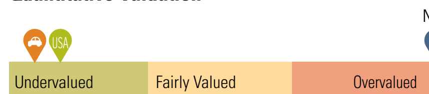
Netflix Inc NFLX (XNAS)

Morningstar Rating	Last Price	Fair Value Estimate	Price/Fair Value	Trailing Dividend Yield %	Forward Dividend Yield %	Market Cap (Bil)	Industry	Stewardship
★	343.28 USD	135.00 USD	2.54	—	0.00	150.09	Media - Diversified	Standard
31 May 2019 22:06, UTC	31 May 2019	18 Jan 2019 04:43, UTC		31 May 2019	31 May 2019	31 May 2019		

Morningstar Pillars	Analyst	Quantitative
Economic Moat	Narrow	Wide
Valuation	★	Overvalued
Uncertainty	Very High	High
Financial Health	—	Moderate

Source: Morningstar Equity Research

Quantitative Valuation



	Current	5-Yr Avg	Sector	Country
Price/Quant Fair Value	1.46	1.38	0.80	0.83
Price/Earnings	122.6	222.2	16.2	20.1
Forward P/E	101.0	—	12.3	13.9
Price/Cash Flow	—	480.2	10.2	13.1
Price/Free Cash Flow	—	576.9	17.7	19.5
Trailing Dividend Yield%	—	—	2.46	2.35

Source: Morningstar

Bulls Say

- Netflix's internal recommendation software and large subscriber base give the company an edge when deciding which content to acquire in future years.
- Netflix has built a substantial content library that will benefit the firm over the long term.
- International expansion offers attractive markets for adding subscribers.

Bears Say

- The firm continues to burn billions of dollars of cash to create its original content with no end in sight.
- The level of competition in the U.S. and internationally is increasing and will continue to do so over the near future. Disney will launch its own branded SVOD service in the second half of 2019.
- The need for increased content and marketing spend outside of the U.S. will limit the rate of margin expansion for the international segment.

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Netflix Continues to Burn Cash; 2Q Subscriber Guidance Weak

Business Strategy and Outlook

Neil Macker, CFA, Analyst, 16 January 2019

From its origins as a DVD rental by mail service, Netflix has morphed into a pioneer in subscription video on demand and the largest online video provider in the U.S. Our economic moat rating of narrow is based on intangibles and a network effect resulting from the use of Big Data stemming from the firm's massive worldwide subscriber base.

Already the largest provider in the U.S., Netflix has expanded rapidly into markets abroad as the service now has more subscribers outside of the U.S. than inside. The firm has used its scale to construct a massive data set that tracks every customer interaction. It then leverages this customer data to better purchase content as well as finance and produce original material such as "Orange Is the New Black." We believe that this data and ability to leverage will help Netflix remain the largest provider in the U.S. and enjoy success in many of its newer markets.

We believe that many consumers use, and will continue to use, SVODs like Netflix as a complementary service, especially as SVOD prices increase and pay-television bundle prices decrease (due to the shift to over-the-top, or OTT, delivery). Media firms will continue to reap the benefits of both an additional window for existing content and another platform for new content. Larger firms like Disney and WarnerMedia are launching their own SVOD platforms to compete against Netflix. We think this usage pattern and increased competition will constrain Netflix's ability to raise prices without inducing greater churn.

We expect that Netflix will expand further into local-language programming to offset the weakness of its skinny offering in many countries. This will likely generate a competitive response from the firm's global and local rivals, which will augment their own first-party content budgets. In turn, we think Netflix's international expansion will disappoint, particularly in terms of the speed of margin expansion.

Analyst Note

Neil Macker, CFA, Analyst, 16 April 2019

Netflix started 2019 with stronger-than-expected subscriber growth as the firm continues to benefit from global expansion. Despite the subscriber beat, revenue came in line with our projection. The free cash flow loss for the quarter hit $460 million, up sharply from a loss of $287 million a year ago. Management raised its 2019 free cash flow loss target to $3.5 billion, up from the previous target of $3 billion. We retain our narrow moat rating and fair value estimate of $135.

Revenue of $4.5 billion is in line with our estimate and consensus. Netflix posted stronger-than-expected subscriber growth in the international segment (7.9 million net adds versus guidance of 7.3 million) and in the U.S. (1.7 million net adds versus guidance of 1.6 million). Netflix continues to expand its streaming base, ending the quarter with just under 149 million global paid subscribers, up from 119 million a year ago. Despite strong growth in quarter, management provided very weak subscriber guidance for the second quarter of 0.3 million net adds in the U.S. and 4.7 million internationally. We note the U.S. guidance implies the firm will post its second-lowest net add quarter since the start of 2012. This guidance reinforces our belief that adding the marginal subscriber will become increasingly hard in the U.S. for Netflix due in part to competition, particularly after Disney+ launches in November at $6.99 per month.

Domestic streaming revenue of $2.1 billion was in line with our estimate and monthly revenue per paid U.S. member came in at $11.64, up 4% year over year. For international streaming, revenue of $2.3 billion matched our estimate as monthly revenue per paid member came in at $9.31, down 5% year over year without foreign exchange adjustments. The segment contribution margin of 22.9% fell by 50 basis points year over year, leading to an operating margin of 10.2%, down 190 basis points versus the same period last year due in part to increased R&D and marketing spending.

