Netflix Financial Analysis

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Executive Summary

Netflix has the potential to become the Apple of entertainment with their unique liquidity potential, investment in original content creation, and large current market cap valuation. The value of the company is expected to increase greatly in the coming years.

The biggest challenge Netflix faces is decreasing their debt funding to become more profitable and less risky with equity funding. Although Netflix shows no signs of having a problem with paying off their debt and the interest expense associated with it, becoming a more equity funded company would allow Netflix to keep more of their profits to invest back into the company and increase value for investors.

The following financial analysis will show that even though Netflix has a great current market value, this is still a rapidly growing company with opportunities to become much more valuable. Netflix would be a great buy for an investor now before Netflix puts themselves in a position to increase their market cap value.

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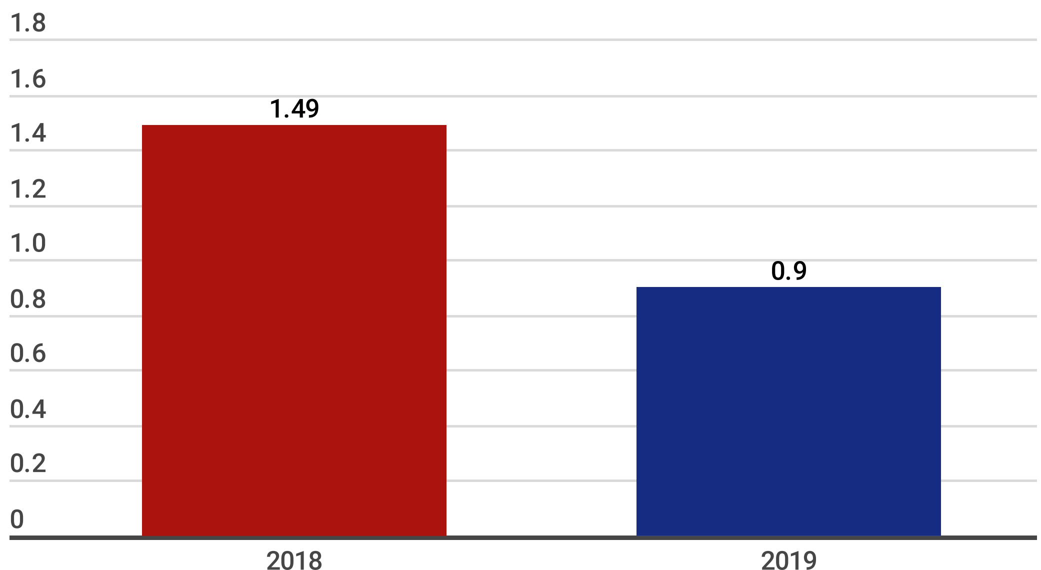
Liquidity

Current Ratio

Liquidity ratios show the firm's ability to pay off debts as they become due; thus, showing the relationship of a firm's cash and other current assets to its current liabilities. The current ratio shows the extent to which current liabilities are covered by current assets, i.e. assets expected to be converted to cash within 12 months. Netflix has decreased their current ratio by 40% within the last 2 years.

This decrease in liquidity is largely due to a $3B decrease in current assets. Even though cash increased by almost $2B and other current assets increased by over $300M; current content assets went from $5B in 2018 to $0 in 2019. Although this has a negative affect on the current ratio as of December 31, 2019, this ratio is expected to increase by December 31, 2020 when accrued residuals from 2019 become material. Therefore, Netflix should not have a problem paying off their current liabilities with their current assets as past residuals from content creation become material.

