates into a $66-a-share price.

"We think earnings are going to slow down dramatically due to margins under pressure [this] year as Netflix is forced to pay more and more for TV programs and movies for its streaming service," he says.

Although the company has vowed to maintain margins even if it means paying less for content, analysts say Netflix will have little choice because of the weak content on its streaming library: Of the 50 top-grossing films of all time, Netflix offers only seven for streaming -- compared with 32 and 23 movies for download from Apple's iTunes and Amazon.com, respectively.

Adding to some investors' unease was the Dec. 7 resignation of Chief Financial Officer Barry McCarthy, after selling a majority of his Netflix shares, and data showing that company officers and other insiders currently hold 20% fewer shares than they did in March.

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