Economic Moat

Neil Macker, Analyst, 17 January 2019

We assign Netflix a narrow moat rating. Netflix is the largest SVOD provider in the U.S. and is rapidly expanding

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Close Competitors	Currency (Mil)	Market Cap	TTM Sales	Operating Margin	TTM/PE
Amazon.com Inc AMZN	USD	873,923	241,545	6.17	74.07
The Walt Disney Co DIS	USD	237,632	59,760	23.12	14.79
Comcast Corp CMCSA	USD	186,090	98,575	19.83	15.53
CBS Corp CBS	USD	18,100	14,920	19.94	6.01

internationally. This rapidly growing subscriber base (over 130 million worldwide) creates a humongous data set that Netflix mines in order to better purchase and create content. This new content not only strengthens its relationship with its current customers, but also attracts new customers via word of mouth and the halo effect from critical acclaim and award nominations.

Through the streaming video delivery method, Netflix tracks every customer interaction, from large (total time spent at Netflix) to minute (whether a user pressed fast forward). This data is aggregated in a massive cloud database housed across multiple data centers worldwide. Netflix can query this information to better understand network and device performance, customer behavior, and content popularity. While current and future competitors such as Amazon and Internet access providers could create similar databases, Netflix's data set is and will remain significantly larger due to the size advantage of its subscriber base and the amount of time spent on the service. According to the 2018 Sandvine Global Internet Phenomena Report, Netflix accounted for 26% of all global video streaming traffic (the largest source), beating out YouTube at 21% and Amazon at 6%. The average Netflix user worldwide now watches more than 90 minutes of video per day.

Netflix leverages this data set across its offerings in multiple ways to derive sustainable competitive advantages. To improve the customer experience, Netflix analyzes data traffic, video performance, and buffering to better understand where data loss and slowdown occurs and route traffic accordingly. The company also examines specific subscriber actions by type of action and device used to formulate better user interfaces and to tweak device-specific applications. The real-time nature of the data provides Netflix with the ability to iterate more quickly than traditional user group or beta testing methods. The large number of subscribers using different devices across multiple countries generates a large, growing robust data set that current competitors can't match and new entrants can't easily replicate.

Netflix also leverages its cloud database to help with its content creation and acquisition efforts as well as to run its content discovery engine. The company has long employed its usage data to drive content acquisition by understanding subscriber usage beyond simple rating metrics. The content discovery engine provides recommendations based on a subscriber's previous viewing habits in context with subscribers with similar viewing habits. While growing rapidly as a streaming video provider, the company understood the need to create original content to differentiate its offering. Instead of simply competing with the studios and networks for new pilots, the company draws upon its data to understand the types of shows, directors, and actors that would appeal to its subscribers. An often-cited example of this data is "House of Cards," an adaption of a British miniseries that starred Kevin Spacey and is produced by David Fincher. Netflix noted that Fincher's movies were generally watched from beginning to end, that Spacey's films had performed well, and that the original version was popular with subscribers. The show has proved to be a success with audiences and critics while providing Netflix with substantial positive press and nonsubscriber recognition.

Fair Value & Profit Drivers

Neil Macker, Analyst, 17 January 2019

Our fair value estimate of $135 per share assumes that Netflix's domestic paid streaming subscriber count reaches roughly 70 million in 2023. Price elasticity plays a major role in our fair value. In general, we are skeptical that pricing will only have a small impact on total customer counts globally. We also assume that the domestic DVD business (the segment with the highest operating margin) will lose about 0.5 million paid subscribers per year through 2023, which implies a decline from 3.0 million at the start of 2019 to under 0.5 million at the end of 2022. The firm could shut down this division before it falls below 2 million subscribers. Due to the completion of Netflix's global expansion (excluding China) and lower prices, we expect the international streaming paid subscriber base to expand to 174 million by 2023.

Our domestic subscriber forecast generates 11% average annual revenue growth between 2019 and 2023, as Netflix benefits from charging $13 as its base price in the U.S. However, customers are more price-sensitive than previously thought and we expect competitors like Disney+ to undercut Netflix's prices. We believe this price differential will cause the lower subscriber growth than

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we had previously expected. We also expect the company to begin enforcing its concurrent streaming limits, leading some families to migrate to the $16 plan for four 4K streams but also causing some families to cancel. We expect domestic streaming contribution margins to expand to 37% in 2023 from 34% in 2018 as subscriber and revenue growth are partially offset by rising content costs for both first- and third-party produced content and increased marketing costs.

On the international side, we expect increased customer penetration will generate average revenue growth of 19% through 2023. We expect average revenue per member to decline slightly as the firm adds more subscribers from lower-priced emerging markets, offsetting pricing increases in more mature countries. The adjusted contribution margin finally turned positive in 2018; we project a 23% contribution margin in 2023 for the international streaming segment. We expect management to continue investing in content and marketing, leading to margins that remains well below the U.S. segment despite rapidly increasing scale. Overall, we forecast average revenue growth of 14% for Netflix, with the operating margin expanding to 19% in 2023 from 10% in 2018.