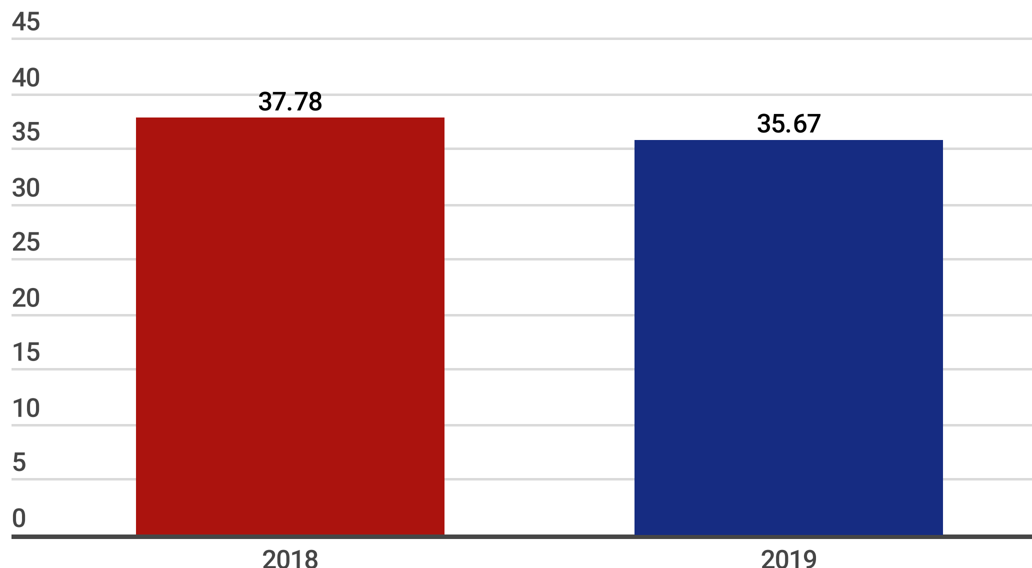


Netflix is in a great liquidity position because they don't have inventory or accounts receivable. As long as cash from subscription revenue is greater than current liabilities, they will be able to not only pay current liabilities, but control their cash outflow with accounts payable terms.

Asset Management Ratios

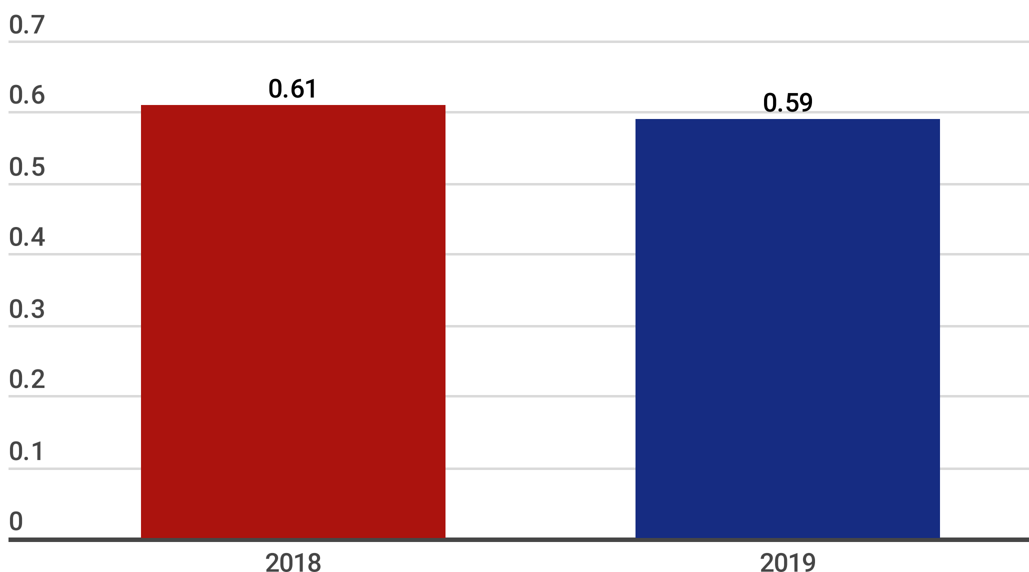
Fixed Asset Turnover

Asset management ratios are also known as efficiency or activity ratios and evaluate how efficiently management uses resources and how much activity is generated from assets. The fixed asset turnover ratio shows how effectively the firm uses its goodwill and equipment. Even though Netflix's fixed assets increased by $100M between 2018 and 2019, their sales increased by $5B. The small increase in fixed assets still caused the fixed asset turnover to decrease; however, generating $35.67 in sales for every $1 in fixed assets shows management is managing fixed assets very well.



Total Asset Turnover

The total asset turnover ratio shows how effectively the firm uses its current and fixed assets. The total assets turnover ratio reflects the fixed assets turnover ratio. As mentioned previously, sales increased by $5B, but total assets increased by almost $9B. This increase in total assets is largely due to the increase in non-current content assets because of a change in accounting practices implemented in the first quarter of 2019. Netflix now categorizes all content assets (licensed and produced) as non-current content assets; thus, causing the large increase in total assets that caused the decrease in total asset turnover. Total assets outweigh sales, which shows management has an opportunity to use its total assets better to increase sales.