Risk & Uncertainty

Neil Macker, Analyst, 17 January 2019

As technology improves, more consumers will be able to download content quickly via the web and play it on their televisions or alternative devices. The cost of licensing content will rise as competitors emerge and bid for content that Netflix desires. The move to more original content adds costs and risks. Netflix's expansion outside the U.S. could continue to drag on cash flow due to different tastes and lower video consumption. The cost to deliver content could increase and the need to pay for fast-lane network access could drag on margins. Network and channel-specific video services could steal subscribers and limit subscriber growth. Increasing price rates could limit growth and increase churn.

Stewardship

Neil Macker, Analyst, 11 January 2019

We rate Netflix's stewardship of shareholder capital as Standard. Despite some missteps, chairman and CEO Reed Hastings successfully transitioned Netflix from a DVD rental service to the premier streaming video on demand service. Hastings founded Netflix in 1998 and owns about 6% of the company. Chief content officer Ted Sarandos also has a long tenure at Netflix, with a proven record. Hastings and Sarandos have positioned Netflix as a major player in content distribution and now content creation. Longtime CFO David Wells announced his planned departure from the firm in August 2018. He was replaced as CFO by Spencer Neumann in January 2018. Neumann had been serving as CFO of Activision Blizzard before joining the company. We respect management's long-term planning and perception and believe that investors have long forgotten the firm’s 2011's questionable Qwikster decision, a short-lived plan to rebrand and spin off the DVD business from streaming.

The subsequent performance of the original content and the management team's ability to elevate the platform have alleviated some concerns that arose from the Qwikster mistake. The company had not written off any of its original series until 2018, and it has renewed most series for at least one additional season until 2017. While we believe that management has largely been willing to renew shows in spite of performance in the past, recent cancellations show that the firm decided to be more judicious in its renewal decisions.

We believe that investors will be watching the impact of the company's rapid international expansion and recent price increases as guidepost for judging Netflix's management. We will also be monitoring the cash burn at the company as management continues to invest in content, both in original and third-party programming. As Netflix is now available in almost every country, this cost could explode, particularly as new competitors enter the market and ramp up their content spending.

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Analyst Notes Archive

NBCUniversal Joins the Streaming Wars

Neil Macker, Analyst, 15 January 2019

Competition within the subscription video on demand, or SVOD, market in the U.S. continues to increase as Comcast's NBCUniversal announced its plans on Jan. 14 to launch a new streaming service in 2020. Comcast, like other traditional media firms, faces the challenge of establishing direct customer relationships without disrupting the highly-lucrative traditional pay-television ecosystem. However, we believe its SVOD proposed approach is superior to AT&T's plans for WarnerMedia. Unlike Comcast, AT&T's legacy consumer segment remains heavily dependent on profits from traditional television distribution without a strong Internet access business to fall back on. We aren't planning on any changes to our moat ratings or fair value estimates across the media and telecom spaces following Comcast's announcement.

In a unique move, the ad-supported version of Comcast's planned SVOD service will be free to pay-TV subscribers with an option to remove ads for a fee. For non-pay-TV subscribers, the service will reportedly cost $12 per month according to CNBC. Management at NBCU have publicly remarked in the past that the firm does not want to endanger the firm's current business model and that the economics around a streaming service are "challenging." By tying its product directly to pay-TV subscriptions, NBCU is attempting to solve both problems at once, as the link to pay television subscriptions should help the service quickly gain scale and allow NBCU to generate its target of $5 in ad revenue per month for each subscriber. However, by pricing the non-pay-TV subscriber version at $12, NBCU is effectively ceding the value spot for that market to Disney+, which we expect to launch at a price under $10, while also likely making the NBCU service unattractive to the vast majority of customers.

Netflix Increases Prices Across the Board in U.S.; Disney+ Could Be The Value SVOD Upon Launch

Neil Macker, Analyst, 15 January 2019

Netflix announced price increases for all three of its U.S. streaming plans on Jan. 15. The increases, which range from 13% to 18%, will take effect immediately for new subscribers while existing subscribers will see the new prices over the next three months. While the timing of the announcement two days before releasing earnings is a little strange, the price increases are in line with the firm's need to generate additional revenue to help offset the ongoing cash burn which is projected to be $3 billion in both 2018 and 2019. We expect that the firm will likely lower its prices in overseas markets like India where its current prices are well above its competitors. We are maintaining our narrow moat rating and fair value estimate of $120.

As a result of the price hikes, the standard Netflix HD and the 4K family plans both increase by $2 to $13 and $16 per month, respectively, and the base plan now costs $9 per month, up from $8 previously. The price hike potentially increases the attractiveness of Disney+ which we expect to debut in the fall at a sub-$10 price point. We also continue to believe WarnerMedia's planned subscription video on demand, or SVOD, offering at a price above $15 is a strategic blunder as the firm needs to gain traction in what will be a highly competitive marketplace in 2019 and beyond. Conversely, NBCU's announcement on Jan. 14 that its new SVOD offering will be free to existing pay-TV customers looks to us like a sensible approach to quickly build an audience.

Netflix Posts Strong Subscriber Growth to End 2018; Margin Expansion Remains Slow

Neil Macker, Analyst, 17 January 2019

Netflix ended 2018 with stronger-than-expected international subscriber growth as the firm continues to benefit from its global expansion. Operating margin came in below our projections, however, as the firm pushed out some of its third quarter content and marketing spend into the fourth quarter. The free cash flow loss for the quarter was a record $1.3 billion, raising the loss for the year to just over $3 billion (19% of total revenue), a figure the firm expects to roughly match in 2019.

We are retaining our narrow moat rating and are raising our fair value estimate to $135 from $120, primarily from incorporating faster international customer growth. We believe the increased U.S. pricing, announced prior to earnings, will be largely offset by lower U.S. net customer additions in the near term and smaller subsequent price increases than the firm would have been able to implement had it taken a lesser increase this year. We also expect that the firm will face stronger competition in the U.S. and internationally, necessitating continuing increases in content and marketing spending which will

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result in continued cash burn and limited margin expansion over the next three years. In short, we don't believe Netflix's current share price considers the potential changes to consumer behavior that a combination of higher prices and increased competition could create, to the detriment of Netflix's business.

Revenue of $4.2 billion came in line with our estimate. Netflix posted stronger-than-expected subscriber growth in the international segment (7.3 million net adds versus guidance of 6.1 million) but in line growth in the U.S. (1.5 million net adds, versus guidance of 1.5 million). Netflix continues to expand its streaming base, ending the quarter with more than 139 million global paid subscribers, up from 111 million a year ago.

Apple TV+ Opens With a Thud; New Service Launches Into Very Competitive Market in Fall 2019

Neil Macker, Analyst, 25 March 2019

At its Show Time event on March 25, Apple unveiled its long-awaited video streaming service, Apple TV+, which will feature its original content. The service will launch this fall as an ad-free service in over 100 countries for a price to be disclosed later. While Apple has secured projects from several high-profile creators and actors, including Oprah Winfrey and Steven Spielberg, the amount of content available at launch appears paltry when compared with Netflix and Disney+. By waiting to launch until this fall, Apple will be competing against not only established services like Netflix and Hulu but also against other new services from media firms with much deeper content libraries like Disney and WarnerMedia. We maintain our wide moat rating and $130 fair value estimate for Disney along with our narrow moat ratings and fair value estimates of $200, $135, and $37 for Apple, Netflix, and AT&T, respectively.

After an overly long video about creativity, Apple essentially held a network upfront presentation with creators and actors coming onstage to discuss their respective shows. However, the presentations did not feature any clips from the shows, and Apple overall showed one brief montage video for the entire TV+ presentation. While the star power of the celebrities on stage was impressive, we found the lack of show clips disappointing.

Between the lack of clips and price point, we did not see any reason for either Netflix or the traditional media firms to be worried about Apple at this point. While Apple's entrance into the space will drive up the ever-increasing cost of producing content, we note that the estimated $3 billion in content spending by Apple prior to launch is equivalent to the combined annual spending by Discovery and Scripps as separate firms. While the two media firms focus on lower-cost unscripted content, we think the relatively low total spending by Apple highlights the lack of content that will be ready for the service's launch in the fall.

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Neil Macker, Analyst, 16 April 2019

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Netflix Inc NFLX ★Q

01 Jun 2019 02:00 UTC

Last Close	Fair Value Q	Market Cap	Sector	Industry	Country of Domicile
31 May 2019	01 Jun 2019 02:00 UTC	31 May 2019			
343.28	235.80	150.1 Bil	Consumer Cyclical	Media - Diversified	USA United States

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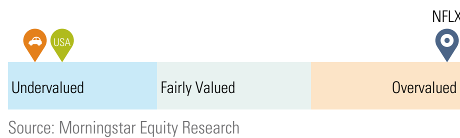
Company Profile

Netflix's primary business is a streaming video on demand service now available in almost every country worldwide except China. Netflix delivers original and third-party digital video content to PCs, Internet-connected TVs, and consumer electronic devices, including tablets, video game consoles, Apple TV, Roku, and Chromecast. In 2011, Netflix introduced DVD-only plans and separated the combined streaming and DVD plans, making it necessary for subscribers who want both to have separate plans.