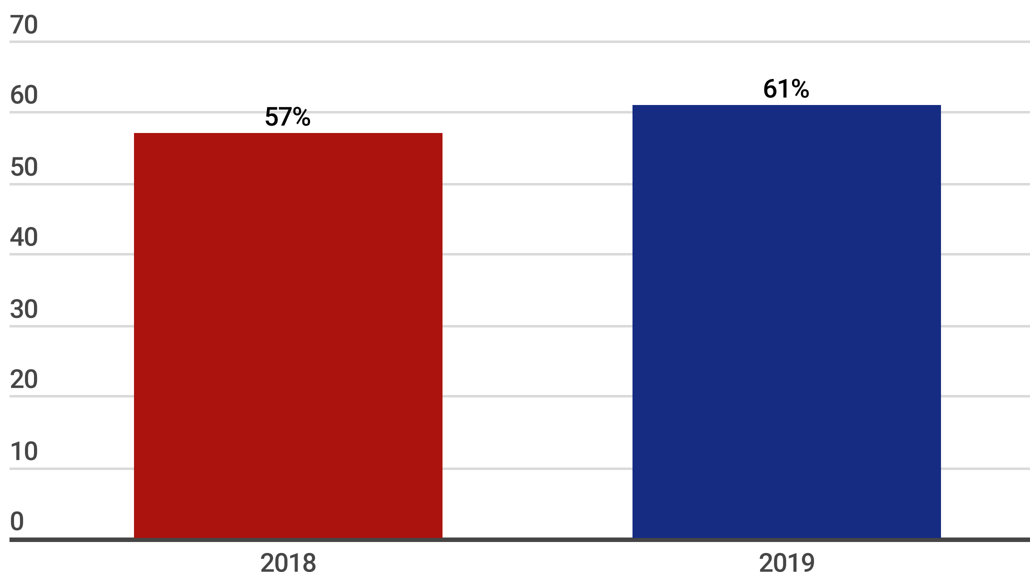
Debt Management Ratios

Debt Ratio

Debt management ratios show the extent to which a company finances its assets with debt. While debt exposes the firm to more risk than if it financed with equity,

debt limits the dilution of the company's ownership. The debt ratio is a financial indicator used to illustrate the percentage of a firm's assets that were financed by interest bearing debt rather than equity. This ratio is an indicator of a company's financial risk, and therefore, an extremely relevant ratio for potential and current investors.

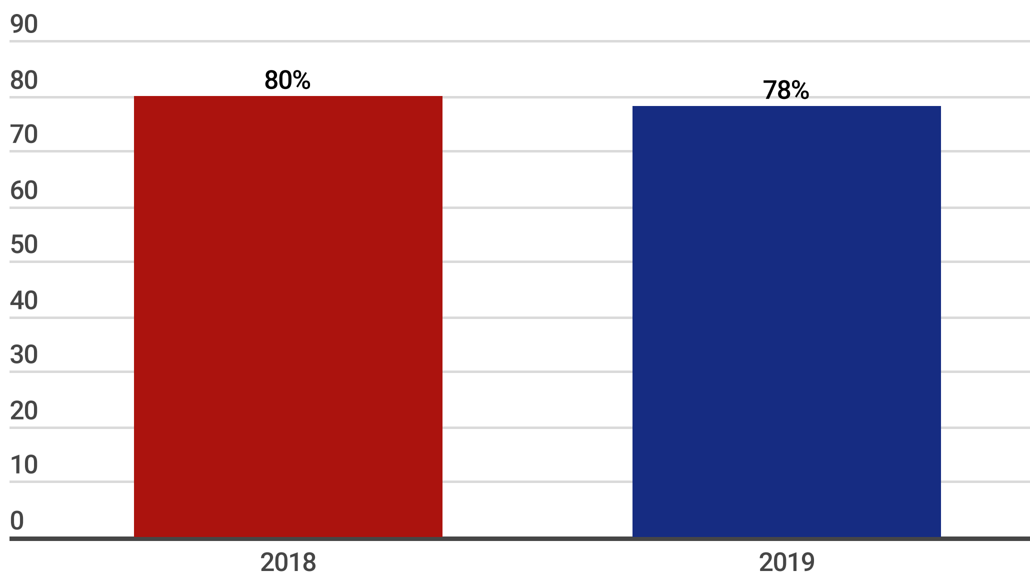
As of December 31, 2019, Netflix was financing 61% of its assets with interest bearing debt. An increasing debt ratio indicates Netflix is starting to use even more debt financing; therefore, making the company more financially risky.