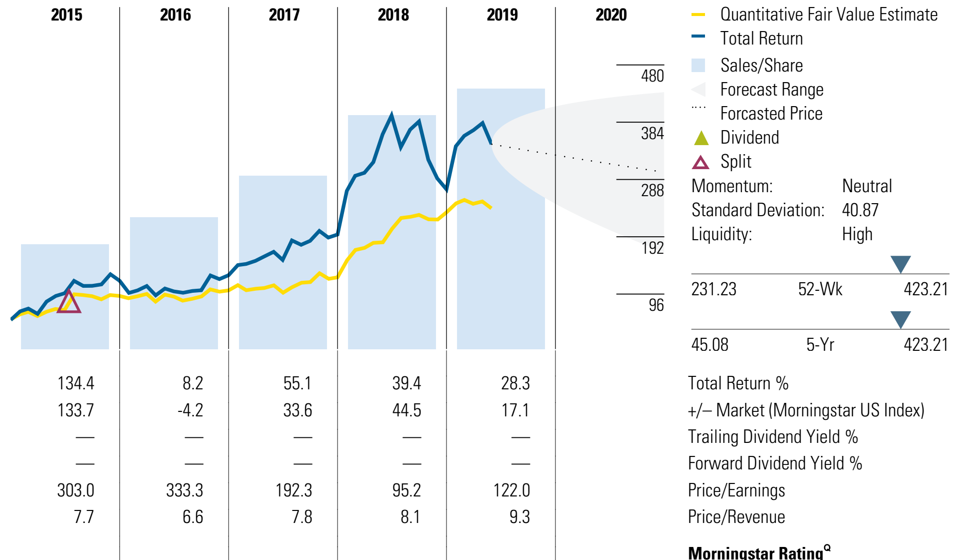
Quantitative Scores

		Scores All	Rel Sector	Rel Country
Quantitative Moat	Wide	100	100	99
Valuation	Overvalued	1	1	1
Quantitative Uncertainty	High	80	79	84
Financial Health	Moderate	60	43	60



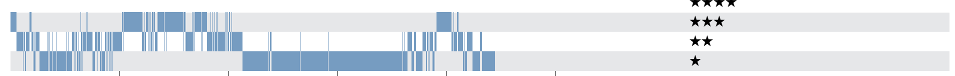
Source: Morningstar Equity Research

Price vs. Quantitative Fair Value



2015	2016	2017	2018	2019	
134.4	8.2	55.1	39.4	28.3	Total Return %
133.7	-4.2	33.6	44.5	17.1	+/– Market (Morningstar US Index)
—	—	—	—	—	Trailing Dividend Yield %
—	—	—	—	—	Forward Dividend Yield %
303.0	333.3	192.3	95.2	122.0	Price/Earnings
7.7	6.6	7.8	8.1	9.3	Price/Revenue

Morningstar Rating Q



Valuation

	Current	5-Yr Avg	Sector Median	Country Median
Price/Quant Fair Value	1.46	1.38	0.80	0.83
Price/Earnings	122.6	222.2	16.2	20.1
Forward P/E	101.0	—	12.3	13.9
Price/Cash Flow	—	480.2	10.2	13.1
Price/Free Cash Flow	—	576.9	17.7	19.5
Trailing Dividend Yield %	—	—	2.46	2.35
Price/Book	26.3	22.3	1.6	2.4
Price/Sales	9.3	7.3	0.9	2.4

Profitability

	Current	5-Yr Avg	Sector Median	Country Median
Return on Equity %	26.0	15.1	12.2	12.9
Return on Assets %	5.3	3.2	5.4	5.2
Revenue/Employee (Mil)	2.3	2.1	0.6	0.3

Financial Health

	Current	5-Yr Avg	Sector Median	Country Median
Distance to Default	0.6	0.6	0.6	0.5
Solvency Score	617.3	—	486.0	552.4
Assets/Equity	5.0	4.7	1.8	1.7
Long-Term Debt/Equity	2.0	1.3	0.2	0.4

Financials (Fiscal Year in Mil)

2014	2015	2016	2017	2018	TTM	
5,505	6,780	8,831	11,693	15,794	16,614	Revenue
25.8	23.2	30.3	32.4	35.1	5.2	% Change
403	306	380	839	1,605	1,618	Operating Income
76.3	-24.0	24.2	120.8	91.4	0.8	% Change
267	123	187	559	1,211	1,265	Net Income
16	-749	-1,474	-1,786	-2,680	-2,824	Operating Cash Flow
-70	-91	-108	-173	-174	-197	Capital Spending
-53	-841	-1,582	-1,959	-2,854	-3,021	Free Cash Flow
-1.0	-12.4	-17.9	-16.8	-18.1	-18.2	% Sales
0.62	0.28	0.43	1.25	2.68	2.80	EPS
133.5	-54.6	53.6	190.7	114.4	4.5	% Change
0.04	-1.46	-2.79	-4.65	-4.57	-6.69	Free Cash Flow/Share
—	—	—	—	—	—	Dividends/Share
4.08	5.06	5.88	7.68	11.47	13.04	Book Value/Share
422,911	427,940	430,054	433,393	436,599	437,220	Shares Outstanding (K)

Profitability

2014	2015	2016	2017	2018	TTM	
16.7	6.0	7.6	17.9	27.5	26.0	Return on Equity %
4.3	1.4	1.6	3.4	5.4	5.3	Return on Assets %
4.9	1.8	2.1	4.8	7.7	7.6	Net Margin %
0.88	0.79	0.74	0.72	0.70	0.70	Asset Turnover
3.8	4.6	5.1	5.3	5.0	4.8	Financial Leverage
31.8	32.3	31.7	34.5	36.9	36.6	Gross Margin %
7.3	4.5	4.3	7.2	10.2	9.7	Operating Margin %
900	2,371	3,364	6,499	10,360	10,305	Long-Term Debt
1,858	2,223	2,680	3,582	5,239	5,703	Total Equity
38.8	41.9	41.7	41.0	42.8	42.8	Fixed Asset Turns