Liabilities-to-Assets Ratio

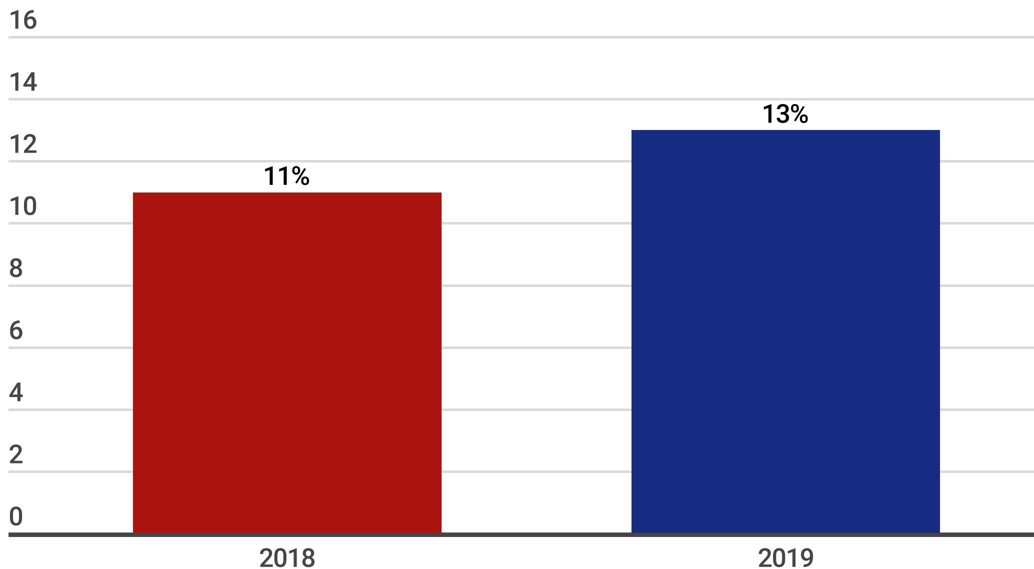
While the debt ratio considers the company's interest-bearing debt, the liabilities-to-asset ratio includes all liabilities. The debt ratio increased showing more than half of Netflix's assets are funded by interest bearing debt; however, the liabilities-

to-assets ratio slightly decreased between 2018 and 2019. This is largely due to total debt increasing at a larger rate than total liabilities making the debt ratio increase and the liabilities-to-assets ratio decrease when divided by the same total assets. Although a decreasing liabilities-to-assets ratio is a positive trend, 78% is still very risky. The bulk of Netflix's liabilities is long-term debt. Once Netflix pays off their long-term debt and is able to fund more of their assets with equity instead of debt, their debt and liabilities-to-assets ratios will increase greatly, which will make the company a lot less risky.



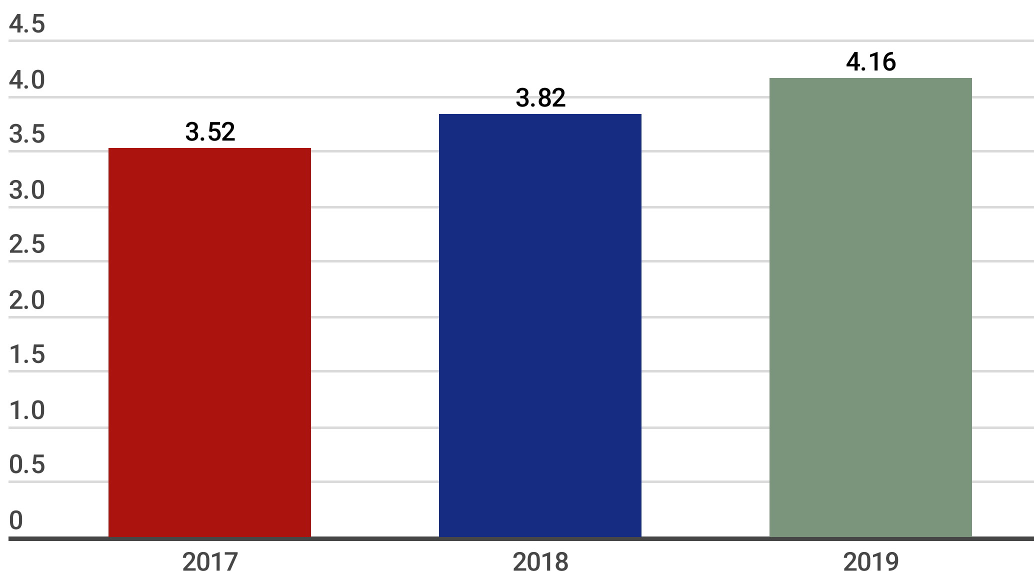
Market Value Debt Ratio

The market value debt ratio uses a company's market value of equity (number of shares outstanding times current stock price) to show how much the company's assets can decline before liabilities outweigh assets and they are not able to pay off debts. Netflix has a great market value ratio at 13% at the end of 2019, which means their assets will have to depreciate by 87% before they aren't able to pay off debt. The debt ratio showed a risk with $20B in debt in 2019; however, Netflix had a market cap valuation of $141B on December 13, 2019.



Times-Interest-Earned (TIE) Ratio

The times-interest-earned (TIE) ratio measures the firm's ability to meet its annual interest payments. The higher the TIE ratio, the more money the firm has from operating profit to pay interest expenses. Over the past 3 years, Netflix has steadily increased their TIE, proving their earnings before interest and taxes (EBIT) is increasing at a faster rate than their interest expense.

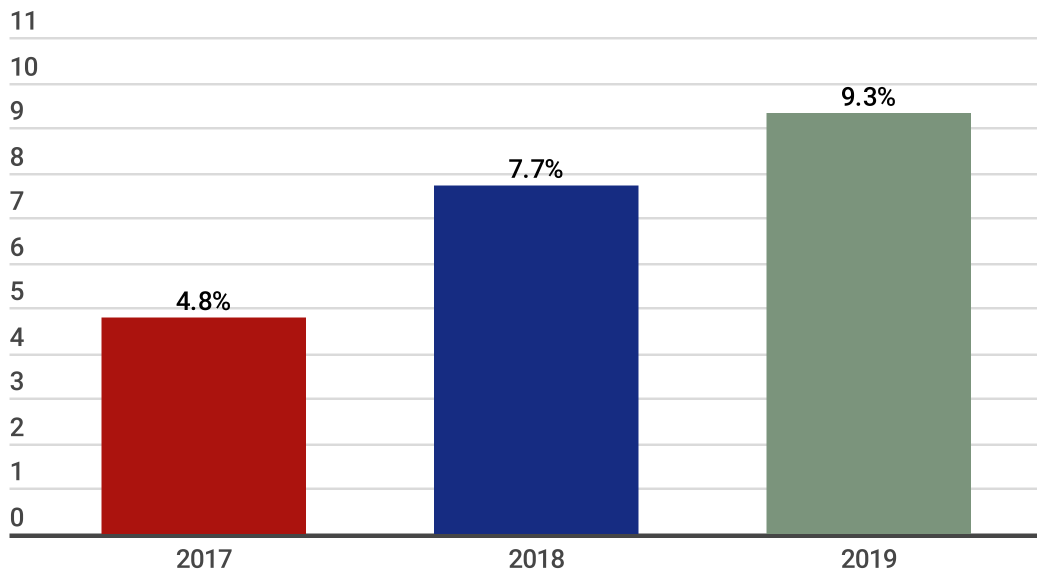


Profitability

Profit Margin

Profitability ratios show the combined effects of liquidity, asset management, and debt on operating results. The profit margin ratio measures operating income per dollar of sales/services, which shows how much money a firm gets to keep from sales/services and how well the firm is controlling its expenses.

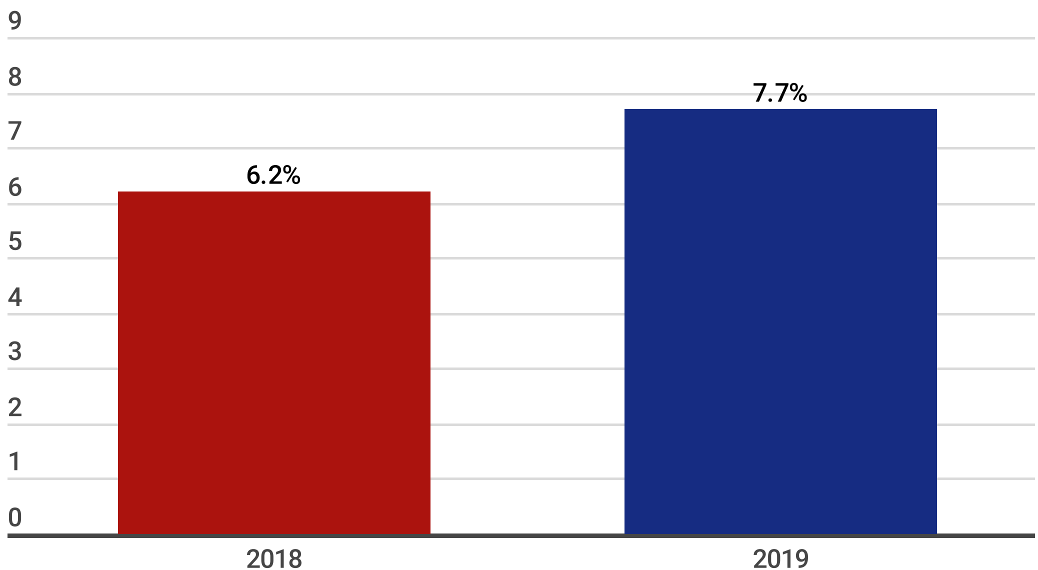
Netflix's profit margin has increased almost 4% in the last 3 years, displaying they are increasingly getting better at keeping revenue from sales after expenses have been paid. As mentioned previously, Netflix has a very high amount of debt. However, with an upward trend in net income, their profit margin will only get higher as they pay off debt.