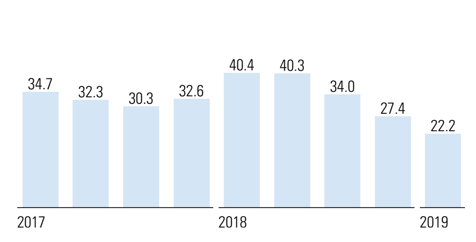
Growth Per Share

	1-Year	3-Year	5-Year	10-Year
Revenue %	35.1	32.6	29.3	27.8
Operating Income %	91.4	73.8	47.7	29.5
Earnings %	114.4	112.3	59.5	30.4
Dividends %	—	—	—	—
Book Value %	45.2	32.2	30.3	30.4
Stock Total Return %	-2.4	49.6	41.9	50.8

Quarterly Revenue & EPS

Revenue (Mil)	Mar	Jun	Sep	Dec	Total
2019	4,521.0	—	—	—	—
2018	3,700.9	3,907.3	3,999.4	4,186.8	15,794.3
2017	2,636.6	2,785.5	2,984.9	3,285.8	11,692.7
2016	1,957.7	2,105.2	2,290.2	2,477.5	8,830.7
Earnings Per Share ()					
2019	0.76	—	—	—	—
2018	0.64	0.85	0.89	0.30	2.68
2017	0.40	0.15	0.29	0.41	1.25
2016	0.06	0.09	0.12	0.15	0.43

Revenue Growth Year On Year %



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Research Methodology for Valuing Companies

Qualitative Equity Research Overview
At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, in-depth competitive advantage analysis, and a variety of other analytical tools to augment this process. We believe this bottom-up, long-term, fundamentally based approach allows our analysts to focus on long-term business drivers, which have the greatest valuation impact, rather than short-term market noise.

Morningstar's equity research group (“we," "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at an uncertainty-adjusted discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values whereas 1-star stocks trade at premiums to their intrinsic worth.

Four key components drive the Morningstar rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's fair value, (3) our uncertainty around that fair value estimate and (4) the current market price. This process ultimately culminates in our single-point star rating.

1. Economic Moat
The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define excess economic profits as returns on invested capital (or ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (or WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

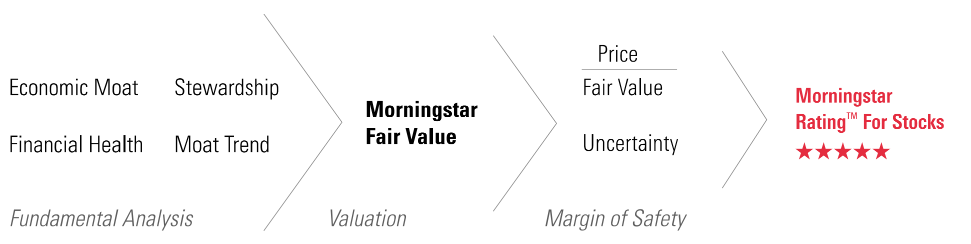
Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality no-moat companies will see their normalized returns gravitate toward the firm's cost of capital more quickly than companies with moats.

To assess the direction of the underlying competitive advantages, analysts perform ongoing assessments of the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger; stable where we don't anticipate changes to competitive advantages over the next several years; or negative when we see signs of deterioration.

All the moat and moat trend ratings undergo periodic review and any changes must be approved by the Morningstar Economic Moat Committee, comprised of senior members of Morningstar's equity research department.

2. Estimated Fair Value
Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value.

Morningstar Research Methodology for Valuing Companies



Our model is divided into three distinct stages:

Stage I: Explicit Forecast
In this stage, which can last five to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in working-capital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes, or EBI, and the net new investment, or NNI, to derive our annual free cash flow forecast.

Stage II: Fade
The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested ("RONIC")—to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital, or RONIC, and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital decline until the perpetuity stage is reached. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

Stage III: Perpetuity
Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total present value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term market-value weights.

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3. Uncertainty Around That Fair Value Estimate

Morningstar's Uncertainty Rating captures a range of likely potential intrinsic values for a company and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating represents the analysts' ability to bound the estimated value of the shares in a company around the fair value estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, and other company-specific factors.

Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case, and a 25% probability that the company will perform worse than the bear case. The distance between the bull and bear cases is an important indicator of the uncertainty underlying the fair value estimate.

Our recommended margin of safety widens as our uncertainty of the estimated value of the equity increases. The more uncertain we are about the estimated value of the equity, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the uncertainty rating provides guidance in portfolio construction based on risk tolerance.

Our uncertainty ratings for our qualitative analysis are low, medium, high, very high, and extreme.