Basic Earning Power

The basic earning power (BEP) ratio is another ratio that shows how efficiently a firm uses its assets to produce income. More specifically, it demonstrates how

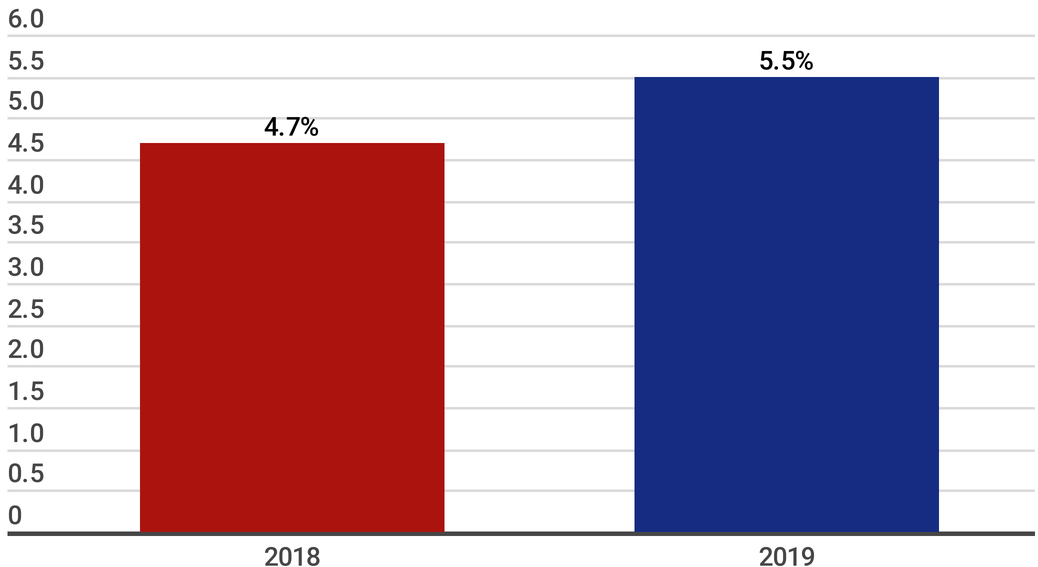
much operating income is produced for each dollar of total assets. Although Netflix's BEP increased between 2018 and 2019, 7.7% is relatively low. This again is due to the large amount of debt that results in a much smaller EBIT (earnings before interest and taxes) than their total assets. Currently, there is a very low amount of operating income being produced from a very large amount of total assets.



Return on Assets

The return on total assets (ROA) ratio demonstrates how much money is made given all the company's assets. In other words, how much net income is kept by a company per each dollar of total assets. This ratio is very closely aligned with BEP; however, BEP can be used to gage the profitability of a company that has a large interest expense since it considers operating income instead of net income. ROA gives a broader scope of a company's profitability since it considers the income a company keeps after all COGS, overhead, and other expenses (including interest and taxes) are paid.