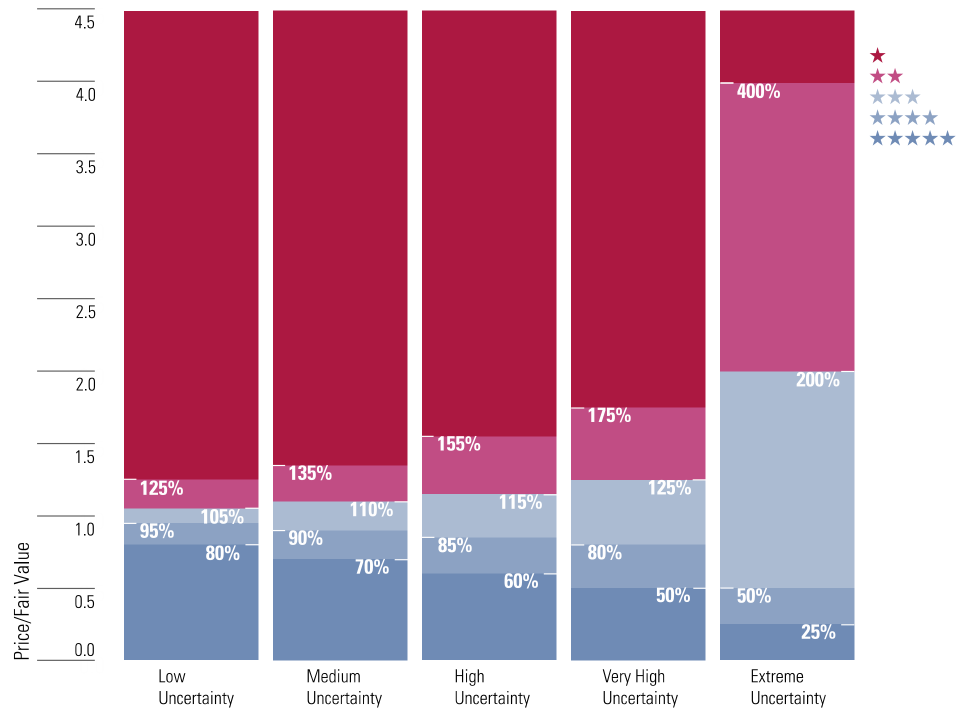
- Low–margin of safety for 5-star rating is a 20% discount and for 1-star rating is 25% premium.
- Medium–margin of safety for 5-star rating is a 30% discount and for 1-star rating is 35% premium.
- High–margin of safety for 5-star rating is a 40% discount and for 1-star rating is 55% premium.
- Very High–margin of safety for 5-star rating is a 50% discount and for 1-star rating is 75% premium.
- Extreme–margin of safety for 5-star rating is a 75% discount and for 1-star rating is 300% premium.

4. Market Price

The market prices used in this analysis and noted in the report come from exchange on which the stock is listed, which we believe is a reliable source.

For more details about our methodology, please go to https://shareholders.morningstar.com.

Morningstar Equity Research Star Rating Methodology



Morningstar Star Rating for Stocks

Once we determine the fair value estimate of a stock, we compare it with the stock's current market price on a daily basis, and the star rating is automatically re-calculated at the market close on every day the market on which the stock is listed is open.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn 5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market's valuation. When there are many 5-star stocks, the stock market as a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true the market price will converge on our fair value estimate over time, generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

★★★★★ We believe appreciation beyond a fair risk-adjusted return is highly likely over a multiyear time frame. The current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

★★★★ We believe appreciation beyond a fair risk-adjusted return is likely.

★★★ Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

★★ We believe investors are likely to receive a less than fair risk-adjusted return.

★ Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. The market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to Capital loss.

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Other Definitions

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Stewardship Rating: Represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.

Quantitative Valuation: Using the below terms, intended to denote the relationship between the security's Last Price and Morningstar's quantitative fair value estimate for that security.

- ► Undervalued: Last Price is below Morningstar's quantitative fair value estimate.
- ► Fairly Valued: Last Price is in line with Morningstar's quantitative fair value estimate.
- ► Overvalued: Last Price is above Morningstar's quantitative fair value estimate.

Risk Warning

Please note that investments in securities are subject to market and other risks and there is no assurance or guarantee that the intended investment objectives will be achieved. Past performance of a security may or may not be sustained in future and is no indication of future performance. A security investment return and an investor's principal value will fluctuate so that, when redeemed, an investor's shares may be worth more or less than their original cost. A security's current investment performance may be lower or higher than the investment performance noted within the report. Morningstar's Uncertainty Rating serves as a useful data point with respect to sensitivity analysis of the assumptions used in our determining a fair value price.

Quantitative Equity Reports Overview

The quantitative report on equities consists of data, statistics and quantitative equity ratings on equity securities. Morningstar, Inc.'s quantitative equity ratings are forward looking and are generated by a statistical model that is based on Morningstar Inc.'s analyst-driven equity ratings and quantitative statistics. Given the nature of the quantitative report and the quantitative ratings, there is no one analyst in which a given report is attributed to; however, Mr. Lee Davidson, Head of Quantitative Research for Morningstar, Inc., is responsible for overseeing the methodology that supports the quantitative equity ratings used in this report. As an employee of Morningstar, Inc., Mr. Davidson is guided by Morningstar, Inc.'s Code of Ethics and Personal Securities Trading Policy in carrying out his responsibilities.

Quantitative Equity Ratings

Morningstar's quantitative equity ratings consist of:
(i) Quantitative Fair Value Estimate
(ii) Quantitative Star Rating
(iii) Quantitative Uncertainty
(iv) Quantitative Economic Moat
(v) Quantitative Financial Health
(collectively the "Quantitative Ratings").

The Quantitative Ratings are calculated daily and derived from the analyst-driven ratings of a company's peers as determined by statistical algorithms. Morningstar, Inc. (""Morningstar," "we," "our") calculates Quantitative Ratings for companies whether it already provides analyst ratings and qualitative coverage. In some cases, the Quantitative Ratings may differ from the analyst ratings because a company's analyst-driven ratings can significantly differ from other companies in its peer group.