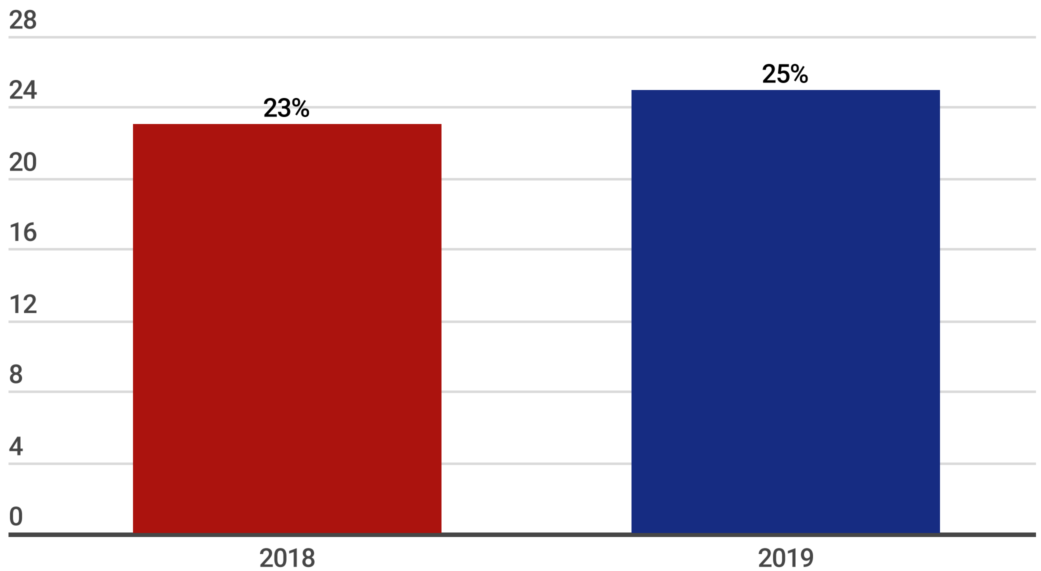
As mentioned while discussing the BEP ratio, Netflix experienced an increase in ROA, but still has a small percentage. In 2019, Netflix had $33B in total assets, but only kept $1.8B of that revenue. The biggest issue facing Netflix's ability to become more profitable will be to decrease debt.



Return on Equity

The return on common equity (ROE) ratio measures the rate of return on common stockholders' investment. The ROE can be calculated by the net profit margin times the total asset turnover times the equity multiplier. The profit margin values a company's cost control, the total asset turnover values a company's volume, and the equity multiplier reflects the use of debt leverage for a company. When companies analyze sales, they want to decrease profit margin in expectations that total asset turnover will increase; therefore, increasing their return on equity.

Netflix's profit margin increased between 2018 and 2019 while their total asset turnover and equity multiplier decreased. The increase in profit margin was enough to cause a slight increase in ROE in 2019. A 25% ROE shows a great return potential for investors.

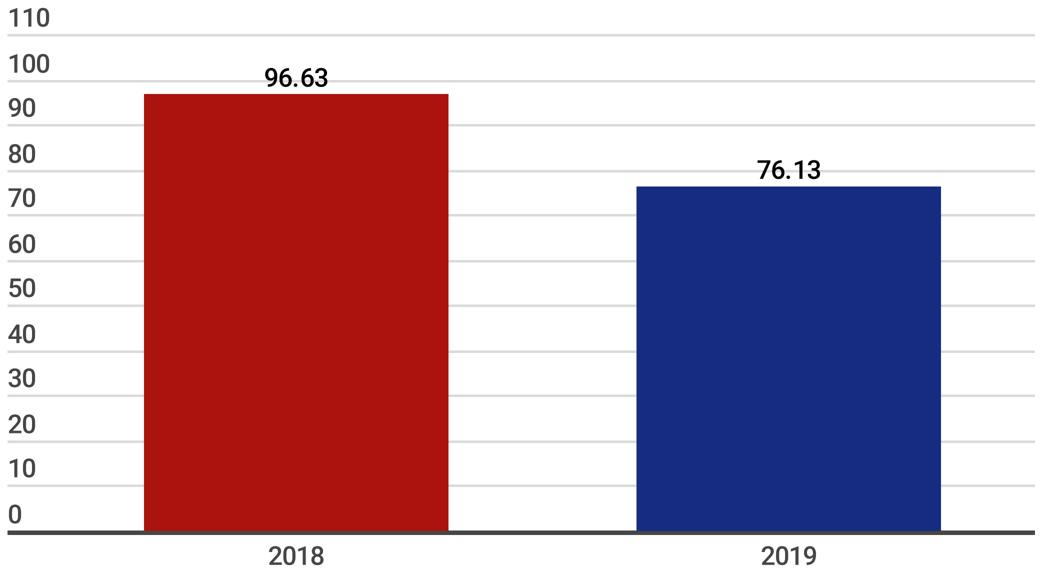


Market Value

Price-per-Earnings (P/E)

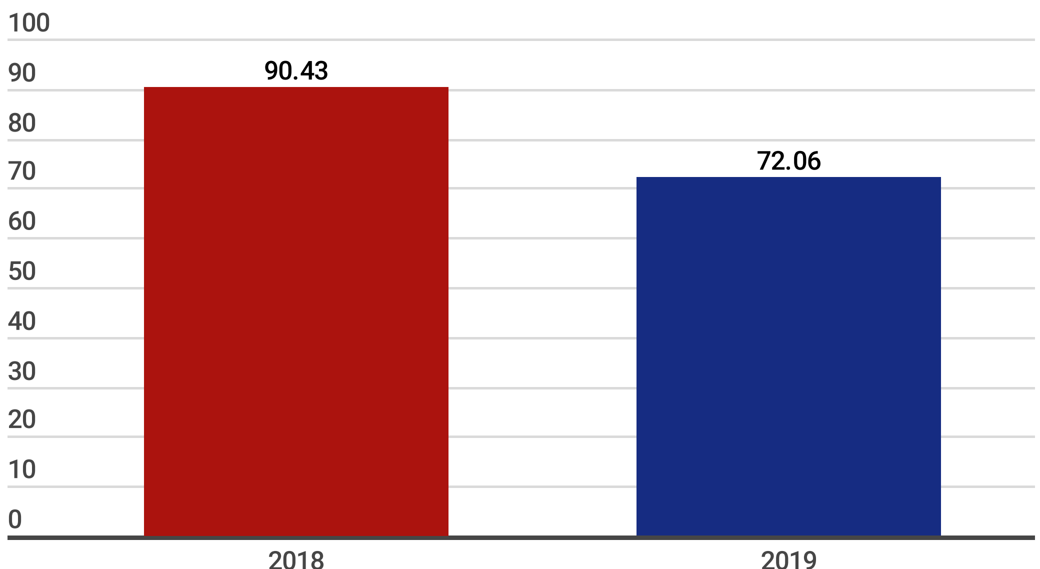
Market value ratios show the market's assessment of the company as an investment. In other words, it shows how much the market values the company and thinks of the company's operations. The price-per-earnings ratio evaluates a company's stock price based on their earnings per share.

Although Netflix's stock price increased between December 31, 2018 and December 31, 2019, their P/E ratio decreased. The extremely high P/E in 2018 may have been due to an over evaluation of Netflix's stock price. In 2018, Netflix spent billions investing in new original content, which may have caused its market price to increase due to investor's early expectation of future increased earnings. However, Netflix stock is selling at 76 times their earnings while the S&P 500 average is 13-15 times earnings. This greatly exceeds the market average and shows a high demand from investors due to expected future earnings growth.



Price per Cash Flow (P/CF)

While the price per earnings ratio uses the book value of profit (net income) to calculate how much the market values the company's operations, the price per cash flow ratio uses the cash value of profits (net income plus depreciation). Netflix's price per cash flow ratio trend mirrors its price per earnings ratio trend; showing a decrease between 2018 and 2019. However, Netflix stock is still selling at 72 times its cash flow, which further shows the market values Netflix very highly.



Conclusion

Netflix has great liquidity potential because they don't have inventory or accounts receivable; therefore, they can control their cash flow conversion cycle by controlling cash outflow with accounts payable terms. However, Netflix's current liquidity decreased by 40% in the past 2 years. There is a good probability of an increase in liquidity with accrued residuals from past content creation becoming material, an upward trending revenue, and a potential decrease in debt funding.

61% of Netflix's assets are financed with interest-bearing debt, which is risky. However, their $141B market cap valuation greatly outweighs their $20B in debt. The potential to generate more stock market value makes Netflix's large debt a lot less risky than another company with a smaller market cap. Not only are their revenues greater than their debt, but Netflix's EBIT is greater than their interest expense. Both indicate that Netflix should not have a problem with paying off their debt so they can increase their net income and finance more assets with equity.

The biggest hurdle Netflix faces is decreasing the $20B in debt financing they have to become a more profitable company. In 2019, Netflix had $20B in revenue, but only kept $1.8B after expenses. They are valued greatly on the market with its stock price as of December 31, 2019 selling 76.13 times its earnings. Netflix is on their way to becoming the Apple of entertainment with an even larger market cap valuation once they decrease debt and continue to invest in original content creation to increase revenue.

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