Quantitative Fair Value Estimate: Intended to represent Morningstar's estimate of the per share dollar amount that a company's equity is worth today. Morningstar calculates the quantitative fair value estimate using a statistical model derived from the fair value estimate Morningstar's equity analysts assign to companies. Please go to https://shareholders.morningstar.com for information about fair value estimates Morningstar's equity analysts assign to companies.

Quantitative Economic Moat: Intended to describe the strength of a firm's competitive position. It is calculated using an algorithm designed to predict the Economic Moat rating a Morningstar analyst would assign to the stock. The rating is expressed as Narrow, Wide, or None.

- ► Narrow: assigned when the probability of a stock receiving a "Wide Moat" rating by an analyst is greater than 70% but less than 99%.
- ► Wide: assigned when the probability of a stock receiving a "Wide Moat" rating by an analyst is greater than 99%.
- ► None: assigned when the probability of an analyst receiving a "Wide Moat" rating by an analyst is less than 70%.

Quantitative Star Rating: Intended to be the summary rating based on the combination of our Quantitative Fair Value Estimate, current market price, and the Quantitative Uncertainty Rating. The rating is expressed as 1-Star, 2-Star, 3-Star, 4-Star, and 5-Star.

★: the stock is overvalued with a reasonable margin of safety.
Log (Quant FVE/Price)<–1*Quantitative Uncertainty

★★: the stock is somewhat overvalued.
Log (Quant FVE/Price) between (–1*Quantitative Uncertainty, –0.5*Quantitative Uncertainty)

★★★: the stock is approximately fairly valued.
Log (Quant FVE/Price) between (–0.5*Quantitative Uncertainty, 0.5*Quantitative Uncertainty)

★★★★: the stock is somewhat undervalued.
Log (Quant FVE/Price) between (0.5*Quantitative Uncertainty, 1*Quantitative Uncertainty)

★★★★★: the stock is undervalued with a reasonable margin of safety. Log (Quant FVE/Price) >1*Quantitative Uncertainty

Quantitative Uncertainty: Intended to represent Morningstar's level of uncertainty about the accuracy of the quantitative fair value estimate. Generally, the lower the quantitative Uncertainty, the narrower the potential range of outcomes for that particular company. The rating is expressed as Low, Medium, High, Very High, and Extreme.

- ► Low: the interquartile range for possible fair values is less than 10%.
- ► Medium: the interquartile range for possible fair values is less than 15% but greater than 10%.
- ► High: the interquartile range for possible fair values is less than 35% but greater than 15%.
- ► Very High: the interquartile range for possible fair values is less than 80% but greater than 35%.
- ► Extreme: the interquartile range for possible fair values is greater than 80%.

Quantitative Financial Health: Intended to reflect the probability that a firm will face financial distress in the near future. The calculation uses a predictive model designed to anticipate when a company may default on its financial obligations. The rating is expressed as Weak, Moderate, and Strong.

- ► Weak: assigned when Quantitative Financial Health <0.2
- ► Moderate: assigned when Quantitative Financial Health is between 0.2 and 0.7
- ► Strong: assigned when Quantitative Financial Health >0.7

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- ► Overvalued: Last Price is above Morningstar's quantitative fair value estimate.

This Report has not been made available to the issuer of the security prior to publication.

Risk Warning

Please note that investments in securities are subject to market and other risks and there is no assurance or guarantee that the intended investment objectives will be achieved. Past performance of a security may or may not be sustained in future and is no indication of future performance. A security investment return and an investor's principal value will fluctuate so that, when redeemed, an investor's shares may be worth more or less than their original cost. A security's current investment performance may be lower or higher than the investment performance noted within the report.

The quantitative equity ratings are not statements of fact. Morningstar does not guarantee the completeness or accuracy of the assumptions or models used in determining the quantitative equity ratings. In addition, there is the risk that the price target will not be met due to such things as unforeseen changes in demand for the company's products, changes in management, technology, economic development, interest rate development, operating and/or material costs, competitive pressure, supervisory law, exchange rate, and tax rate. For investments in foreign markets there are further risks, generally based on exchange rate changes or changes in political and social conditions.

A change in the fundamental factors underlying the quantitative equity ratings can mean that the valuation is subsequently no longer accurate.

For more information about Morningstar's quantitative methodology, please visit http://global.morningstar.com/equitydisclosures.

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Netflix Inc NFLX (XNAS)

Morningstar Rating	Last Price	Fair Value Estimate	Price/Fair Value	Trailing Dividend Yield %	Forward Dividend Yield %	Market Cap (Bil)	Industry	Stewardship
★	343.28 USD	135.00 USD	2.54	—	0.00	150.09	Media - Diversified	Standard
31 May 2019 22:06, UTC	31 May 2019	18 Jan 2019 04:43, UTC		31 May 2019	31 May 2019	31 May 2019		

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Netflix Inc NFLX (XNAS)

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★	343.28 USD	135.00 USD	2.54	—	0.00	150.09	Media - Diversified	Standard
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